



National Board of Revenue

Government of the People's Republic of Bangladesh

The proposed new VAT Act - streamlined revenue services for satisfied taxpayers

Major Benefits of the new VAT System

Value Added Tax (VAT) system was first introduced in July 1991, replacing excise tax in order to design a broad based indirect tax system. VAT has been an important, integral part of the tax revenue system since then and it is the largest source of tax revenue of the government. It was first introduced only in the manufacturing and export stages, but has slowly grown to include wholesale, retail, and a range of services. However, after twenty years, many of its shortcomings have become starkly apparent, and are consequently in need of modernization, in terms of both amendment and improvement.

Full implementation of new VAT law is likely to turn the current system into a modern VAT, relying on automation; audit based supervision; comprehensive coverage of activities; functioning of VAT chain and credit mechanism. Such a modern system will be beneficial to both government or overall economy and the tax payers. From the perspective of the government/overall economy, the main benefits of the new VAT system are: (i) increased revenue; (ii) reduced corruption; and (iii) neutrality of resource allocation. From the tax payer's perspective the benefits of the new VAT system are: (i) hassle-free; (ii) easy to follow; (iii) reduced cost of doing business; and (iv) enhanced self-governance.

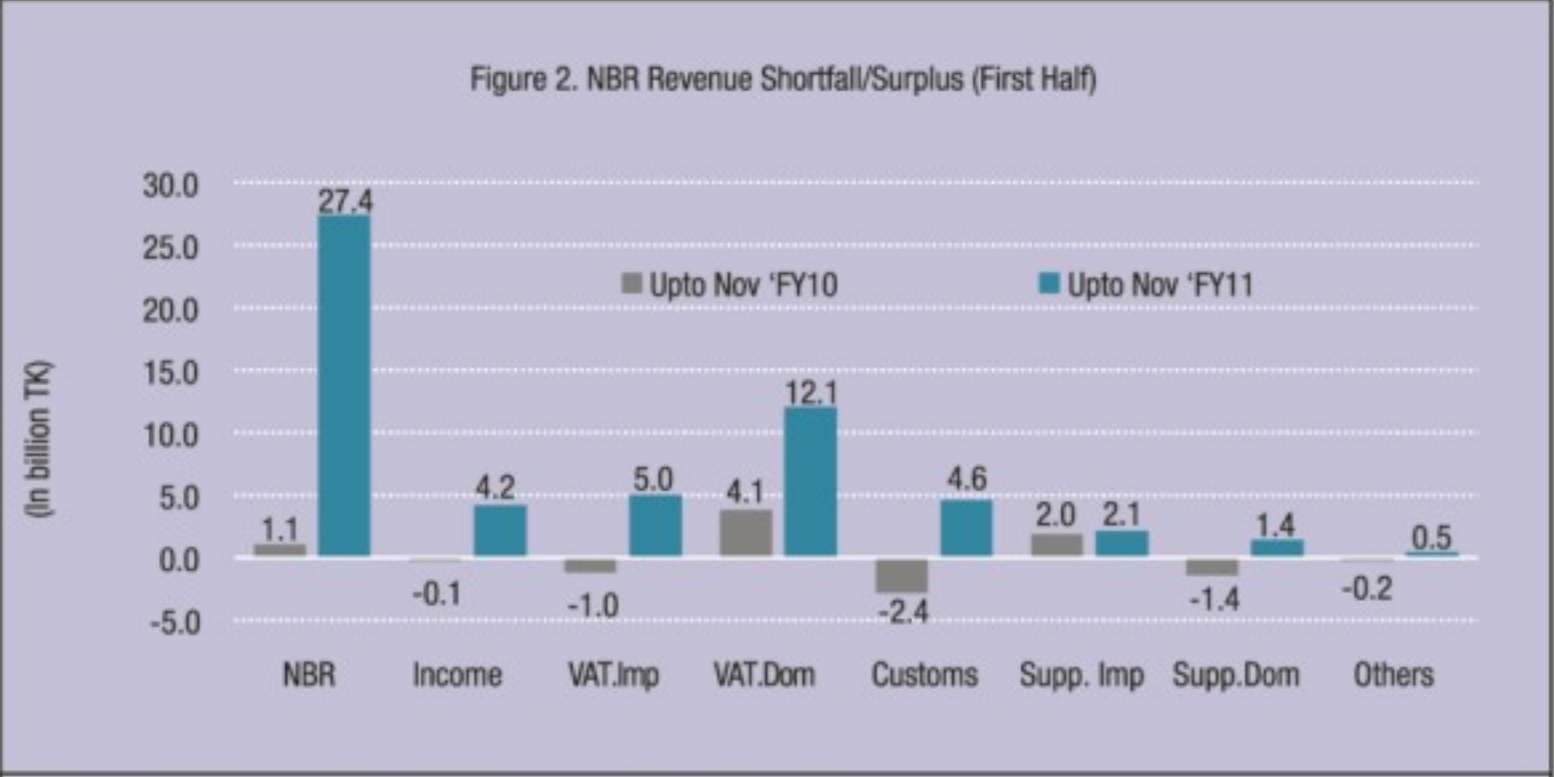
Benefits from Overall Economy Perspective

Some of the important elements proposed in the new VAT law have been included in the Finance Bills of Fiscal Year 2010 and Fiscal Year 2011. Salutory effects of the VAT reforms initiated in FY11 budget have readily been observed. Historically, actual revenue collection usually fell short of the target but it recorded surplus in FY08, FY10 and on the track up to the first half of FY11. Fiscal performance has been better than expected due to two reasons: (i) *better than expected revenue generation from domestic VAT, due mainly to reforms undertaken in the last budget*; and (ii) increase in income tax collection. However a sizeable amount may be attributable to higher profits of commercial banks and financial institutions (due to their profits from the stock market).

Historically, actual revenue collection usually fell short of the target but it recorded surplus in FY08, FY10 and on the track up to first half of FY11. Fiscal performance has been better than expected due to two reasons: (i) Better than expected revenue generation from domestic VAT, due mainly to reforms undertaken in the last budget. (ii) Increase in income tax collection. However a sizeable amount may be attributable to higher profits of commercial banks and financial institutions (due to their profits from the stock market). *This outcome of the recent VAT collections is quite impressed though our VAT system is not fully modernized and exist a lot of exemptions in VAT system. This is*

good news for us that a lot of scope still remains to boost up our VAT revenue collections if a modern and efficient vat system could be implemented through initiating different reform measures.

Although no evidence is readily available to support better allocation of resources, it is widely believed that elimination of distortions such as tax rate differentials; and administered prices will help guide resources to move to better usage. *It is expected that with full elimination of truncated bases and tariff values, resource allocation will improve resulting in higher income generation and employment.*



Source: National Board of Revenue, Bangladesh

Benefits from Tax Payers Perspective

It is claimed that implementation of the new VAT system would lead to following benefits to the tax payers. These benefits will be in the forms of reduced costs and hassle-free transactions.

Under the 1991 law, VAT payments can only be made through treasury challan. The New law proposes to modernize VAT payment system by allowing for payment of VAT through electronic bank transfers, credit cards, and certified bank cheques. *Thus, VAT payment process will be simple, safe and hassle-free.*

The 1991 VAT law was not fair to the tax payers as there is no provision for carrying forward the excess VAT paid by taxpayers. Under the new law, tax payers will be eligible to carry forward their excess amounts and adjust the excess VAT paid earlier against future tax liability. *This will bring fairness in the tax system, reduce cost of doing business and will enhance tax compliance and benefit taxpayers.*

A major virtue of a well functioning VAT system is hassle-free refund to the tax payers. According to the 1991 VAT law, it is very complex and almost impossible for taxpayers to get refund. As a result, refunded amount is very small and also a source of corruption. Under the new VAT law, taxpayers will be able to carry forward their tax credits for six months by recoding those through regular VAT returns. After this period, if they fail to adjust against their VAT liabilities, then the excess amount of tax paid earlier will be refunded to the taxpayers as refunds. It is proposed to establish a separate account for refund and reward with 5% and 0.1% of the collected revenue allocated to these accounts respectively. *It is believed that, this provision will create incentive for strengthened tax administration. Disposal of refund claims should be quicker and will reduce corruption.*

According to the 1991 VAT law, the excise type "Account Current" system is used for collection of revenue from the manufacturing activity. Under the "Account Current" system, taxpayers engaged in manufacturing activity are required to make advance payments before the clearance of goods from factories leading to higher cost of doing business. *Under the new law, "account current" system will be abolished and taxes would be payable at the time of return submission. The new provision will regularize and simplify VAT payments through monthly returns and thereby expected to increase cash flow of manufacturing firms.*

The definition of inputs is limited in 1991 VAT law and excludes many inputs from input tax credit (such as laboratory re-agent, laboratory equipment, laboratory accessories, etc.). The definition of inputs for the purpose of input tax credit will be widened in the new VAT law. *This is a taxpayer-friendly measure since they will be allowed to take more input tax credit and thus would lessen their tax burden.*

Improved Self-Governance

According to the new VAT law due to its organization and easiness to follow as well as scope for personal interaction with tax officials are minimized, most of the tax payers will be able to maintain their tax liabilities. An important objective of the new VAT law is thus also to enhance tax payer's responsibility and self-governance with regard to VAT payments.

Major Differences between the Old and New VAT Law

Value Added Tax (VAT) was introduced in Bangladesh through the enactment of the Value Added Tax Act of 1991. Initially the VAT was applicable at the manufacturing and import stages and to a limited number of services, essentially by replacing the excise duty on domestically manufactured goods and services, and at the import stage by replacing the import stage Sales Tax. However, due to political compromises made during the expansion of the VAT system to wholesale and retail activities and to a broader range of services, a number of distortions were introduced over the last 20 years making the old 1991 law difficult to administer efficiently.

Against this background, a new draft VAT law has been prepared by the National Board of Revenue (NBR) and posted on its website since January 2011. A series of consultation meetings were held with a broad range of stakeholders over the last 10 months. Some of the important stakeholders include members of FBCCI, MCCI, DCCI, representatives of various national associations representing industry and service providers, and various chambers/federations of Chittagong. Several rounds of consultations were also held with the Parliamentary Committee on Finance. One issue that came out quite clearly from discussions on the new draft VAT law at the stakeholders meetings is that there are many good aspects in the new VAT law which not only would raise revenue but would also be beneficial to the taxpayers. Some of the noteworthy improvements of the new VAT law over the current one are presented below.

- The VAT Act of 1991 was not properly organized as a modern law of this kind should be. The Draft new VAT Act has been organized into different chapters according to the subjects. Since specific items are properly grouped in their relevant places, and also highlighted in appropriate cases with examples, the draft VAT law is easy to read and comprehend.
- Under the 1991 Law, if a company has several units or outlets at different places, all units or outlets are required to register as individual entity which is in conflict with the Company Act and extremely difficult for the taxpayers in terms of compliance costs and associated paper works. Under the new law, a single registration for a company with many operations (manufacturing/processing and sales) will be introduced and branch registration would also be allowed as an option if accounts are maintained separately.
- Due to the decentralized unit based registration system under the 1991 law, return processing has been Circle Office based. The new law allows for central and electronic (online) submission of VAT returns which should improve tax administration, generate higher revenue through increased/better tax compliance and reduced corruption.
- Under the tariff value provision in the VAT Act of 1991, for certain types of products instead of actual market prices administered prices are used for tax assessment. Since the administered prices are usually substantially lower than the actual market prices, this practice opens up scope for collusion between the taxpayers and tax officials leading to lower assessment and loss of revenue. This is one of the major distortions of the 1991 VAT system. Under the new VAT law, tariff value provision will be abolished and tax liability would be assessed on the basis of actual market prices. This will reduce corruption, make the playing field even for taxpayers and increase revenue earnings.
- Another major distortion in the VAT Act of 1991 is the truncated base system. For a large number of services instead of full value added base, truncated value added bases have been used for tax assessment. Use of truncated bases, de facto, results in multiplicity of tax rates, although the VAT Act of 1991 provides for a single basic VAT rate of 15 percent for all

goods and services. The provision of truncated base also brings in distortion into the VAT system leading to discontinuation of the VAT invoice chain, which operates through the input tax credit mechanism. This also contributes to low revenue yield from the service sector, although this sector has a strong role in the national economy. In order to restore the functioning of full invoice-based VAT chain and input-tax credit, the new draft VAT law proposes complete elimination of the truncated base system.

- Due to the provisions of tariff value and truncated base, the 1991 VAT law allows for partial invoice system. With the abolishment of tariff value and elimination of truncated bases, full invoice system would be restored under the new VAT law. This will lead to higher revenue potential through better enforcement, and will also lead to better statistics and economic analysis.
- At the time of introduction of the VAT in 1991, a provision for the excise type "Account Current" system was retained for a limited time for collection of revenue from the manufacturing activity. Under the "Account Current" system, taxpayers engaged in manufacturing activity are forced to make advance payments before the clearance of goods from factories leading to higher cost of doing business. The short-term provision, which was kept on a time-bound basis to safeguard revenue, was retained even after 20 years. Under the new law, the "account current" system will be abolished and VAT would be payable at the time of return submission. The new provision will regularize and simplify VAT payments through monthly returns and also increase cash flow of manufacturing firms.
- Under the 1991 law, VAT payments can only be made through treasury challan. The New Law proposes to modernize VAT payments system by allowing for payment of VAT through electronic bank transfers, credit cards, and certified bank cheques. This proposed change will make the VAT payment process simple, safe and hassle-free.
- The 1991 VAT law is not fair to the tax payers since there is no provision for carrying forward the excess VAT paid by taxpayers. Under the new law, taxpayers will be eligible to carry forward their excess amounts and adjust the excess VAT paid earlier against future tax liability. This will bring fairness in the tax system, and will enhance tax compliance and benefit taxpayers.
- A major virtue of a well functioning VAT system is hassle-free refund of excess amounts to the taxpayers. Under the current system, it is very complex and almost impossible for taxpayers to get back refunds. As a result, refunded amount is very small and it is also a source of corruption. Under the draft VAT law, taxpayers will be able to carry forward their tax credits for six months by recoding those through regular VAT returns. After this period, if they fail to adjust against their VAT liabilities, then the excess amount of tax paid earlier would be refunded to the taxpayers. In order to facilitate speedy clearance of refunds, the draft law proposes the establishment of a separate account for refunds with 5% of the collected revenue allocated to the account. It is believed that, this provision will accelerate disposal of refund claims and will reduce corruption.
- The definition of inputs is limited in 1991 VAT law and thereby excludes many inputs from input tax credit (such as laboratory re-agent, laboratory equipment, laboratory accessories, etc.). The definition of inputs for the purpose of input tax credit will be widened in the new VAT law. This is a taxpayer-friendly measure since they will be allowed to take more input tax credit based on VAT paid on purchased inputs thereby lessening their tax burden.

- One of the main reasons for the low Tax/GDP ratio in Bangladesh is revenue lost due to wide spread exemptions, commonly known as tax expenditure. At present, tax expenditure is estimated to be very high at about 2.5% of GDP. Under the new law, the exemption list will be narrowed. Parliament would only be able to grant exemptions by amending the law/exemption list. Only under some specific circumstances (like natural disasters or other emergencies), the Cabinet would be able to grant exemptions. VAT exemption through any other law is also prohibited. These measures will reduce tax expenditure and help increase the tax-to-GDP ratio.
- Under the 1991 VAT law, show cause notices served to the VAT registered persons by the VAT officials do not require corresponding papers or documents explaining the reasons for the show cause notice. The system is non-transparent and has led to harassment of taxpayers. Under the draft VAT law, show cause notices must be accompanied by relevant papers and documents on the basis of which the notice will be served. It is believed that this will bring transparency in the system and help taxpayers better understand the issues/violations involved.
- Requirement for Price Approval from divisional VAT office is a major distortion under the 1991 VAT law. In reality transaction value depends on the fair market value and hence any prior approval is inconsistent with an accounts based VAT system. Under the new law, price approvals will not be required. Firms will also be able to announce discount sales, the extent and duration of discounts being dependent on market conditions. A declaration of value and input-output coefficient (recipe for manufacturing of a good) will be needed only for information gathering so that auditors can use the information for audit purpose and can compare among firms producing similar products.
- Currently there is no central VAT database. VAT data base is maintained manually at different locations. Automation of VAT administration is a central element for the modernization of VAT administration and success of the new VAT law. The new VAT law allows for establishing and managing a central VAT data base to be maintained electronically, including the engagement of an out-sourced company. Such a modern VAT registration and database operation will allow cleaning up of the current database which is full of nonexistent taxpayers. Such a clean database will lay the foundation for following up on non-filers, stop-filers and short-filers and generating computer generated notices, which are keys to modern tax administration.

Parliamentary approval of the draft VAT Law will be the most important first step for its effective implementation. It will take at least 2-3 years of intensive preparations for the NBR to modernize and reorganize its tax administration before the new VAT Law can become effective. A modern VAT administration should reorganize tax administration along functional lines with focus on audit and providing services to taxpayers, requiring a complete change in the mind-set of tax officials. The task will be difficult but maintaining the status quo would be much more costly for the country as a whole. Bangladesh cannot and should not rely on the current low tax to GDP ratio of 10%, if it wants to be a middle income country and reduce poverty further by half (to about 15%) by the time we celebrate the nation's Golden Anniversary in 2021. Increased revenue mobilization in a taxpayer friendly manner will be key to Bangladesh's dream to become a prosperous society, and a modern VAT Law and tax administration will be an essential stepping stone for us to move in that direction.

Some Examples of Confusion

Some Misperceptions about the VAT System

VAT system is sometimes misunderstood by the business community. Such misunderstandings often lead to resistance in adopting and complying with the VAT law. If properly understood, business community would in general refrain from resisting a broad-based and modernized VAT administration. Blew please find some examples highlighting some common misperceptions.

For businesses VAT is not a cost price-factor

Business community often thinks that VAT is a tax on their business income. This is a wrong perception. VAT is a tax on consumers and no business people bears the burden of VAT. Below is an example of all stage VAT. VAT is levied at 15% rate. Total VAT to the consumer is BDT 900. It is collected as different stages. Since it is passed on to the final consumer, for business VAT is not a cost price-factor.

Production/Distribution Stages	Sales	Net tax	To Treasury
Tool Factory	500+75	75-0	75
Forester	1000+150	150-075	75
Pulp Factory	2000+300	300-150	150
Paper Factory	3000+450	450-300	150
Wholesaler	4000+600	600-450	150
Retailer	6000+900	900-600	150
Cost to the Consumer	6900		900

As illustrated in the above example, none of the business enterprises pay any amount of VAT. At every stage of production, processing and distribution, the business enterprises simply act as tax collectors (on behalf of the Tax Department). At every stage the business enterprises get credit for what they paid at the time of purchasing the inputs, and the amounts received by the businesses at different stages of the production and distribution chain are exactly the same as the amount which they would have got in the absence of the VAT. In a proper VAT system, the full amount of the VAT is passed on to the final consumer, which is Taka 900 collected by the retailer at the point of final sale to the ultimate consumer.

Business pays more VAT with exemption in production and distribution chain

Sometimes businesses lobby for VAT exemption for their products. However, in reality such exemptions increase the tax burden for a range of other products or industries because of cascading effect (tax on tax) created by exemption. Below is an example of exemption in production. Total VAT is now Taka 986 instead of Taka 900. Due to the exemption granted to the forester at an early stage in the production process, VAT payable is higher for the subsequent stages. Moreover, cost of production is higher due to tax inclusive higher input price. Businesses and the consumers both are disadvantaged by the granting of exemption to the forester at an early stage of the production and distribution chain.

Production/Distribution Stages	Sales	Net tax	To Treasury
Tool Factory	500+75	75-0	75
Forester (exempt)	1075+	-	-
Pulp Factory	2075+311	311-0	311
Paper Factory	3075+461	461-311	150
Wholesaler	4075+611	611-461	150
Retailer	6075+911	911-611	300
	6986		986

Businesses and Consumers are in disadvantageous situation under truncated base

Below is an example of tax liability under the truncated base system currently available to selected sectors of the economy. The base if truncated at the constructor stage where only 30% of the full value is taxes at 15% rate producing a tax liability of BDT 183. Due to truncation service provider can't take input tax credit. The outcomes are higher price of services and higher tax burden. Again, businesses as well as consumers are in disadvantageous situation under a system of base truncation. Total tax burden increases to Taka 1,197 compared with Taka 900 in the standard VAT system.

Production Stages	Sales	Net tax	To Treasury
Materials	500+75	75-0	75
Constructor	4075	-	-
Truncated Value (i.e. 30% of Constructor Full Value)	1223		183
Restaurant	(4075+183+2000)=6258+939	939	939
	6258+939=7197		1197

Advance Tax is not cost-price factor for business

Importers are required to pay advance trade VAT (ATV) in Bangladesh at some specified rate at the import stage. This is not a standard practice in advanced economies. In Bangladesh it has been introduced with a view to enhance tax compliance and develop a broader VAT base. It is generally believed that ATV may enhance tax burden for the businesses. In reality tax burden remain unaffected as businesses are allowed to adjust the full amount of ATV instantly against their other current VAT liabilities. Below is an example of tax burden under ATV situation. Please note that due the provision of tax credit against ATV, the tax burden remains unaffected. The final consumer ends up paying the same Taka 900 as VAT as in a standard VAT system. The main purpose of introducing this ATV with full credit mechanism is to incentivize importers and wholesalers to issue VAT invoices and submit VAT returns on time, thereby ensure continuation of the VAT invoice chain and develop VAT paying/complying culture without any additional tax burden. This is a temporary measure and would be abolished once the VAT paying culture is well-developed in Bangladesh.

Supply Stages	Sales	Net tax	To Treasury
Importer	4000+600		
Advance Trade VAT (@2%)	+120	600+120	720
Supply to Retailer	4800+720	720-720	0
Retailer	6000+900	900-720	180
	6900		900

Business community sometimes oppose the reform of proper VAT system without understanding the issues properly. Issues like truncated VAT base and exemption of certain products/activities are bad for the business community in general, and it is the business community who should be lobbying against continuation of such bad practices. The NBR also has an important role in educating the taxpayers through year round taxpayer education campaigns. Once fully understood, the business community will be on the side of reformers and welcome the new VAT Act and the associated modernization of tax administration without apprehension.