

LEGAL UPDATE

Ethiopia's New VAT Refund Directive: A Risk-Based Approach to Refund Administration

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1. Introduction

The Ministry of Revenues has issued Directive No. 1132/2018, establishing the conditions and procedures for value added tax refunds. The Directive was issued pursuant to the authority granted under Article 51 of the Value Added Tax Proclamation No. 1341/2016 and is now in force. It replaces the previous refund directives and introduces a risk-based approach to the administration of VAT refunds, distinguishing between regular refunds, expedited refunds, and refunds for persons exempt by law. The Directive applies to any person entitled to a refund of VAT paid.

The Directive represents a significant development in VAT administration. It seeks to facilitate legitimate refund claims while safeguarding government revenue through risk classification, audit thresholds, documentary requirements, and payment timelines. It also introduces a manual for risk-based refund processing and sets specific timeframes for the assessment and payment of refunds depending on the risk profile of the claimant and the nature of the transaction. For taxpayers entitled to refunds, the Directive provides both a procedural framework and a set of compliance obligations that must be satisfied to secure timely payment.

2. What Does the Directive Regulate?

The Directive regulates the conditions under which VAT refunds are made. It applies to registered persons who have paid VAT and are entitled to a refund under the Value Added Tax Proclamation. It covers refunds arising from zero-rated supplies, excess input tax credits, mixed supplies, and transactions involving persons exempt by law. It also addresses the documentary requirements for different categories of claimants, including exporters of goods, exporters of services, providers of international transport services, suppliers of gold to the National Bank, and privileged organisations such as diplomatic missions. The Directive also establishes the institutional framework for processing refunds, including the roles of tax audit, investment audit, service audit, and other work units.

3. Risk-Based Refund System

One of the Directive's central features is the introduction of a risk-based refund system. The tax authority is required to classify each claimant according to a risk level, using criteria that assess the likelihood of non-compliance and the potential impact on government revenue. The risk classification determines the type of audit to be conducted and the time within which the refund must be processed. Low-risk claimants may receive refunds without a full audit, while high-risk claimants are subject to a comprehensive audit before payment. The Directive also provides for a manual that sets out the operational procedures for risk-based refund processing. This approach is

intended to balance the facilitation of legitimate refunds with the protection of government revenue.

4. Refunds for Zero-Rated and Standard-Rate Transactions

The Directive specifies the conditions for refunds in respect of zero-rated transactions. A registered person whose zero-rated supplies constitute fifty percent or more of its total supplies in an accounting period may apply for a refund of input tax paid on purchases related to those supplies. The application must be accompanied by documentation establishing the zero-rated nature of the supplies, the volume of goods exported, customs declarations, transport documents, bank permits, evidence of foreign exchange earnings, legal original invoices, tax debit and credit notes, and reverse tax payment evidence. Similar requirements apply to exporters of services and providers of international transport services. For standard fifteen percent rate transactions, the Directive requires evidence that the input was used in the production process, stock confirmation, and legal original invoices.

5. Excess Input Tax Refunds Without Carry-Forward

The Directive provides for the refund of excess input tax without carry-forward in certain circumstances. A registered person whose zero-rated supplies constitute fifty percent or more of its total supplies in an accounting period may apply for a refund of the excess input tax within the accounting period or within one year from the date of filing the VAT return. The Directive also provides for an expedited refund system for exporters selected by the Ministry of Industry, allowing them to claim refunds of input tax paid on local purchases before export, with refunds processed within seven days of application. This provision is intended to improve cash flow for exporters and support export competitiveness.

6. Refunds for Mixed Supplies

The Directive addresses the treatment of input tax paid on purchases used partly for taxable supplies and partly for exempt supplies. It provides a formula for apportioning input tax based on the ratio of taxable supplies to total supplies. Where the ratio is 0.95 or higher, the input tax is fully deductible and any excess is refunded. Where the ratio is between 0.05 and 0.95, the input tax is apportioned and any excess is refunded. Where the ratio is below 0.05, the input tax is neither deductible nor refundable. This formula provides certainty for taxpayers with mixed supplies and ensures that input tax is allocated in proportion to taxable use.

7. Refunds for Persons Exempt by Law

The Directive establishes a refund system for persons who are exempt from VAT by law but are permitted to pay VAT and claim refunds. This category includes privileged organizations such as diplomatic missions, consular missions, international organisations, foreign governments, and entities exempt under investment incentive regulations. The

Directive sets out the documentary requirements for such refunds, including detailed and summary evidence of each transaction, signature samples verified by the Protocol Directorate of the Ministry of Foreign Affairs, confirmation that the purchase was for the organization's official use, legal original tax invoices, tax debit and credit notes, and evidence of bank payment. Refunds are processed within one month where payment was made through a bank and within forty-five days where payment was made in cash.

8. Documentary Requirements for Refund Claims

The Directive sets out detailed documentary requirements for different categories of refund claims. For exporters of goods, the requirements include evidence that fifty percent or more of transactions in the accounting period relate to export inputs, customs declarations, transport documents, bank permits, evidence of foreign exchange earnings, legal original invoices, tax debit and credit notes, and reverse tax payment evidence. For exporters of services, the requirements include evidence that fifty percent or more of service supplies are zero-rated, the contract with the recipient, bank documents showing foreign exchange earnings, and legal original invoices. For providers of international transport services, the requirements include evidence of directly related service payments or input tax paid on consumables such as lubricants. For suppliers of gold to the National Bank, the requirements include evidence from the National Bank and legal original invoices for local input purchases.

9. Refunds for Building Construction

The Directive addresses refunds for input tax paid on building construction. A registered person may claim a refund of input tax paid on goods or services used for new building construction or expansion after the building is completed and begins to generate revenue. The refund is claimed in the first accounting period after the building begins generating revenue, after the input tax has been deducted from collected tax, and any remaining balance is claimed in the following month. The Directive also provides that input tax paid on building construction cannot be deducted from tax collected on other taxable transactions before the building begins generating revenue. Where the building is constructed by a contractor, the contractor must provide a breakdown of input costs and evidence of VAT paid.

10. Timelines for Refund Processing

The Directive establishes specific timelines for refund processing. A registered person classified as low-risk and eligible for refund without audit may receive payment within one month of application. A registered person classified as low-risk but subject to audit may receive payment within forty-five days. Refunds for high-risk claimants are processed after a comprehensive audit. The Directive also provides for refunds within seven days for exporters participating in the expedited refund system. Refunds for persons exempt by law are processed within one month where payment was made through a bank and

within forty-five days where payment was made in cash. These timelines provide certainty for taxpayers and establish performance standards for the tax authority.

11. Retention of Refund Amounts

The Directive provides for the retention of a percentage of collected VAT for the purpose of facilitating refunds. The percentage is determined in accordance with a directive issued by the Ministry of Finance. This provision is intended to ensure that the tax authority has sufficient funds available to process refunds promptly. The Directive also provides that refund amounts determined in favour of a taxpayer shall first be applied to offset any outstanding tax liabilities under Article 50 Sub-Article 4 of the Federal Tax Administration Proclamation No. 983/2008. This provision ensures that refunds are not paid where the taxpayer has outstanding tax obligations.

12. Conditions for Refund Claims

The Directive sets out conditions that must be satisfied for a refund claim to be valid. A taxpayer whose business license has been cancelled may not submit a refund claim for purchases made after cancellation. A taxpayer may not claim a refund of input tax that has been capitalised and treated as a depreciation expense. In any refund claim, the tax authority must verify that suppliers who issued the VAT invoices are properly registered and have declared and paid the tax collected on their sales. The Directive also provides that input tax paid on building construction cannot be deducted from tax collected on other taxable transactions before the building begins generating revenue. These conditions are intended to prevent abuse and ensure that refunds are made only in respect of legitimate transactions.

13. Refund Decisions by Different Work Units

The Directive addresses the processing of refund decisions issued by different work units, including tax audit, investment audit, service audit, and other units. A taxpayer may submit a refund claim within six months from the date of receipt of a refund decision, and the claim shall be processed within forty-five days without the need to resubmit documents. This provision is intended to ensure consistency and efficiency in the processing of refund claims across different work units and to avoid duplication of effort.

14. Repeal of Previous Directives

The Directive repeals the previous VAT refund directives, including Ministry of Finance Directive No. 148/2011 and Ministry of Finance Directive No. 164/2013, and any other directives inconsistent with it. This consolidation is intended to provide a single, coherent framework for VAT refunds and to eliminate confusion arising from multiple directives. The Directive also provides for the issuance of implementing guidelines by the Ministry of Revenues and the Ministry of Industry where necessary.

15. What This Means for Taxpayers and Advisers

For taxpayers entitled to VAT refunds, the Directive creates both opportunities and compliance obligations. The risk-based system may expedite refunds for low-risk claimants while subjecting high-risk claimants to greater scrutiny. The documentary requirements are detailed and specific, and failure to provide the required evidence may result in delay or denial of refunds. The timelines for refund processing provide certainty, but they are contingent on the taxpayer satisfying the applicable conditions. For tax advisers, the Directive requires close attention to the classification of supplies, the apportionment of input tax for mixed supplies, the documentation of export transactions, and the conditions for refunds in respect of building construction. Taxpayers should also ensure that their suppliers are compliant with their own VAT obligations, as the tax authority is required to verify supplier compliance before processing refunds.

16. Conclusion

Directive No. 1132/2018 marks an important development in the administration of VAT refunds in Ethiopia. Its significance extends beyond the introduction of a risk-based system: it establishes a comprehensive framework covering documentary requirements, timelines, audit thresholds, retention of funds, and conditions for refund claims. For businesses entitled to refunds, regulatory compliance should be addressed at the transaction stage rather than at the refund application stage. Proper documentation, supplier compliance, and accurate classification of supplies are essential to securing timely refunds. The Directive is now in force, and taxpayers should review their refund procedures and documentation practices to ensure compliance with the new framework.

Disclaimer

This legal update is provided for general informational purposes only and does not constitute legal advice. The application of the Directive may depend on the specific circumstances of a taxpayer, transaction, or refund claim. Professional legal and tax advice should be sought before relying on this update or taking any action.

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