



# TECHNICAL ASSISTANCE REPORT

## SRI LANKA

Repeal of Simplified Value Added Tax and the  
Transition to Risk-Based Value Added Tax Refund  
Processing

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# Abbreviations and Acronyms

<b>CMU</b>	Change Management Unit
<b>CRMC</b>	Compliance Risk Management Committee
<b>CV</b>	Credit Voucher
<b>IRD</b>	Inland Revenue Department
<b>LTU</b>	Large Taxpayer Unit
<b>MCU</b>	Medium Corporate Unit
<b>MOF</b>	Ministry of Finance
<b>RIP</b>	Registered Identified Purchaser
<b>RIS</b>	Registered Identified Supplier
<b>RMSC</b>	Risk Management Steering Committee
<b>RMU</b>	Risk Management Unit
<b>SOP</b>	Standard Operating Procedure
<b>SVAT</b>	Simplified Value Added Tax
<b>SVATRC</b>	Simplified Value Added Tax Repeal Committee
<b>TA</b>	Technical Assistance
<b>UCU</b>	Upper Corporate Unit
<b>VAT</b>	Value Added Tax

# I. Introduction

**1. The EFF arrangement between the IMF and Sri Lanka includes a structural benchmark that commits to the repeal of the simplified value added tax (SVAT) framework by April 2025.** This mechanism will be replaced by a conventional VAT refund processing model. It represents a significant challenge to the Inland Revenue Department (IRD) as they have no experience in risk-based refund management. The purpose of the CD mission was to introduce international good practice in VAT refund administration and risk management techniques, and to help map the transition from SVAT to a risk-based Exporter VAT Refund program.

## A. Background

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**2. The SVAT legislation was introduced in 2011 in response to a high-profile refund fraud perpetrated on IRD in 2006.** The SVAT is an administratively complex mechanism with the objectives of i) reducing the volume and amount of VAT refunds to be processed by Sri Lanka's Inland Revenue Department (IRD) and ii) minimizing the cash flow impact on exporters. Under this arrangement, eligible purchasers and suppliers transact without cash settlement of VAT on supplies. Additionally, bona fide exporters, and many SVAT participants who supply exporters also qualify to have VAT on imports deferred<sup>1</sup>. This is later acquitted by way of a refund application to IRD. Once processed, taxpayers are issued a credit voucher (CV) that is used to satisfy the deferred liability at Customs.

**3. SVAT eligible taxpayers are designated as either Registered Identified Purchasers (RIP) or Registered Identified Suppliers (RIS).** The determination of eligibility<sup>2</sup> is a point in time assessment made by referencing recent VAT declarations. Most VAT taxpayers qualified for the program years ago and eligibility is not reviewed in any substantive way. Analysis of a sample of the RIP and RIS taxpayers reveals a portion of them no longer qualify for eligibility. The consequence is that these taxpayers are improperly making and acquiring taxable supplies in the marketplace without cash settlement.

**4. The SVAT represents a significant gap in the self-enforcing properties of a VAT.** Intended to mitigate cash flow pressure on a relatively small population of bona fide exporters<sup>3</sup>, participation in the SVAT program ballooned to where 60 percent of the ~13,000 VAT registered taxpayers in Sri Lanka acquire or make taxable supplies without the monetary payment of VAT. When the SVAT is repealed, this mechanism will be dismantled and several thousand VAT taxpayers will be required to transition to usual taxable supply rules, paying and collecting the VAT with monetary settlement.

**5. Despite the complexity and compliance burden associated with SVAT, business support for the program is, understandably, strong.** Consultation with exporters and businesses who supply exporters indicate they oppose the repeal of SVAT as they consider it to be a well-functioning mechanism. They communicated with consensus that there is no evidence to suggest a link between poor revenue performance of the VAT in Sri Lanka and the extraordinarily large portion of taxpayers making taxable

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<sup>1</sup> Provided they meet certain criteria, they are considered deemed exporters.

<sup>2</sup> Qualifying criteria in the SVAT program is 51 percent supplies zero rated, 51 percent supplies to an exporter or deemed exporter.

<sup>3</sup> Data provided did not definitively identify the bona fide exporters, but anecdotal estimates by IRD staff indicate 200 or less.

supplies without monetary settlement. When SVAT is repealed only bona fide exporters will qualify for refunds on exports. All others will be required to carry forward any credits they accumulate.

**6. The VAT refund processing system in IRD is smothered by extreme risk aversion.** The stock of unresolved refunds is years old. A sampling of cash refund requests in Table 1 shows the cause behind this backlog<sup>4</sup>. As an example, as of January 2024 only 3 per cent of cash refund claims received in the first quarter of 2020 have been coded approved, rejected, or offset. Verification of claims is excessive, frequently duplicated, and ignores the compliance history of the applicant as well as the cost benefit of conducting such intense verifications. Several industry representatives provided summaries of surprising levels of unpaid refund requests spanning several years<sup>5</sup>. There is a justified lack of confidence that IRD will be able to deliver VAT refunds in a timely manner.

**Table 1. Multi-Year Sample of Cash Refund Requests (Greater than LKR 1000 (As at January 2024))**

VAT Period	Number of Cash Refunds Requested	Value of Cash Refunds Requested	Number of Refunds Approved or Rejected	Value of Claims Approved or Rejected	Percentage of Claim Value Approved or Rejected
First Quarter 2023	582	732M	2	.042M	0
First Quarter 2022	858	822M	18	21.7M	3
First Quarter 2021	1157	630M	37	8.1M	1
First Quarter 2020	1100	782M	62	26M	3
First Quarter 2019	2470	2021M	195	224M	11
First Quarter 2018	2634	2020M	423	423M	21

Source: Inland Revenue Department

**7. VAT revenue performance in SRI Lanka remains persistently low – generating just two percent of GDP in 2022 with a C-Efficiency of .27.** These results are well below regional averages<sup>6</sup>. Previous TA and policy missions have repeatedly opined that SVAT contributes significantly to the poor VAT revenue performance in Sri Lanka. This mechanism is self-regulated by taxpayers, is not readily visible to the administration, and is available to an extraordinary 60 per cent of VAT taxpayers. When SVAT is repealed in April 2025, it will be informative to have mechanisms in place to measure and monitor VAT revenue movements reasonably attributed to the dismantling of this framework.

## B. Findings

**8. The newly formed Risk Management Steering Committee (RMSC) has embraced its role and is advancing risk-based approaches.** While activities undertaken by the committee so far are not related to refund processing, they are developing experience in risk-based approaches. The committee expressed enthusiasm for applying these methodologies to refund processing.

<sup>4</sup> Staff indicated that refunds were frequently delayed due to lack of funds. However, information obtained from the IRD Finance unit showed that during 2023 LKR 660M were paid from the VAT Refund Account holding LKR 6,598M (10 percent of funds available).

<sup>5</sup> While many registrants benefit from VAT deferral on import, supplies acquired by exporters from domestic suppliers include VAT, giving rise to refund requests once exported.

<sup>6</sup> Alexander Klemm, Sebastian Beer, Olena Makeieva, Revenue Raising Tax Policy Reform Options, August 2022

**9. An SVAT Repeal Committee (SVATRC) was established during the initial days of the STX visit.** Generally charged with overseeing the repeal of the SVAT, the exact role of this committee is not fully defined, as both its role and membership were developing during the STX visit. There will need to be discussion between this committee and the Change Management Unit (CMU) regarding respective roles in repealing the SVAT and transitioning to a risk-based refund processing program.

**10. Following the 2006 fraud, the VAT refund program's principal objective changed from how to pay VAT refunds to how not to pay VAT refunds.** This shift in objective underwrote the distortionary design of SVAT and led to excruciating levels of validation and cross-checking of each refund claim. Progress will only be attained if all stakeholders within government (Ministry of Finance (MOF), Treasury, senior managers of IRD) demonstrably that VAT refunds are essential to the efficient economic operation of a VAT and commit to safely providing refunds to the export community rather than denying them.

**11. Failure to shift the operational culture to a risk-based approach to VAT refunds is the biggest risk to successful transition from SVAT.** Managing this change must be deliberately addressed as part of the project planning. While there are numerous tactical and system changes necessary to transition to a redesigned VAT refund program, they can be managed with thorough planning. Conversely, driving the change in mindset is a strategic challenge and a considerably more difficult aspect of the project. Staff are reluctant to accept approaches that manage risk rather than eliminate it. They believe they are subject to reprisal for judgements or decisions that contain the potential for error. Discussion with senior managers justifies this belief. Staff are protected from liability provided they follow operating instructions strictly. Unfortunately, existing operating procedures are not premised on a risk-based program design.

**12. Line staff will need visible support from senior management to adopt and have confidence in applying risk-based methodologies.** The first step is for management to accept the concept and then formally endorse it through operational procedures, performance management and training. Currently, an understanding of what constitutes reasonable risk tolerance is not present in IRD, so it is understandable that staff fear exercising judgement. By shifting to an approach that facilitates and expedites refund payments to low-risk taxpayers with minimum intervention, the organization's scarce resources can then be redirected toward medium and high-risk refunds.

**13. Just changing the refund processing framework will not be adequate if the mindset of those administering the program does not shift.** When processing VAT refunds, there is always some element of risk, and therefore risk-informed judgements must be made. Staff response to the current uncertainty is to conduct 100 per cent cross-matching of inputs and export verification. This practice has little hope of being operationally attainable or sustainable, as reflected in Table 1. Processing operations are effectively choked off.

**14. Addressing the large backlog of unresolved refund cases in the near term is not a realistic option for IRD and will distract efforts from SVAT transition.** Project focus should be firmly focused on moving forward – building an effective VAT refund program and securing the export community's confidence that it will work. The likelihood is that backlogged refund inventory relating to legacy and years 2016 to 2022 will have a low viability rate under existing processes, and even a dedicated cleanup project would take years to complete.

## II. Technical Assistance Provided

**15. Technical assistance (TA) was provided through two interactive workshops and numerous discussions with managers and staff.** SVAT has suppressed the usual credit/invoice machinations of a value added tax for thirteen years. Consequently, the first workshop was to reintroduce officials to the fundamental principles, policy motivations, and economic necessity behind VAT refunds. The workshop then introduced a practical example of risk profiling and risk-based processing of refunds. The presentation used in the workshop was provided to IRD with a draft of this report, for reference by the RMC. These concepts will need to be reinforced in subsequent TA.

**16. A second workshop was conducted to brainstorm on measures needed to transition from SVAT to traditional refund processing.** This workshop brought together participants from various areas of IRD impacted by these changes. A collateral objective was to sensitize the broader organization to the nature and breadth of the coming change that is not fully understood and is underestimated in some quarters. Documentation from these discussions was assembled into a high-level timeline that will help guide preparation of the detailed project plan for SVAT repeal, as discussed in paragraph 17.



## III. Next Steps

### A. Immediate/Short Term Actions

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**17. The timeline for SVAT repeal and transition to a new refund program is tight.** Preparation of a project management plan is an immediate priority. The plan should be developed by CMU in collaboration with the SVAT repeal committee and other impacted areas of IRD, and then presented to Senior Management for approval as soon as possible. Oversight for the plan should rest with CMU. The responsible CMU executive should report directly to the senior management team on a regular reporting cycle. Annex III of this report provides a suggested task map and high-level timelines for the workstreams that could form the framework of planning.

**18. There are urgent activities that are foundational to the SVAT transition and can be initiated even before the project plan is finalized.** These activities are listed in Box 1, Immediate Next Steps with further elaboration in paragraphs 19 - 24.

#### Box 1. Immediate Next Steps

- Prepare project implementation plan for repeal/transition of SVAT, and transition to risk based VAT Refund program.
- Identify bona fide exporter population.
- Extract multi-year VAT filing and import information on exporters.
- Estimate VAT Refund Account requirements under the redesigned refund program.
- Commence risk profiling of the exporters.
- Develop post payment validation and verification procedures.

**19. The population of taxpayers who will qualify for refunds under the redesigned VAT refund program are bona fide exporters only.** They are the nucleus of the post April 2025 refund mechanism, and it is important they be clearly identified as soon as possible. Knowing the makeup of this group well is key to the activities and communications that must take place in the coming months.

**20. Extract from RAMIS and ASYCUDA a comprehensive compliance history of the VAT taxpayers identified as eligible for VAT refunds in the future.** This information should be complemented with similar system extracts from all tax lines held in RAMIS. This data is foundational to risk profiling and other activities described in the balance of this report. This should occur as soon as possible.

**21. In a risk managed VAT refund system the timely payment of low-risk refunds relies in large part on the risk profile of the taxpayer seeking the refund.** Developing a risk profile for each of the taxpayers is a time-consuming process that should start immediately. Risk profiles or trusted trader programs being used by Customs system should be leveraged as they will inform the profiling significantly. The risk categorization methodology discussed at the workshop, coupled with local knowledge and industry

specific risks will enable IRD to assign low, medium, or high-risk profiles to each taxpayer. Detailed analysis of filing compliance and import history will be instrumental in establishing refund trigger values. Suggested risk profiling criteria are shown in Annex II.

**22. Post payment verification of low-risk taxpayers is a key element of the risk-based processing framework.** While low-risk taxpayers should generally benefit from quick payment of VAT refunds, selective post payment verification and periodic audits are an integral part of managing refund risk. As IRD currently has an overdeveloped approach to validating refunds, it will be necessary to develop more metered procedures for pre and post payment techniques as they relate to low-risk taxpayers. The process of developing these procedures will challenge the existing operational culture around refund claims but should prove to be catalytic to adopting the new approach. This activity should commence immediately following the risk profiling of exporters.

**23. Proper funding of the VAT Refund Account by the government is central to the efficient functioning of the invoice/credit VAT, and to timely refunds.** Estimates of the funding requirements for the future program should be developed. Based on information provided by the Finance Unit in IRD the current allocation of funding to the VAT Refund Account may prove to be adequate but should not be assumed. By analyzing the VAT filing history and Customs import information of the exporter group, a reasonable estimate of the amounts needed to fund the VAT Refund Account in the future can be made. This will permit IRD and MOF to determine whether the funding rate provided in section 71 of the Value Added Tax Act requires amendment.

**24. The Cabinet Memorandum<sup>7</sup> contemplates increasing the threshold to retain RIP designation in the period before SVAT is repealed.** Should this occur, the affected taxpayers would transition to the normal process of paying and charging VAT even before the actual repeal. This could be a useful tactic to phase in the transition, but it carries significant reputational and revenue risk if not properly executed. If IRD is not positioned to effectively administer to the needs of those being early transitioned out of SVAT, the potential damage would easily outweigh any perceived benefit. It is recommended this decision be reserved until IRD is assessed to be confidently positioned for administration of the post repeal program – perhaps late calendar 2024 or early 2025.

## B. Strategic Activities

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**25. To ensure risk to revenue is managed, IRD needs to ensure a strong well-prepared launch for those taxpayers transitioning out of SVAT.** There are several thousand taxpayers currently designated as RIP and RIS who must change longstanding VAT filing and compliance behaviors on April 1, 2025. This includes how they transact business-to-business. Having operated within the unique framework of SVAT for 13 years, changing the behaviors of this group (who continue to strongly favor the SVAT model) is no small task. This requires a very deliberate change effort, with all procedures and systems tested and ready at launch.

**26. Preparation for the transition requires a targeted communications plan and a focused compliance facilitation effort aimed at the RIP/RIS population.** This is not only the right thing to do in

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<sup>7</sup> This memorandum is found in Annex I.

terms of taxpayer service but also an important revenue protection measure. If the hypothesis that SVAT contributes significantly to poor performance of VAT in Sri Lanka is correct, it is from this group of taxpayers that the leakage is occurring. They should be fully supported, fully informed, and then fully monitored in the months following the transition. The risk of over half of the VAT taxpayers being unprepared for or unclear about their future compliance requirements is not a tolerable risk.

**27. A compliance facilitation project that includes field presence should be planned to ensure that former SVAT taxpayers get it right from the start.** Due to the extraordinary proportion of all VAT taxpayers that this group represents, the communication and compliance effort should be constructed as a micro version of a new VAT implementation program – where the primary thrust is facilitation, not enforcement. Design and preparation of both the communication and compliance projects should commence by April 2024 and be in readiness for December 31, 2024.

**28. The three VAT refund operations should be amalgamated and centralized into a single Exporter VAT Refund Unit.** This unit should be organizationally distinct with a narrow mandate of processing VAT refunds to exporters following the SVAT repeal. Care should be taken with the staffing of this unit as importing existing refund processing habits into the new unit should not be an option. The processes, procedures and work culture used by the Exporter VAT Refund Unit cannot duplicate or resemble those in the existing refund units. In terms of organizational placement, it is suggested that the Exporter VAT Refund Unit be placed in the LTU.

**29. The refund conditionality linked to the Central Bank requirement to repatriate export proceeds within six months precludes timely refunds.** Paragraph 3.9 of the Cabinet Memorandum commits to delink or alter this requirement. Ideally, administration of this monetary policy would not rest with IRD. However, if IRD continues to administer it, the timing of requirements must be adjusted so that payment of refunds is not fettered.

**30. A proof-of-concept project to improve exporter confidence in IRD's ability to pay refunds should be considered.** One option would be to apply risk-management approaches and expedite refunds to a small selection of exporters in advance of the repeal of SVAT. This should occur only after the risk profiling of exporters (paragraph 21) is complete. IRD could prioritize and pay outstanding refund requests from 2024 using the risk-based approaches that will be used in the new refund process. Industry representatives communicated a willingness to take part in proof-of-concept projects. Properly executed this could increase confidence and be a signal of good faith that the exporter community is seeking. It would also serve as a soft launch pilot exercise to iron out wrinkles in developing processes and procedures.

**31. Failure to smoothly launch the Exporter VAT Refund program following SVAT repeal will have serious reputational consequences.** IRD should seek additional TA support during this project. This would be best delivered through a periodic mixture of remote and on-site support throughout the project period. Of particular importance in obtaining TA is i) developing a comprehensive project plan and reporting mechanism that is clear on accountabilities and project reporting, ii) conducting risk assessments on the identified exporter community, iii) developing post payment validation and verification procedures related to low risk taxpayers, iv) preparation of communication and compliance project plans, and later in the project, v) measures to guard against refund fraud.

## IV. Risks to Implementation

**32. The project implementation plan should include a table of risks that could threaten the successful implementation of the SVAT repeal project.** A thorough risk matrix may contain a dozen or more items that must be monitored or mitigated. Project reporting to senior management should always include a discussion/or report about the key risks they need to be aware of (top three or four), the mitigation plans in place, whether the risk has changed since the last report, and who is responsible for monitoring and reporting on the risk. It need not be complicated – a simple risk register is shown in Annex IV. The example has been populated with two risks that are relevant to the SVAT repeal project but should be expanded while developing the Project Implementation Plan.

## V. Summary of Recommended Actions

**33. Box 2 summarizes the suggested actions and measures included in this report. Greater detail and suggested timelines are included in the body and Annexes to this report.**

### Box 2. Summary of Actions Recommended

- Prepare a project implementation plan, including project risks, for repeal/transition of SVAT to an Exporter VAT refund program. See Annex III.
- Identify the bona fide exporter population.
- Extract multi-year VAT filing and import information on exporters.
- Estimate future VAT Refund Account requirements for the future VAT refund program.
- Conduct risk profiling of the exporter population. See Annex II
- Develop business rules for post payment verification of low-risk refunds.
- Develop a communications and compliance plan to ensure smooth transition of RIP and RIS taxpayers to the post SVAT regime.
- Establish an Exporter VAT Refund Program independent from other refund processing operations.
- Ensure delinking of Repatriation of Export Proceeds requirements from refund conditionality.
- Consider a proof-of-concept pilot for expediting 2024 refunds to a small group of low-risk exporters once risk profiling of exporters is complete.
- Seek TA support for key aspects of the new refund program development.