

COMMONWEALTH OF THE BAHAMAS



A VALUE ADDED TAX WITHIN A REFORMED TAX SYSTEM

White Paper
on
Tax Reform to Secure
Adequate Revenues for the Future

February 2013

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FOREWORD

The provision of programmes, services and infrastructure by the Government is vital to the general welfare of the citizenry of The Bahamas and the orderly, progressive development of our nation. However, for this role of Government to be financially sustainable, it is incumbent upon citizens to conscientiously discharge their tax obligations to the state. This is the only way in which the government can, in turn, amass the necessary financial resources to meet its own obligations to the Bahamian people.

The other essential component of this paradigm is an efficient, adequate and progressive system of taxation and revenue collection. In this regard, it is common ground that our current tax system is sorely in need of reform. There are now more than 30 departments and agencies collecting a variety of taxes and fees that constitute both tax and non-tax revenue for the Government. Significant revenue leakage continues to occur and enforcement results are consistently poor. Indeed, the reality is that our tax structure is antiquated and completely out of sync with the demands of 21st century governance.

Taxes and duties in the form of import and export duties, excise taxes, stamp duties and tourism-related taxes collectively constitute some 60 percent of total Government Recurrent Revenues. Unlike most countries, however, we do not impose personal or corporate income taxes, nor do we have a broad-based consumption (sales) tax.

In essence, therefore, the Government's revenue base is extremely narrow and ill-suited to the expanding needs and demands of modern Bahamian society.

By predominantly focusing on goods, our tax system is also out of balance. It does not share the tax burden with those who are providing services in a way that is either fair or adequate. Moreover, a "goods-centric" taxation system is inherently unfair as it essentially makes the poor, struggling Bahamian pay the same in taxes as the wealthier citizen does. In short, the current system is regressive. In distributing the tax burden, it takes no account of varying levels of means within our society.

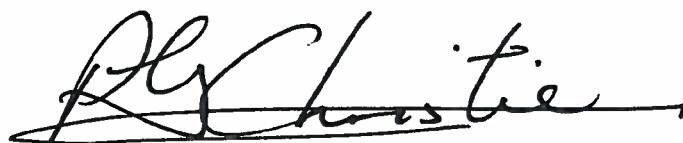
Reform of the tax system is therefore essential. Indeed the need for it is becoming more urgent with each passing year.

Happily, important initiatives are now underway to improve revenue administration. Comprehensive programmes are already in train to effect the modernization of both the Customs Department and the Real Property Tax Office to bring their operations up to the standards of best international practices. We are also establishing a new Central Revenue Agency to consolidate the collection of a number of taxes and fees in a more efficient and effective manner.

However, we need to go further now and tackle the more fundamental problem of tax reform. That is the focus of this White Paper. It speaks to the urgent need for fundamental reform of our tax structure.

I am confident that our programme of tax reform, when fully implemented, will result in considerably greater and more efficient revenue collection, the proceeds of which will better equip the government to meet the increasingly complex financial needs of our nation. More fundamentally, it will bring into being a new system of taxation that shares the tax burden more fairly and equitably.

On behalf of the Government of the Commonwealth of The Bahamas, I take this opportunity to invite your comments and feedback on this White Paper so that we can be thereby guided and assisted in crystallizing our taxation policies and preparing the relevant legislation for presentation to Parliament.

A handwritten signature in black ink, reading "Perry G. Christie". The signature is fluid and cursive, with a long horizontal stroke extending to the right.

Rt. Hon. Perry G. Christie
Prime Minister and Minister of Finance

Introduction

In the 2012/13 Budget Communication, the Government announced that it would address the issue of tax reform as a means of broadening the tax base to include both goods and services. To that end, a White Paper would be prepared and issued to serve as the basis for extensive public discussions and consultations.

The overarching objectives of the tax reform proposals in this White Paper are threefold, namely:

1. to secure an adequate revenue base in support of modern governance;
2. to establish a tax structure that promotes economic efficiency and stronger economic growth; and
3. to make the tax system more equitable.

As a means of achieving these objectives, it is proposed that a Value Added Tax (VAT) be introduced as of July 1, 2014 as part of a fundamental reform of the tax system. In tandem, we also propose to:

- effect the eventual reductions in import duty rates that will accompany The Bahamas' accession to the World Trade Organization (WTO);
- reduce excise tax rates to compensate for the VAT;
- eliminate Business Licence Tax as currently structured; and
- eliminate the Hotel Occupancy Tax.

The Current Tax System

Studies undertaken in the last several years by the International Monetary Fund (IMF) and Crown Agents (CA) have found serious deficiencies, of both a structural and administrative nature, in our current revenue system.

Structurally, the system has a relatively narrow tax base that is reliant on customs duties on imports and a few other taxes and fees on international trade, which account for well over one-third of Recurrent Revenue (Table 1).

Table 1: Taxes, Fees and Service Charges

	Projected Revenue 2012/13 \$ millions	%
Customs import, export, departure tax, stamp duties, other fees/service charges	552.7	36.5
Excise Taxes	358.1	23.6
Stamp Tax	176.4	11.6
Property Tax	116.7	7.7
Business Licence Tax/Communication Levy	107.7	7.1
Hotel Room Tax	45.1	3.0
Casino Tax	12.5	0.8
Other Bank/Trust Fees	6.3	0.4
Immigration Fees	47.0	3.1
Road Traffic Licences & Fees	41.5	2.7
Company Fees	24.3	1.6
Other Taxes, Fees, Service Charges	26.8	1.8
TOTAL	1,515.1	100.0

As a result of numerous concessions, the tax system effectively captures only a relatively small portion of the overall economy. As well, the system essentially covers goods to the virtual exclusion of services, with the latter representing 60-70% of household expenditures.

As well, by international standards, the system yields relatively small revenues relative to the size of the economy. It also generates revenue streams that tend to grow more slowly than the economy. This is because the consumption of goods tends to fall as a share of total consumption, as living standards increase.

Options for Tax Reform

A number of options may be considered as a central element of a tax reform package that is designed to achieve the core objectives set out in the Introduction. These include:

- income tax (personal and/or corporate);
- payroll tax; and
- consumption tax (sales or VAT).

Each of the options has its pros and cons in relation to the overriding objectives of tax reform. As such, the choice of preferred instrument should be based on an evaluation of the net benefits of each option.

Income Tax

Income taxes are in general application around the world and they do generate significant sums of money for governments. However, as taxes on income, their yield is subject to the usual impacts of the economic cycle on employment and profits.

The personal income tax can also be tailored to be quite progressive which, as may be seen in some countries, involves the imposition of somewhat steep tax rates on higher levels of income. In some cases, marginal tax rates well in excess of 50 per cent are applied.

The economic effects of income taxation on economic growth and efficiency are well documented in the tax policy literature. For instance, the 2008 "Tax and Economic Growth" study undertaken by the OECD (Organization for Economic Cooperation and Development) reviewed over 90 studies in this area. The principal drawback of the personal income tax is that it acts as a disincentive to work effort and entrepreneurship. It also discourages saving as interest income, dividends and capital gains are subject to tax. Likewise, the corporate income tax on profits discourages investment and innovation.

These negative effects, of course, grow in magnitude with the degree of progressivity of the income tax. As such, it is clear that the income tax works at cross-purposes to two of the major goals of tax reform.

The imposition of tax on income can also lead to an onerous compliance burden for individual taxpayers. Employers, for their part, must withhold

income taxes from the monthly wages and salaries of employees and then remit these to the government. Individuals must then file an annual tax return, declaring income from all sources and submitting all receipts required to support claims for whatever deductions are permitted. Private sector enterprises must do the same in respect of corporate income taxes.

Payroll Tax

As its name suggests, a payroll tax is simply a tax on an employer's total payroll. Such a tax represents the major source of revenue in some countries but relatively high rates of tax on employment must be imposed in order to generate significant revenues.

As such, the main drawbacks of a payroll tax are that it represents a clear impediment to employment and that, being based on employment, it is highly cyclical.

Consumption Tax

Taxes on consumption in application around the world take two general forms: a Sales Tax and a Value Added Tax. The Sales Tax, as its name implies, is a tax imposed at the final point of sale. While relatively simple to administer, a Sales Tax suffers from important drawbacks. For one thing, experience abroad has shown that, as a single stage tax, a Sales Tax is susceptible to evasion if it is imposed at a rate in excess of 10 per cent. As well, as a single stage tax, it results in the cascading of the tax burden, whereby tax imposed at one stage of the production and distribution process, is subject to Sales Tax at a later stage (i.e. Sales Tax

is charged on Sales Tax). Finally, under a Sales Tax regime, exporters are disadvantaged as their selling prices include Sales Tax paid on the materials and supplies that they purchase.

An important variant of the Sales Tax, known as the Value Added Tax (VAT), was first introduced by the French Tax Authority in 1954 but has since been adopted by a vast number of developed, developing and transition countries. Well over 140 nations now impose a VAT. According to one recent study: "The rapid rise of the value-added tax (VAT) was the most dramatic – and probably most important – development in taxation in the latter part of the twentieth century, and it still continues".

The primary distinctive feature of a VAT as compared to a traditional sales tax is its unique method of collection which also represents its main attraction relative to a sales tax. VAT is collected and remitted at each stage of the production and distribution chain. VAT paid at each stage is credited against VAT owing at the next stage, and only the difference is remitted. As such, a VAT system has a built-in mechanism to encourage compliance. A VAT registrant expects the buyers of his product to claim credits for VAT paid to him, thereby discouraging him from attempting to hide VAT receipts.

With a sales tax system, buyers may seek to avoid the payment of tax and sellers may be tempted to acquiesce in order to complete a sale. Such a transaction is easy to conceal to the detriment of Government coffers.

The evidence that has been collected suggests that fraud in a sales tax system becomes a significant problem when the rate of tax exceeds 10 per cent. It may be noted that VATs around the world are generally imposed at rates in excess of that rate.

Another advantage of VAT over a sales tax is that it avoids the problem of cascading, where tax at one stage is imposed on tax at a previous stage.

A VAT may be perceived to be complex as far as its administration is concerned, thereby imposing an undue burden on smaller businesses. However, experience has shown that successful VATs are based on relatively high registration thresholds. The vast majority of small firms contribute such a small portion of aggregate value added in the economy that bringing them into the VAT net represents a waste of administrative resources.

A VAT is also attractive from an economic perspective. As a tax on consumption, it does not deter work effort and entrepreneurship, nor does it discourage investment and innovation. It also encourages savings which, in turn, supports enhanced investment in the domestic economy.

Economic Impact of the Tax Options

Studies of the impact of taxation structure on economic performance confirm that a move away from distortionary taxes on income towards less distortionary taxes on consumption leads to stronger economic growth and higher levels of real GDP per capita. Work undertaken by

the European Commission has found that taxes on real estate (which is immobile), followed by consumption taxes, are the most favourable to growth and employment (“Tax Reforms in EU Member States 2011: Tax Policy Challenges for Economic Growth and Fiscal Sustainability”). Personal income taxes, social security contributions and especially corporate income taxes were found to be more detrimental to economic activity.

These findings are confirmed by another OECD study which assessed the relationship between tax structures, growth and real GDP per capita for a panel of 21 OECD countries over a 35 year period (“Do Tax Structures Affect Aggregate Economic Growth?”). The study produced a ranking of tax instruments in terms of their growth “friendliness”. Property taxes and consumption taxes are the most growth friendly. Personal income taxes are significantly inferior while corporate income taxes have the most negative effects on GDP per capita.

The IMF and CA studies mentioned above both recommended the adoption of a VAT by The Bahamas, along with reforms of some of the other major taxes. As well, a VAT has repeatedly been recommended by IMF Article IV missions over the last several years.

The implications of this analysis for tax policy are clear-cut. Given that taxes on consumption are, from an economic efficiency and growth perspective, superior to taxes on income, our analysis and that of both the IMF and CA suggest that the adoption of a VAT in The Bahamas should be a central element of the tax reform strategy going forward.

Proposed Reform of the Tax System

Within the proposed package of tax reforms, it is recommended that a VAT be introduced, as of July 1, 2014 at a rate of 15%, consistent with VAT rates generally charged elsewhere. Such a VAT rate would be at an appropriate level to ensure that, after factoring in the likely revenue losses from the other parts of the reform package, Government will have access to adequate revenues for the future.

It is generally acknowledged that, based on the experience of other acceding countries, pending membership in the World Trade Organization (WTO) will require reductions in Bahamian bound tariff rates. The final determination of those import tariff reductions is yet to be made and will be subject to the ongoing WTO access negotiations. It is to be noted, however, that the excise taxes currently imposed on selected products, namely tobacco, petroleum, vehicles and certain luxury items will be unaffected by WTO accession as, by law, they are imposed at the same rate on both domestic production and imports of those products.

It is also proposed to capitalize on the introduction of a VAT to further rationalize the area of consumption taxation in The Bahamas. Both the IMF and CA studies recommended the elimination of business licence tax. It amounts to a tax on consumption, in any event. At present, no rebate of business licence tax is allowed for exports (thus hindering international competitiveness) and it also results in cascading of taxes (tax being imposed on tax through the production chain).

It is proposed that, if eliminated in their current form, business licence taxes should nonetheless be retained as a simple, annual registration fee on businesses at a rate of \$100 per year. The current Business Licence tax structure for banks and insurance companies would continue.

In addition, it is proposed, for competitiveness reasons, to eliminate the hotel occupancy tax and to subject hotel accommodations to VAT rather than subject them to both taxes. This will allow hotels to claim VAT input credits on their purchases of materials and supplies and will be consistent with the current Hotels Encouragement regime. Hotels will benefit from lower compliance costs and the Government will benefit from administrative economies of scale.

However, again for competitiveness reasons, it is proposed that hotels be subject to a VAT rate equal to the current hotel occupancy tax rate of 10%. Similarly, given the large contribution of hotels to economic activity, it is proposed that food and beverage sales in hotels be subject to VAT at the same rate of 10%.

Given the relatively high rates of excise tax imposed on a number of excisable items, it is proposed that all excise tax rates be reduced by an amount just sufficient to counteract the imposition of a 15% VAT on those products. As a result, the total tax payable on excisable products would remain unchanged.

Overview of VAT

As was mentioned above, VATs are now in place in over 140 countries around the world, including a number of small island economies. The prevalence of VATs in the Caribbean is illustrated in Table 2 below.

Table 2: VAT in the Caribbean

Country	Standard VAT Rate	Year Introduced
Haiti	10%	1982
Dominican Republic	16%	1983
Trinidad & Tobago	15%	1990
Jamaica	16%	1991
Barbados	17.5%	1997
Belize	12.5%	2006
Dominica	15%	2006
Antigua & Barbuda	15%	2007
Guyana	16%	2007
Grenada	15%	2010
St. Vincent & the Grenadines	15%	2007
St. Kitts & Nevis	17%	2010
St. Lucia	15%	2012
Turks & Caicos	11%	2013

Despite its name, VAT is indeed a tax on consumption, similar to a retail sales tax (RST). Some may argue that, as a single stage tax levied at the point of final sale, an RST is simpler to administer than a VAT. However, there are drawbacks to RSTs in comparison to a VAT. For one, it is difficult, in practice, to ensure that RST does not fall on business inputs; VAT input credits avoid this problem. As well, the collection of RST at one

single point renders it more susceptible to evasion than a VAT, which is charged at each stage of production.

The charging of VAT at each stage of the production and distribution process is one of the key features and advantages of a VAT, from which its name derives. VAT is charged only on the value that is added at each stage of the production process, thus allowing businesses to receive a credit for VAT paid on their inputs. When implemented effectively, the full burden of a VAT falls only on the final selling price. As such, VAT is not a tax on output nor is it a tax on businesses.

A straightforward, simple example is presented in the Box below to illustrate the multi-stage collection of VAT and its ultimate reflection in the final selling price of a product.

	Price	VAT Paid at 15%	VAT Remitted to Government
A farmer cuts down trees and sells them to a lumber mill for \$20.00, charging 15% VAT of \$3.00 which he remits to the Government.	\$20.00	\$3.00	\$3.00
The lumber mill transforms the trees into wood that it sells to a furniture manufacturer for \$50.00, charging VAT of \$7.50. It remits \$4.50 to the Government (\$7.50 minus the VAT of \$3.00 paid to the farmer).	\$50.00	\$7.50	\$4.50
The manufacturer transforms the wood purchased from the lumber mill into a chair and sells the chair to a retailer for \$125.00, charging VAT of \$18.75. He remits \$11.25 to the Government (\$18.75 minus the VAT of \$7.50 paid to the lumber mill).	\$125.00	\$18.75	\$11.25
The retailer then sells the chair to a client for \$170.00. He charges VAT of \$25.50 and remits \$6.75 to the Government (\$25.50 minus the \$18.75 paid to the manufacturer).	\$170.00	\$25.50	\$6.75
TOTAL REMITTED TO GOVERNMENT			\$25.50

In this example, the entire VAT of \$25.50, or 15% of the chair's selling price of \$170.00, is paid by the retail customer. No VAT falls on the furniture retailer, the furniture manufacturer, the lumber mill or the tree farmer. For example, the retailer did pay VAT of \$18.75 to the chair manufacturer, but he recouped that full amount, through his input credit, when calculating his VAT remittance to the Government. He collected VAT of \$25.50 from the client but only had to remit \$6.75 to the Government. Likewise for the manufacturer, the mill and the farmer.

In total, VAT in the amount of \$54.75 is collected throughout the process but only \$25.50 is remitted to the Government as each participant claims input credits for VAT paid on its purchases. The Government receives \$3.00 from the tree farmer, \$4.50 from the lumber mill, \$11.25 from the chair manufacturer and \$6.75 from the furniture retailer, for a total of \$25.50.

As VATs have been in existence for such a long time and are currently in place in so many countries, their optimal structure and desirable features are generally well-known. Since they apply to all sectors of the economy, their principal advantage is that they are a reliable, secure, stable and buoyant source of budgetary revenue. If applied in an unbiased way, they also result in fewer economic distortions than the current tax system. By taxing goods and services, they also tend to be less regressive than our current tax system.

The key caveat is that, given the range of features possible for a VAT, it can easily become extremely complex, which leads to very high costs of administration, low compliance and poor performance. Some countries have

encountered such difficulties with their VATs in the past and have ended up removing them, only to subsequently either re-introduce them with modified features or replace them with an alternative tax on consumption. Minimizing complexity in a VAT is therefore of paramount importance.

The consensus view of fiscal experts generally, as summarized in the CA study referenced above, is that a good VAT should have the following features:

- application to all goods and services, including imports
- be based on a system of self-assessment (to minimize complexity and compliance and administration costs);
- be administered through a well-designed system of invoices to facilitate accounting, assessment and auditing;
- taxes on inputs (including tax on capital goods) credited against VAT payable on output/sales;
- one uniform rate with, at most, one additional lower rate to prevent a significant increase in the tax burden on vital industries or to address critical equity concerns (also to promote fairness and simplicity of administration);
- zero-rate (i.e. apply zero VAT and allow credits for VAT paid on inputs) applicable only to exports and international transport of goods and passengers to eliminate the tax burden on and improve the competitiveness of exports (this also reflects the fact that a VAT is a tax on domestic consumption);
- exempt (i.e. apply zero VAT but do not allow credits for VAT paid on inputs) as few sectors as possible since exemptions are fundamentally

incompatible with the logic of a VAT. As seen in other countries, it is often the proliferation of exemptions that over-complicates a VAT and thereby undermines its chances of success;

- to minimize administration costs, application of a fairly high threshold for exemption from mandatory registration for VAT in such a way as to balance the loss of revenue from exempting some businesses against the revenue gain from focusing resources on the largest taxpayers (who in any event generally collect and remit the bulk of VAT revenues).

Main Features of VAT

Registration

The level of the registration threshold is widely acknowledged to be a critical choice in the design and implementation of a VAT. In far too many cases, countries have set the threshold at a level that is too low in the misguided belief that maximizing the number of registrants will maximize net VAT collections (gross collections net of administrative costs).

Such a choice, in many cases, reflects an under-estimation of the costs of collection of VAT, especially the costs of auditing activities, which are crucial to VAT success. Unfortunately, in many cases, experience has shown that doing so creates considerable difficulties when tax administrations, and especially newly-created ones, are found to be insufficiently developed to administer a large VAT registrant base effectively and efficiently.

In setting a VAT threshold, the critical criterion is the trade-off between, on the one hand, the need to reduce the costs of compliance to business and the costs of administration to the government and, on the other hand, the revenue foregone from exempting businesses from the VAT. In this regard, it is clearly the case that the costs of compliance with a VAT, as a percentage of sales, fall with exceptional severity on small businesses, many of which fare poorly in the areas of record-keeping and accounting.

Beyond the costs of compliance to the private sector, another key criterion in setting the VAT registration threshold is the size distribution of firms in the economy. In this regard, according to the IMF study "The Modern VAT", it is generally observed internationally that the largest 10 percent of firms account for roughly 90 percent of total turnover. The study suggests that revenues collected from smaller firms are such that they do not warrant the resources required to collect them.

Even if a small amount of revenue is foregone by dropping many small taxpayers, any such revenue loss should as a rule soon be recouped because the tax administration will be able to concentrate its efforts where they are most needed, that is on the medium and large taxpayers who account for almost all VAT revenues.

It is also relevant to note that, with the record keeping practices of small firms generally, the task of auditing them is extremely challenging and costly (relative to any potential revenue recoveries).

Based on information from the Business Licence Office, it is clear that the size distribution of licenced firms in the Bahamas is broadly in line with that elsewhere. Of the 19,253 firms licenced in 2011, fully 80 per cent (15,455) had turnover at or below \$50,000 and in aggregate accounted for only 1.4 percent of total turnover. The larger remaining 3,798 firms with turnover above \$50,000 (just under 20 percent of all firms) accounted for 98.6 percent of total turnover in the economy.

Most countries do allow firms below the threshold to register voluntarily. Despite high compliance costs, this may be in the commercial interest of those firms selling to registered traders as they can claim input tax credits and purchasers can recover tax paid. Safeguards must however be built into the registration process to ensure that smaller registrants can indeed comply with the record-keeping and other requirements of the VAT legislation. In this regard, the Government is firmly committed to dedicating adequate resources for the education and training of the private sector in preparation for VAT introduction.

In light of the above considerations, it is proposed that the VAT registration threshold be set at \$50,000. That would result in a registrant population of some 3,798 firms, accounting for fully 98.6% of total turnover in the economy.

It is also proposed that a business licence fee of \$100 per year be charged to all Business Licence registrants (except banks and insurance companies whose tax structure would remain unchanged). Firms below the threshold

would therefore continue to pay the same \$100 fee that they currently are paying.

Taxable Supplies

The proposed VAT will be applied to every supply of goods or services made in The Bahamas in the course of a taxable activity carried on by a VAT registrant. The concept of a taxable supply includes a zero-rated supply but not an exempt supply.

A supply of goods includes a sale of goods or a grant of the use or right to use goods, while a supply of services means anything which is not a supply of goods or money.

As is the case in general application elsewhere, the supply of goods and services occurs when:

- an invoice for the supply is issued by the supplier;
- all or part of the payment for the supply is received;
- the earliest of the date on which the goods are delivered or made available; or
- the performance of the service is completed.

In drafting the VAT legislation, consideration will be given as how best to implement this definition of the supply of goods and services in the Bahamian context.

Zero-rated Supplies

Zero-rating a supply implies applying a zero VAT rate and allowing credits for VAT paid on inputs. As such, zero-rating should definitely be applicable to exports as a VAT is designed to tax only domestic consumption. Other than that, zero-rating should be strictly limited, if utilized at all.

Adding other items to the zero-rated list undermines the VAT as a broad-based, neutral tax on consumption. It also adds to the compliance costs of the private sector, as well as the administration costs to government, by increasing the volume of VAT collections which are subsequently refunded. Zero-rating also provides opportunities for fraud.

VAT refunds have been frequently referred to as the potential Achilles heel of a VAT system and, accordingly, experts have argued against extensive zero-rating in order to minimize the magnitude of refund claims and payments.

Under the proposed VAT, only exports will be zero-rated. As an extension of that principle, it is proposed that zero-rating will also be extended to the international transport of goods and passengers.

Exempt Supplies

Items that are exempted under a VAT are not subject to VAT and credit for VAT paid on inputs is not allowed. As such, exemptions are inconsistent

with the fundamental logic of VAT and they break the VAT chain, thus making enforcement more difficult.

There is, however, a concern in some circles that a VAT may adversely affect the distribution of income. Because of that, governments have chosen to exempt selected items as a means of mitigating VAT's purported regressive effects. However, as cited in the IMF study "The Modern VAT", a VAT is not inherently a regressive tax. Indeed, in a number of countries, VAT proved to be more progressive than the trade taxes it often replaced.

Household expenditures on food and beverages, personal care items, clothing, footwear, fuel and consumer durables all decline as a share of spending as total expenditures rise. On the other hand, the share of spending on services such as entertainment, health, transport and communications and other services rises with overall spending. As import duties, the major source of revenues, currently tax goods and not services, and relatively heavily at that, it is clear that a combination of lower import duties and a VAT (which applies to both goods and services) would improve the fairness and equity of the Bahamian tax system.

The consensus view of tax experts is that a VAT should exempt as few sectors as possible as exemptions are fundamentally incompatible with the logic of a VAT. As seen in other countries, it is often the proliferation of exemptions that over-complicates a VAT and thereby undermines its chances of success. Having said that, the following sectors are generally exempted (for valid economic and social policy reasons) in many countries:

- Financial services, because value-added in this sector is difficult to measure and because, in essence, these services relate to the process of saving and investment rather than consumption
- Transfers and leases of land and residential buildings (again in the nature of saving and investment)
- Agriculture and fisheries
- Social and community services
- Health and education services

The main drawbacks of exemptions are that they:

- narrow the VAT tax base, thereby necessitating a higher standard VAT rate to meet revenue requirements;
- lead to cascading: if an intermediate seller is exempt, it cannot claim credit for VAT paid on its inputs. The upstream producer then ends up charging VAT on VAT paid on those inputs;
- increase administration costs to government and compliance costs to the private sector, especially firms that sell both taxed and exempt goods and services;
- violate the destination principle for internationally traded items, where exports embody exempted inputs (exports are thereby disadvantaged in a competitive sense); and
- lead to exemption creep as non-exempt sectors lobby for exemptions, which can quickly undermine the success of the VAT system.

In light of the drawbacks attendant on exemptions discussed above, it seems desirable to keep the number of exemptions to the bare minimum, and to only exempt those that are clearly justifiable on economic and social policy grounds.

As such, it is proposed that the following be exempted:

- The food and agricultural products that currently benefit from duty free status under the Tariff Act
- Other imports that benefit from the same status and that can be justified on social grounds (e.g. medicines)
- Health and education services
- Transfers and leases of land and residential buildings
- Financial services
- Social and community services

The exemption for the Free Trade Zone would be secured by the provisions of the Hawksbill Creek Act.

Input Credits

When a VAT registrant buys supplies and inputs, it will pay VAT on those purchases. When that registrant prepares its periodic VAT remittance report for transmittal to the Government, it will be allowed to claim an input tax

credit if the goods and/or services purchased are utilized in making taxable supplies but not exempt supplies.

Returns

All VAT registrants will be required to file a monthly VAT return within 21 calendar days after the end of every month (or the first working day thereafter), regardless of whether or not tax is payable in respect of that month. Returns will be filed, electronically to the extent feasible, with the Director of the soon-to-be-created Central Revenue Agency (CRA) in the form prescribed by the Minister of Finance.

Payments

VAT payable by registrants for a tax period (one month) is the total amount of VAT collected in respect of taxable supplies made during the month (output tax) less the total VAT paid on inputs for the month (input tax). The deadline for payment is the due date for filing the return. Late payments will attract a penalty and interest per month as prescribed in the Regulations.

Assessments

In general, VAT registrants will be allowed to self-assess their VAT liabilities. However, if the Director of the CRA is not satisfied with any return filed, he may issue an assessment, or an amended assessment where the amounts reported on the self-assessed return are not accurate. As

discussed below, registrants will be able to file appeals against decisions of the Director.

Should a registrant fail to file a return as required by the law, the Director may issue an assessment and payment will be due as specified in the Notice of Assessment.

Refunds

Where a registrant's input tax (i.e. the tax paid on materials and supplies) for any month exceeds the output tax (i.e. the tax charged on its sales) for that month, a tax credit will exist. With the exception of exports, such a tax credit will be carried forward to the next month and will be treated as a deductible input credit for that month. Further credits will be carried forward consecutively for a maximum of three months, or the registrant may ask that the credit be applied to another tax type where a liability exists. However, if after three months excess credit remains, the registrant may request a refund.

If the refund is not paid within two months of the application, the Government will pay interest at a rate prescribed in the Regulations.

Registrants engaged in exports, which will be zero-rated, may request a refund without the necessity of the three-month waiting period.

Accounting and Records

One of the undeniable strengths of a VAT system is that it requires registrants to maintain adequate books and records, documenting business transactions completed for the filing period. Records must be up-to-date and must clearly show the figures reported in the VAT return for the taxable period. These books and records, including electronic data, must include the following:

- purchases and sales books
- purchase invoices/import and export documentation
- sales invoices, sales receipts, services billing invoices
- credit or debit notes
- income and expenditure records
- cash register tapes or similar records
- bank statements
- VAT Invoices received and VAT invoices issued
- accounting instruction manuals, systems, programmes and any relevant documentation in use to describe the accounting system.

The proposed VAT legislation will require the registrant to issue an invoice for every taxable supply made to another VAT registrant, which must contain all information as prescribed in the legislation.

A VAT invoice will not be permitted to be issued to an unregistered person; instead a sales receipt must be issued stating clearly the amount of VAT charged.

Registrants will be required to produce information that will enable the tax administration or authorized persons to determine a registrant's liabilities and obligations, or the amount of refund to which a person is entitled.

Objections and Appeals

A taxable person dissatisfied with an appealable decision may lodge an objection with the Director of the CRA within 30 calendar days of the decision. The objection must be in writing and must specify in detail the grounds upon which the objection is being made. An objection must be accompanied by payment of all of the tax not in dispute. It is for consideration whether any portion of the amount of tax in dispute should also be remitted at the time of the filing of the appeal.

A person dissatisfied with the decision of the Director may, within 30 calendar days after being served with that notice, lodge a notice of appeal with the Appeal Commission and must serve a copy of such notice on the Director.

A person dissatisfied with the decision of the Appeal Commission may, within 30 calendar days after being notified of the decision, lodge a notice of appeal with the Supreme Court stating the question of law on the appeal.

The burden of proving that an assessment is excessive or that a decision of the Director is wrong is on the person objecting to the assessment or decision.

Offences and Penalties

The VAT legislation will make provision for a number of offences and penalties, which include:

- failure to apply for registration
- failure to display the certificate of VAT registration
- failure to notify the Director of CRA of change of address
- failure to notify the Director of CRA of cessation of operations
- issue of a false invoice
- use of a false taxpayer identification number
- failure to pay VAT due
- failure to file a VAT return
- failure to comply with notice for recovery of tax
- failure to maintain proper records
- non-compliance with price quotation requirements
- failure to comply with notice to give information
- making false or misleading statements
- VAT evasion
- impeding tax administration

It is for consideration whether penalties should be waived for strictly procedural offences during a VAT transition period to be determined.

Effect on Prices

The effect of VAT on prices will vary as between goods and services and, within the goods category, the effect will depend on the current taxation of individual goods. The final impact on the price of goods will depend on the extent of reductions in import tariff rates flowing from accession to the WTO.

Agricultural, food and certain other products that currently benefit from duty-free status under the Tariff Act will also be exempt from VAT. Their prices should be unaffected by tax reform.

Similarly, the services also proposed to be exempt from VAT, such as health and education services, etc., should experience no direct change in price under a VAT system.

Treatment of Selected Sectors

Diplomatic Missions

Diplomatic missions (including offices of international organizations) and their staff who have been accorded duty free status will continue to be exempted from import duty and VAT in respect of goods imported by them.

In keeping with the principle that VAT must be paid on all transactions except where goods are zero rated or exempted, Diplomatic Missions and

staff will be required to pay VAT on local purchases and periodically apply to the Director of CRA for a refund of the VAT paid.

Businesses Enjoying Fiscal Incentives

Businesses with existing fiscal concessions under, for example, the Hotels Encouragement Act, the Industries Encouragement Act or the Fourth Schedule of the Tariff Act, will continue to receive those concessions. However, they will be required to pay VAT on imports and domestic purchases. Furthermore, they will be required to register which will entitle them to charge VAT on taxable sales and submit a claim for VAT paid on inputs.

It is for consideration whether these businesses should have the ability to claim a refund for VAT credits immediately rather than having to wait for the standard 3-month refund period.

Implementation

Experience in a number of countries which have been successful in introducing a VAT suggests the following key requirements for success:

- a strong Government commitment to implement a VAT;
- a sound, well-designed implementation plan with a realistic timetable;
- a comprehensive and extensive public education campaign;

- a well-designed VAT law with few exemptions, no zero-rating of domestic consumption and an appropriate registration threshold;
- a well-designed, client-oriented organization to administer the VAT with, among others, an effective refund mechanism, a strong compliance and enforcement mechanism and an effective audit program;
- adequate and properly trained staff; and
- adequate and effective information technology systems.

As for the Government's commitment to VAT, it is to be noted that a Cabinet sub-committee has been established to ensure that VAT introduction is being overseen at the highest level of Government.

The practical implementation of VAT will be overseen by a Steering Committee chaired by the Financial Secretary and comprising relevant senior officials of Government. The Committee will receive regular progress reports on implementation and will provide guidance.

A dedicated VAT Implementation Team will be established, under the leadership of a senior officer of the Ministry of Finance, to develop a detailed implementation plan and to assure its effective execution. The Team will be supported by two international experts, one in respect of the VAT system and one in respect of VAT Information Technology requirements.

As it represents a significant change in the way of doing business, the introduction of VAT needs to be explained to the general public to clear up

any uncertainties. To that end, the Government will undertake programs to: create awareness among the population; host consultative sessions with the business sector and the general public on the proposed changes and operational procedures of VAT; and inform citizens of their rights and obligations under the new system and the resulting consequences of non-compliance.

Individual VAT registrants will receive individualized support from the Implementation Team to ensure that they meet all legal requirements.

Transitional Issues

The legislation will contain transitional arrangements to facilitate smooth VAT implementation. In principle, no credits will be allowed in lieu of input tax credit for consumption and other taxes paid on imports (and domestic supplies) prior to implementation date. Businesses will have the option of depleting stocks to minimum levels or utilizing bonded warehouses.

However, in practical terms, it is for consideration which other alternative methods might be employed during the transition to ensure that double tax is not paid on any product.