VAT and the TCI

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an independent appraisal

commissioned by the Turks & Caicos Independent Business Council

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He also advises on tax reform, and acted as Expert Adviser to the Scrutiny Panel of the States of Jersey during the recent fundamental reforms to Jersey's tax system.

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Introduction

In October 2012 the Interim Administration of the Turks & Caicos Islands (TCI) passed a law to introduce VAT in the TCI from April 2013. Following the subsequent elections and the resumption of democratic government, there is a move to postpone this introduction of VAT.

This is proposed to replace several existing taxes, with import duties being reduced and a range of specific taxes (primarily the Accommodation Tax and the Communications Tax) being abolished.

The VAT is primarily designed to replace the revenues from those other taxes, although it is also expected to raise some additional revenues.

This report looks at the suitability of a VAT for the TCI, and examines whether it would be better or worse than the range of current taxes that it is proposed to replace.

This report was commissioned by TCIBC, the Turks & Caicos Independent Business Council.

Executive summary

VAT is a complex tax and one that is not well suited to small island economies such as TCI.

The main findings of this report are:

1) The implementation timetable is extremely tight. VAT requires forward planning by businesses (especially those in long-term contracts such as the tourism sector) and training. Equivalent jurisdictions have used a four year programme to design the VAT law, implement appropriate systems and train business and government staff.

2) Because VAT is charged on all (or nearly all) business transactions, but then is refunded to business customers, it is much more administratively complex and expensive to operate than the simple, targeted taxes that it will replace. This will increase costs for businesses and the government.

3) A VAT will not tax any significant sectors of the TCI economy that are not already being taxed under existing taxes (primarily import duties, the Accommodation Tax and the Communications Tax).

4) Those sectors that are not currently taxed are either unsuited to a VAT (mainly financial services and government services) or are largely business services, so any VAT collected from

the sector would be largely refunded to its business customers.

5) Therefore the VAT would increase administrative costs without bringing any significant benefit of broadening the tax base.

6) There are significant points of detail that have not yet been dealt with, including the transition to a VAT system and administrative matters such as VAT groups.

In conclusion therefore, VAT does not appear to be suited to the TCI. It would be expected to increase administrative costs without spreading tax across any significant sectors that are currently untaxed. Even if it is to be introduced, the proposed date is far too soon.

Part 1 – VAT and small islands

Since its introduction by France in 1954, VAT has spread to most large countries in the world. However there are some notable exceptions; the USA has no VAT at all, and India does not have a national VAT.[1]

But whilst the USA is unusual amongst large countries for not having a VAT, VAT is still much less common amongst small jurisdictions – and for very good reasons.

VAT is an administratively very complicated tax, because it is charged and collected at each stage in the supply chain and then generally refunded at the next stage. So a manufacturer will charge VAT to a wholesaler, but the wholesaler will reclaim that VAT from the tax authorities.[2] The wholesaler will then charge VAT to the retailer, which the retailer will reclaim, and so on down the supply chain.

There is also the difficulty of defining what is subject to VAT, particularly when there are multiple rates and exemptions. Nor does this become easy over time; in the UK, forty years after VAT was first introduced, there are still disputes about the VAT treatment of particular transactions, and the government is still amending VAT law to try to ensure the correct treatment.

[1] Although most Indian States have a state-level VAT.

[2] Usually by offset against VAT owed, but actual refunds of VAT are also common.

This is very expensive for both governments and businesses to administer, and takes up a good deal of time that could be better devoted to running business or government. A UK Parliamentary study found that small businesses spend an average of 1.8 hours per week dealing with VAT administration.[3]

VAT and geography

For large countries with complex, diverse economies, a VAT is probably the only efficient way to collect a broadly based consumption tax. Because goods in a large economy go through so many different routes on their way to the final consumer, there is no one point in the supply chain at which a consumption tax can be reliably levied.

But for small countries with much simpler economies, there are usually other alternatives. If most goods are imported then import duties will collect much the same tax at a much lower administrative cost, for both business and government, and usually a few simple taxes will deal with most other sectors of the economy.

Even the IMF, usually wholly supportive of VATs, is not necessarily in favour of VAT for small islands:

[3] UK House of Commons Treasury Select Committee, "The Administrative Costs of Tax Compliance", HC 269, May 2004.

> *"The suitability of the VAT for small countries, and for small islands in particular, is an issue that arises with increasing frequency."*[4]
>
> *Michael Keen,*
>
> *Deputy Director of the Fiscal Affairs Department of the IMF*

Whilst some Caribbean jurisdictions have indeed adopted a VAT, notably Barbados and Jamaica, many have not and some, notably Grenada and Belize, have tried a VAT only to later abandon it.[5]

Problems with VAT for small islands

No small island country had a VAT until 1989, and it was long thought that they were unsuited to a VAT. This is because of a combination of two reasons:

- First, in a small country the costs of implementing a VAT system can be disproportionately high;

  "small island states will nevertheless have to adopt substantial structural adjustments"[6]

[4] Bodin, Ebrill, Keen & Summers, "The Modern VAT", IMF, 2001

[5] Peters, A. & Bristol, M., "VAT: is it suitable for the Caribbean community?", University of Munich MPRA 8, 2007. Granada subsequently reintroduced a VAT in 2010.

[6] Grandcolas, G., The Occasional Failure in VAT Implementation, Asia-Pacific Tax Bulletin, January/February 2005, 6-13.

- Second, in a small island economy a high proportion of the economy is based on imports, which can be taxed by means of much simpler import duties, and with proportionately very little domestic value-added business that needs to be taxed by way of a VAT.

The natural and logical way to tax consumption in such economies would therefore be by way of import duties; they are easy to operate and relatively cheap to collect, and in a typical small island economy with relatively little domestic production a well-designed import duty combined with a few specific taxes will tax almost all consumption.

VAT v import duties

It is not that a VAT cannot be implemented in a small island economy; Barbados and Jamaica in particular show that it can be done. No; the real question is not whether it can be done but whether it should be done, or if there is a better tax (or combination of taxes) that would be more efficient.

In deciding between a VAT and import duties, there are two main considerations:

- Import duties are generally simpler and cheaper to operate than a VAT, both for businesses and for the government;
- But a VAT is more comprehensive, because it taxes all consumption rather than just imports.

For a small country, the costs of collection will be disproportionately higher because the need to maintain a tax collection system will be spread over a smaller economy. The impact of the collection costs, and so the disadvantage of a VAT, will therefore be greater.

However for a typical small island economy, with relatively little domestic production, imports will be a much higher proportion of the economy and therefore the advantage of a VAT, in taxing consumption that is not caught by an import duty, will be much less than in a large industrialised country.

For a small island economy therefore the advantages of a VAT will be less, and the disadvantages of higher administrative costs will be greater.

Import duty reduction

It is true that several small island countries have adopted a VAT, but this is often because of external pressure rather than the natural advantages of VAT for such states.

The main reason for the adoption of VAT by small island nations is external pressure to reduce import duties, rather than because VAT has advantages in itself for such islands.

The growing trend in international trade is for compulsory reduction in import duties, whether via global trading groups such as the

World Trade Organization or regional bodies such as the European Union.

In the case of small island countries, many have adopted or considering adopting VAT because of regional international trade agreements such as the Pacific Islands Countries Trade Agreement (PICTA) and the Pacific Agreement on Closer Economic Relations (PACER).[7]

In other cases, the small island's proximity to an international trading bloc has forced it to adopt their import duty reduction programmes.

For example Jersey introduced a VAT-type tax in 2008, but that was because its relationship with the European Union meant that, although not an EU member, it was unable to charge import duties on goods from the EU, which make up virtually all its imports.[8] The option of an import duty was therefore not available to Jersey.

[7] Grandcolas, G., The Occasional Failure in VAT Implementation, Asia-Pacific Tax Bulletin, January/February 2005, 6-13.

[8] See Protocol 3 to the UK's Treaty of Accession in 1972.

Part 2 – Examples of small country VAT

None of the British Overseas Territories has introduced a VAT or equivalent tax.[9]

This includes Bermuda (population 64,000)[10], Cayman Islands (population 52,500), the British Virgin Islands (population 31,000) and Gibraltar (population 29,000) as well of course as TCI – all without a VAT.

It is true that two of the Crown Dependencies have a VAT or equivalent tax, but:

- The Isle of Man (population 85,000) does not have a VAT of its own, but adopted UK VAT under the terms of the UK's Accession Treaty when the UK joined the European Union and operates VAT jointly with the UK under the "Common Purse" arrangement;
- Jersey (population 95,000) recently[11] introduced its own VAT-type tax known as GST (Goods and Services Tax), but this was introduced because Jersey was unable to levy the taxes that it wanted to under its arrangements with the European Union (see elsewhere in this report).

[9] The Sovereign Base Area of Akrotiri and Dhekelia, a UK-controlled military base on Cyprus, is treated as being part of Cyprus for VAT purposes but does not have a VAT of its own.

[10] All population data from the CIA World Factbook.

[11] 2008.

Of the Caribbean jurisdictions that have adopted VAT. These are full members of CARICOM, which like the European Union is tending to replace import duties with VAT, and most are substantially larger than TCI such as Dominican Republic (population 10,000,000) or Trinidad and Tobago (population 1,225,000). However in the last few years a handful of smaller countries have adopted VAT and are worth studying; see for example the discussion of St Lucia (population 162,000) below.

Saint Lucia

St Lucia (population 162,000) introduced VAT with effect from 1st October 2012, and it would be very useful to study how smoothly that is introduced, and the effect of VAT on its economy, before doing the same in TCI.

One immediately obvious point is that introducing VAT to St Lucia was a long and highly skilled process:

- The VAT Implementation Unit, responsible for preparing St Lucia for VAT, was established in October 2008, a full four years before VAT was actually introduced. [12] In contrast in TCI, VAT was still only one of several options being discussed in the Roe Report barely a couple of years ago.[13]

[12] Website of the St Lucia VAT Office.

[13] Roe, A., “TCI Government current and potential revenue sources: an assessment”, January 2010.

- The introduction of VAT to St Lucia has clearly been a major operation, with the VAT Implementation Project having a team of ten members within the Inland Revenue Department, plus external advisers.[14]

- This was clearly a highly skilled team, including several qualified chartered accountants and headed by a former participant in international tax organisations such as the Caribbean Organization of Tax Administrators and the Global Forum Peer Review.

- As a brief sign of how much work went into the implementation of VAT in St Lucia, the work of the Implementation Unit before VAT could be introduced included[15]:

  - "development of the relevant forms, guides and other material for use by potential VAT registrants";

  - "development of operations manuals needed to administer the VAT" (i.e. procedures and guidance for VAT Office staff);

  - "an extensive public education campaign";

  - "training for VAT registrants and their accountants, sectoral talks, seminars, lectures as well as traditional and new media outputs";

  - "quality assurance on the appropriate legislation for the introduction of the VAT system."

[14] Website of the St Lucia VAT Office.

[15] Website of the St Lucia VAT Office.

Nor is a four-year implementation programme unusual; Jersey began drawing up their detailed VAT proposals in September 2004 and published the draft law in March 2006, but did not implement the new tax until May 2008.

Despite all this work over four years, the introduction of VAT in St Lucia still had to be postponed for the vitally important hotel sector.[16]

The St Lucia scheme has not yet been running for long enough to judge its impact, but there are already strong concerns that it is damaging local manufacturing.[17] In addition the predicted increase in tax revenues from the VAT have not materialised; indeed the VAT is collecting slightly less tax than the systems it replaced.[18]

Malta

Another useful case study on the introduction of VAT to small islands is Malta, which introduced a VAT in 1995 but then repealed it in 1997.[19]

The reasons given for the repeal were:

[16] "St. Lucia delays VAT implementation for hoteliers", The Jamaica Gleaner, 8th October 2012.

[17] "St Lucia manufacturers blast the VAT", The Jamaica Gleaner, 15th October 2012.

[18] Statement from the Office of the Prime Minister of St Lucia, 5th December 2012

[19] Bodin, Ebrill, Keen & Summers, "The Modern VAT", IMF, 2001

1) that the reality of Malta's economy was that the VAT was mostly being collected on imports, and so that it was in effect functioning as a disguised import duty;

2) that compliance costs were high, particularly for medium-sized businesses; and

3) that considerable exemptions, reduced rates and zero-ratings were required in order to reduce the disproportionate impact on people with low incomes, and that this made the system much more complex than the previous import duties.[20]

Malta did indeed reintroduce a VAT in 1999, but this was part of its preparations for joining the EU, which it did in 2001.

Customs duties are not permitted within the EU, and VAT is compulsory, so again the motivation for the adoption of a VAT was not the inherent advantages of the VAT but the requirements of a trading bloc.

[20] Government of Malta, "For a Better Tax System", 1997.

Part 3 - Effect on consumers

The biggest effect on consumers will be felt in the retail sector, as prices are increased by VAT.

It has been said that the effect will be minimal, because import duties will be reduced by a similar amount to the VAT rate. However this misses the crucial distinction between import duties and VAT; import duties are charged on the import value, whereas VAT is charged on the resale value.

It is that difference that will make the cost to the consumer of VAT much higher than import duties. Retailers need to add an uplift to cover the costs of distribution and the various costs of operating, heating, lighting and staffing their stores, and so retail costs are typically a multiple of the raw cost of goods.

A further problem for consumers is that VAT will be charged on locally produced goods, and on service, many of which are currently not subject to consumption taxes. Although the overall effect on the economy and VAT revenues from these will be small (see below), the impact on individual businesses and consumers will be greater.

However the impact on locally produced goods and services will depend on which producers are large enough to be over the VAT threshold and so liable to charge VAT. Without that information, modelling the effect of VAT on different groups of consumers will be impossible.

Another important effect on consumers is what items qualify for reduced or zero VAT rates, or for exemption from VAT. This is often part of a government strategy to reduce the impact of VAT on low-income households, by having lower rates on household necessities.

But the distinction between a zero rate and an exemption is very important. With a zero rate there is no VAT in the final price, because the business is able to recover all of the VAT it has been charged on its purchases and expenses. However with an exemption the business is unable to recover the VAT on its purchases and expenses, and so its costs are increased. The business will have to pass that increased cost on to its customers, and so customers will see costs rising even on goods that are exempt from VAT.

Part 4 – Costs and benefits

VAT is a notoriously complex tax, and although some VATs are more complex than others a certain degree of complexity is unavoidable because tax is collected from every business and also refunded to every business within the system:

> *"One charge commonly levelled at the VAT is that it is an intrinsically complex tax, cumbersome to both the authorities and the taxpayer"*[21]

To put this in perspective, the cost for the UK government of administering VAT is (for each pound of tax collected) similar to the cost of corporation tax, and over twice the cost of collecting social security contributions.[22]

The costs of VAT administration for businesses are more difficult to measure, although one study by the UK Parliament found estimates:

- for small businesses the cost of VAT compliance is almost 1.5% of turnover (that is merely the administrative costs, not the costs of the VAT itself);

[21] Bodin, Ebrill, Keen & Summers, "The Modern VAT", IMF, 2001

[22] HM Revenue & Customs, Business Plan data summary, October 2011.

- small businesses spend an average of 1.8 hours per week dealing with VAT administration.[23]

In most cases historically a VAT is introduced to replace a great number of specific sales taxes, import duties and so on, and so the administrative costs of the VAT have to be weighed against the advantages of abolishing these.

However for TCI these existing taxes are few and simple, and so the cost savings from abolishing them will be small. In addition import duties will not be abolished, merely reduced, and so there will be no administrative savings there.

Overall the expectation is that a VAT is likely to increase administrative costs for both government and business, because a few simple taxes will be replaced by a much more complex one.

On the revenue side, the analysis of the TCI economy (see part 5, below) suggests that additional revenues will be small. Major sectors are already covered by existing taxes, notably the Accommodation Tax, the Communications Tax and Stamp Duty on land transactions.

It is therefore a question of which is the better way to raise revenue; a general VAT or the current collection of specific taxes.

[23] UK House of Commons Treasury Select Committee, “The Administrative Costs of Tax Compliance”, HC 269, May 2004.

Part 5 - VAT and TCI economy

How would a VAT interact with the TCI economy?

The fact is that there is relatively little in the TCI economy that would be taxed under a VAT and is not already taxed either through import duties or specific taxes.

Components of the TCI economy

The main sectors of the TCI economy, according to government data, are:[24]

Sector	% GDP
Hotels & restaurants	35
Financial services	13
Construction	8
Owner-occupied housing	7
Public administration	7
Communications	6

Of these:

- The hotel & restaurant and communications sectors are already taxed through simple, long-standing mechanisms;

[24] TCI Department of Economic Planning and Statistics, National Accounts, Table 3, Turks and Caicos Islands, Percentage Contribution of Gross Domestic Product by Economic Activity, 2009 data.

- Financial services are not suited to a VAT, and in almost all VATs are largely untaxed;
- Owner-occupied housing is not taxed under a VAT, and is much better taxed by means of an occupier property tax;
- Public administration is not taxed under a VAT.

So of the six main sectors in the TCI economy, there is only one (construction) that might be better taxed under a VAT.

The full breakdown of the TCI economy is:[25]

Sector	% GDP
Agriculture & fishing	1
Mining & quarrying	1
Manufacturing	1
Electricity & water	4
Construction	8
Wholesale & retail	3
Hotels & restaurants	35
Communications	6
Transport	4
Financial services	13
Owner-occupied housing	7
Business services	1
Other services	4
Public administration	7
Education	3
Health & social work	2
	100

[25] TCI Department of Economic Planning and Statistics, National Accounts, Table 3, Turks and Caicos Islands, Percentage Contribution of Gross Domestic Product by Economic Activity, 2009 data.

We shall take each of these sectors in turn and examine the VAT implications.

Agriculture & fishing, Mining & quarrying, Manufacturing

In total these are 2.7% of the TCI economy.

These will mostly not be taxed under the current system, although they will pay certain general taxes and may be paying import duties on imported equipment (particularly machinery) and consumables (such as fertilizer).

These sectors would be taxed under a VAT, although in the TCI economy it may be that many businesses would be small enough to fall under the VAT registration threshold and so escape tax even under a VAT.

However this is such a small sector that introducing a VAT just for 2.7% of the economy would not seem worthwhile.

There are also questions of government economic policy, which aims to encourage TCI production and diversification of the economy:

> "growth that generates local employment, that is increasingly diversified and that is also spread across all the islands of the country."[26] *TCI Development Strategy*

[26] Turks and Caicos Development Strategy, 2013-17,

There are already reports that VAT in St Lucia (introduced in October 2012) is damaging local manufacturing businesses.[27] If these same problems are seen in TCI, it will make it much more difficult for the government to deliver on its economic diversification strategy.

The current system of duties helps local manufacturers and other domestic businesses, because it only taxes imports and not domestic production. Providing similar assistance to domestic businesses would be very difficult (and impose additional administrative costs) under a VAT.

Electricity and water

In total these are 4.4% of the TCI economy.

To the extent that this is domestic energy, a VAT on these products could be suitable.

However although business use would also be taxed under a VAT, it would be a business expense and so the VAT would be automatically refunded to the customer (provided the business is VAT registered).

Since a third of the TCI economy is the hotel and restaurant sector, it is likely that a large part of the electricity and water use would relate to this sector, and so VAT collected on that would be refunded.

[27] "St Lucia manufacturers blast the VAT", The Jamaica Gleaner, 15th October 2012.

This is also a sector where other policies, particularly social and environmental policies, are likely to be important, and so it is common in other countries to have different tax systems on energy use in order to meet those other policy objectives.

If it is desired to tax this sector, it is therefore likely that specific energy and water usage taxes would be more suitable.

Construction

This is 7.8% of the TCI economy.

This would be taxed under a VAT, although as with energy the VAT on any business construction would be automatically refunded provided the business is VAT registered.

Given the dominance of the hotel sector in the TCI economy, it is likely that a large part of the construction business will relate to hotels and other tourist accommodation, so after business refunds are made, very little VAT will be collected from this sector.

There will also be a strong overlap between major construction projects and land sales, so that a lot of construction operations will currently be indirectly generating stamp duty receipts. If charging VAT leads to a reduction in construction activity, there would also be a reduction in stamp duty receipts.

Wholesale & retail

This is 3.3% of the TCI economy.

Most of this will already be taxed by charging import duties. Items that will not already be caught will be:

- Items on which no import duties are charged (which, if necessary, can be dealt with by reform of the import duty system); or
- Locally produced items, which are likely to be an insignificant part of the economy.

See Part 3 above for more on this sector.

Hotels & restaurants

This is 34.7% of the TCI economy.

This sector is already taxed by way of specific tourist taxes, particularly the Accommodation Tax. If there are some areas which are not caught, that would be easier to deal with by amending the current tourist taxes, since the administrative system is already in place to collect that.

Indeed the tax paid by this sector may reduce under a VAT. Instead of paying import duties and hotel tax, both will be replaced by a VAT. Although VAT will be paid on imported goods at the time of import, because that is then a business expense under the

VAT system it will be refunded to the hotel as input VAT, which does not happen with import duties.

Whether the overall tax take increases or decreases will depend on the precise rates and the ratio of imports to turnover. But if the hotel tax is roughly the same as the VAT rate, and import duties are reduced by roughly the same amount as the new VAT rate, then it is likely that the tax paid by this sector would decrease.

A further problem with hotels is that rooms are generally let a long time in advance, and brochures are often printed a year in advance. To introduce a new tax without a long lead-in time can cause legal, contractual and public relations problems in this very sensitive sector.

Communications

This is 6.3% of the TCI economy.

Although this could be suitably taxed under a VAT, this sector is currently mostly taxed under the Communications Tax on mobile phone calls. It is therefore likely that a VAT will have little or no impact on this sector, except that a relatively simple tax will be replaced by a more complex VAT.

Transport

This is 3.6% of the TCI economy.

This could be suitably taxed under a VAT, although in many VATs there is a reduced rate for public transport for social policy reasons.

In particular, taxing inter-island transport may cause policy issues, with smaller islands being disadvantaged by seeing their costs increase. The TCI Development Strategy includes the goal of:

> *"growth that generates local employment, that is increasingly diversified and that is also spread across all the islands of the country."*[28]
>
> *TCI Development Strategy*

Spreading growth across the country will be more difficult if VAT is added to the difficulties of inter-island transport.

The net tax revenues under a VAT from this sector will be lower than might be anticipated, because currently this sector will be quite heavily taxed through import duties on vehicles and fuel. Once import duties are replaced by a VAT, that VAT will be refunded to the business as business input tax, and so it is only the margin that will generate additional government revenues.

Financial services

This is 13.1% of the TCI economy.

[28] Turks and Caicos Development Strategy, 2013-17,

Financial services are notoriously difficult to tax under a VAT,[29] and with very few exceptions VAT systems do not attempt to do so and simply exempt more or less the whole of the financial services sector.[30]

It is far more practical to continue to tax these businesses by way of license fees.[31]

There would be some extra tax collected from the sector under a VAT, because they would pay VAT on their purchases and expenses which (not being taxable businesses under a VAT) they would not be allowed to reclaim. However they will already be paying import duty on a lot of their equipment (e.g. computers), and so any extra revenues under a VAT are unlikely to be significant.

Owner-occupied housing

This is 6.6% of the TCI economy.

Although it could be possible to tax the annual value of owner-occupied housing under a VAT system, in practice no VAT system attempts to do so.

[29] For an analysis of the problem as it applies to insurance services, see Teather, R., "Financial value added - an analysis of the TCA system for extending VAT to the insurance business", *Journal of European Financial Services*, Warsaw, vol.9, no.4.

[30] The main problem is that VAT needs to be determined at the time of the transaction, at which point it is difficult, often impossible, to know what the profit margin is in order to calculate the VAT charge.

[31] Or some other flat rate alternative to licence fees, see for example Jersey's ISE system for dealing with financial services within their VAT-type tax (known as GST).

This part of the economy is invariably taxed through occupier property taxes.

Business services

This is 1.5% of the TCI economy.

Although this could be taxed under a VAT, it will not generate any net tax revenue. This is because the customers are themselves businesses, so any VAT collected would be refunded (except to the extent that the business customers are not taxable businesses, such as financial services providers).

Other services

This is 3.8% of the TCI economy.

These will mostly not be taxed under the current system, although they will pay certain general taxes and may be paying import duties on imported equipment and consumables.

These would be taxed under a VAT, although it is likely that many businesses in this sector would be small enough to fall under the threshold and so escape tax even under a VAT.

Again, this is a very small part of the TCI economy.

Public administration, Education, Health & social work

This is 12.5% of the TCI economy.

Government functions are generally not taxed under a VAT, and there would be little benefit in doing so since it would be merely a transfer from one government department to another.

In addition it is common for private sector health and education services to be exempt from VAT, to avoid unfair competition with the public sector.

Even if private sector activity is taxed, the amounts are very low; 0.8% of the TCI economy for private education and 0.6% for private healthcare.

Part 6 - Roe Report

One of the forerunners to the proposal for VAT in TCI was the Roe Report, the 2010 tax reform report to the TCI government by Alan Roe.[32]

The Roe Report was not a ringing endorsement of VAT.

Although it did recommend that TCI should move "in time" towards a VAT, it saw several problems with implementing a VAT and did not have enough space to investigate how a VAT should be structured and what form would be most suitable.

VAT and import duties

In particular the Roe Report saw problems in the interaction between a VAT and TCI's existing system of import duties, which:

> *"will need to be addressed with great care in the design of any system that was considered for TCI"*[33]

The preferred option in the Roe Report is for a VAT that will become a "*full replacement*" for import duties, so that "*taxes paid on imports … would be rebated as a credit against any VAT*". That has not happened in the proposed TCI VAT law, which leaves most of the import duties in place.

[32] Roe, A., "TCI Government current and potential revenue sources: an assessment", January 2010.

[33] Roe, A., "TCI Government current and potential revenue sources: an assessment", January 2010.

The very problem that Roe intended a VAT to solve, that there is double taxation by charging both import duties and business taxes (such as the Accommodation Tax), has not been dealt with under the Interim Administration's proposal.

By leaving most of the import duties in place, double taxation has not been eliminated – indeed it has been extended to many more businesses.

Broadening the tax base

The other reason the Roe Report suggested a VAT was to broaden the tax base. Currently, Roe said, only some sectors of the economy are taxed and so those sectors "*bear a higher rate of tax and a higher burden of tax than is strictly necessary*". If a VAT were able to tax more parts of the economy, the tax burden on the currently taxed sectors could be lowered.

However the report overestimates the ability of a VAT to collect tax from new sectors, because it does not deal with the more detailed points above. In fact the scope for collecting VAT from currently untaxed sectors is limited, as we saw in Part 5 above.

The Roe report says that:

> *"A tax such as VAT could potentially extend indirect taxation to important sectors such as Construction (18% of GDP); Transport and Communication (9%); Utilities such as Electricity and Water (4%); Wholesale and Retail Trade*

(4.5%); Manufacturing and Mining (3%) and other Business services (3%).”[34]

However of those sectors:

- Construction (which, on average, is well below 8% of GDP) is in a large part for the tourism industry, and so much of the VAT collected will be reclaimed by businesses;
- Transport & communication is mostly mobile telephone communications, which are already taxed under the Communications Tax;
- Utilities will be partly for business purposes (particularly the tourism sector) and so part of the VAT collected will be refunded to businesses;
- Wholesale & Retail already pay import duties, which will be reduced under a VAT;
- Business services will largely be supplied to VAT-registered businesses, and so the VAT collected from this sector will be refunded to its business customers.

The only sector where significant extra tax could be collected would be domestic energy and other utilities, but for those a specific utilities tax would be much easier to administer (and social and environmental policy issues would need to be considered).

[34] Roe, A., “TCI Government current and potential revenue sources: an assessment”, January 2010, page 8.

Part 7 - Specific problem areas

This report has not looked into all of the numerous problem areas of VAT, which would have to be dealt with in a properly functioning VAT system.

Whilst not an exclusive list, these would generally need to include:

- The administrative system, particularly the interaction with input taxes.
- The VAT treatment of land and buildings, a notorious problem area.[35] This will be particularly important in TCI because of the importance of stamp duties as a source of government revenue, and the risk of damaging stamp duty revenues if the VAT system discourages land transactions.
- The range and scope of exemptions (particularly for financial and government services) and the treatment of partially exempt businesses (including on the purchase of capital assets).
- Procedures for special business classes, including imports and exports, VAT grouping for groups of companies, and those dealing in second-hand goods.

These are all areas where taxpayers and administrators have difficulty, but need to be in place and understood before the system is implemented.

[35] For a typical example of the problems of VAT with land transactions, see Teather, R., “Reverse Premiums and VAT – return to the beginning” *British Tax Review*, Sweet & Maxwell, London, 2004, pp. 37-45.

A few of these issues are notoriously difficult, and so are examined below.

Administration

A VAT requires much higher levels of bookkeeping and record keeping than other taxes.

This will require trained staff, i.e. staff who are trained in good bookkeeping practice and also trained in the specifics of TCI VAT law. It will also need trained staff in the tax office. Unfortunately in a small island jurisdiction such as TCI it is far from certain that there will be sufficient trained and qualified staff to deal adequately with these matters.

The rapidity of the introduction of VAT will have made it difficult for smaller business owners to have digested the VAT law, worked out how it applies to their business, designed processes and administrative systems to comply with the law and trained their staff in how to operate them.

An additional problem in TCI will be the lack of 'off the peg' computer software. In the UK there are plenty of available accounting software packages to help businesses manage VAT, but the market in TCI is likely to be too small to any specific TCI VAT systems to be developed. This will further increase costs.

VAT returns

A related administrative issue is VAT returns. Clearly the more frequently these are required, the greater the cost of preparing them (for businesses) and processing and checking them (for the tax authority).

In the UK only a very few businesses complete monthly tax returns; most do quarterly returns and the smallest businesses only have to submit a single annual VAT return once a year.

TCI appears to have adopted a monthly system for all VAT-registered businesses, and so the cost of collecting and administering VAT will be even higher than it is in the UK.

VAT groups

One important feature of a well-designed VAT system is the ability to form VAT groups. This allows several connected companies to be treated as a single taxpayer for VAT purposes, so:

- There is only one VAT return for each period, rather than one for each company, and so the administrative cost is reduced (for both taxpayer and tax collector); and
- There is no charging and reclaiming of VAT between members of the same group. If there is no facility to form VAT groups, then whenever one group company sells to (or provides services for) another, there is a VAT charge from the first

company that is then reclaimed by the second company. A VAT group, because it treats all the companies in the group as a single taxpayer, ignores these “intra-group” transactions.

To have a VAT system without VAT grouping not only increases the administrative cost but it also loses the neutrality of a VAT. Without VAT groups then a business carried on by several companies will have higher VAT costs than one carried on by a single company, and so some businesses will be disadvantaged just because of their corporate structure.

Tourism

With hotels and restaurants accounting for 35% of TCI GDP, and presumably other tourism spending recorded under other categories, the tourism sector is hugely important to the TCI economy and employment.

Issues that will need to be addressed include:

- The effect of increased costs on tourism numbers, particularly in the current difficult economic climate.
- As we saw above with the retail sector, import duties are charged on raw material costs, but VAT is charged on the full price to the customer (i.e. including a mark-up to cover the other business costs and expenses). This means that prices can rise by more than the VAT rate, and will rise even if import duties are reduced by the same percentage as the new VAT rate.

- The transitional problems of customers who have booked at a pre-VAT rate, and of customers who try to book using a pre-VAT brochure.
- The specific TCI problems of the tourism condo apartments. Many of these are owned by individual investors, many from overseas, and the administrative cost of dealing with large numbers of monthly VAT returns will be huge. In addition where individual apartments are managed collectively there will be cross-charges between the owners and the manager, which will be subject to VAT.

These problems are likely to discourage future investment in new tourism developments, particularly by non-TCI investors who will find the TCI VAT system more difficult to deal with.

Administration and enforcement

The impact of VAT on business administration is huge, and the administrative costs of dealing with VAT are significant for businesses and government.

As has already been pointed out, this will require additional recruitment and training, and it is not certain where the additional recruits, or the time to train them, will come from.

Unfortunately this means that some businesses will fail to comply with the new VAT laws. Some will make honest mistakes, some will struggle because of lack of training or of suitable staff, and others may simply decide to ignore the whole system and operate illegally without registering for VAT.

For this reason new tax systems are generally accompanied by a ‘light touch’ enforcement regime for the first few years, with the emphasis on checking VAT returns and educating businesses in their legal obligations and encouraging them to register.

The problem is that such an approach requires well-qualified, well-trained staff, which (as discussed above) are likely to be difficult to recruit in a small population such as that of TCI.

Transition

There are also problems of the transition from the old system to the new one, and a lot of transactions are likely to be double taxed.

Any goods in stock at the implementation date will be subject to VAT when they are sold but will also have been subject to the full rate of import duty when they were imported. Usually under a VAT system the VAT charged on import will be refunded by being offset against the VAT due on the sales, but that does not happen with import duties.

There should therefore be a transitional scheme for treating part of the import duty on pre-implementation imports as being VAT and so allowing it to be refunded.

Part 8 - Timing

As has been explained above, VAT is an administratively complex tax and is unlike anything that has been charged in TCI before.

Business owners will need to digest the VAT law, apply it to their business and deal with any specific problem areas that relate to them, and then design processes and administrative systems to comply with the law, issue VAT invoices and keep records.

With TCI having a unique VAT law and a small population, computer software to deal with TCI VAT will not be available and so computer systems will have to be individually designed.

Once the revised systems are in place, businesses will need to recruit and train staff and train existing staff in how to operate them.

In parallel, the government will have had to set up a whole new department to deal with this new tax, and design systems for processing tax returns, collecting payments, checking returns and dealing with taxpayers. Then staff will need to be recruited and trained to do this.

To ensure that taxpayers are treated consistently and fairly, there will need to be common procedures and staff manuals, otherwise different tax office employees will be giving different answers to the same questions.

The rapidity of the introduction of VAT will have made it difficult to comply with all of this by the proposed implementation date.

As we have seen above, both Jersey and St Lucia have introduced a VAT in the last few years, and both had a four-year implementation process.

Most of the preparatory work cannot start until the legal structure of the tax is known. What is taxable and what isn't? What input VAT can be recovered and what cannot? How does the business capture what data to ensure that both charges and claims are correct? The business process system cannot be designed until it is known what information is needed.

In the light of this experience, the proposed implementation date appears to be far too soon for either businesses or government to prepare adequately.