

**GST POLICY PAPER TO THE
HONOURABLE MINISTER OF
FINANCE, DEVELOPMENT AND
ECONOMIC PLANNING**

(1)

List of contents

| <u>Part</u> | | <u>Page</u> |
|-------------|--|-------------|
| 1 | Overview of the Paper | 3 |
| 2 | Registration Threshold | 4 |
| 3 | Tax Rate | 7 |
| 4 | Tax Periods and Returns | 13 |
| 5 | Interest and Penalties | 15 |
| 6 | Repayments and Refunds | 17 |
| 7 | Treatment of Capital Items/Deferral Scheme | 20 |
| 8 | Conclusion | 23 |

1.0 OVERVIEW OF THE PAPER

This paper is the first of three papers lined up to be forwarded to the Honourable Minister of Finance and Economic Development on GST policy issues over the next three weeks. The papers seek to present to the Minister an objective evaluation of policy options on the key issues in GST design and implementation. They also put forward the policy options recommended by the Project/GST Oversight Committee (PGOC) after series of working sessions and deliberations.

This first paper covers the following issues:

- Registration threshold;
- Tax rate;
- Taxable periods/returns;
- Interest/penalties;
- Repayments/Refunds; and
- Treatment of capital goods

We look forward to the Minister's decisions that will be incorporated in to the draft GST Bill that will be forwarded to the Minister for onward submission to the Law Officers Department.

2.0 REGISTRATION THRESHOLD

2.1 Introduction/Overview

The GST registration threshold is the level of annual taxable turnover set in the GST law as the dividing line between businesses that must compulsorily register for GST and those not obliged to register for GST. The latter could however be granted the option of registering voluntarily.

There are three aspects of the registration threshold. The first is whether to have different thresholds for goods and services; the second is what the level the threshold should be; and thirdly whether voluntary registration should be allowed.

2.2 Differential thresholds vs. Single Threshold

Differential threshold for different sectors normally involves setting one level of registration threshold for the service sector operators and another for others.

This approach is normally defended on grounds of there being a gap between the average value added in the service sector and the goods sector. In general, businesses in the service sector such as restaurants and hotels are known to have wider margin of value added relative to firms in the distribution sector for example. This leads to businesses engaged in the provision of services generally having lower input tax claims relative to their output tax.

In the example below, the hotel operator procuring taxable inputs amounting to just 20% of its output ends up accounting for as much as Le 12M p.a. to NRA as compared to the large retailer of goods whose taxable inputs constitute 70% of sales and accounting for only Le 9M p.a. to NRA in spite of its turnover being double that of the hotel operator.

| | In Millions of Leones | | | |
|--|-----------------------------|-----------------|----------------|---------------------|
| | Turnover/Taxable Sales p.a. | Output Tax p.a. | Input Tax p.a. | Payment to NRA p.a. |
| Large Retail of Goods (e.g. supermarket) | 200 | 30 | 21 | 9 |
| Hotel Operator | 100 | 15 | 3 | 12 |

It is the phenomenon illustrated in the table that is cited as the justification for setting a higher threshold for the goods sector and a lower for the service sector.

In practice however, the setting of differential thresholds comes with a number of difficulties:

- There is a thin line between descriptions of supplies. Having different thresholds will cause classification problems.
- It is common business practice to supply some goods with services. Separating the goods element from the services element is difficult.
- Additional administrative and compliance complexity caused by mixed activities.

In the face of the problems associated with setting different thresholds most GST systems operate on a single turnover threshold defined across the board for all sectors. Indeed, it is best practice that a single threshold is used for all types of supplies.

2.2.1 Recommendation:

*It is recommended that a **single threshold** defined on the basis of annual taxable turnover is adopted.*

2.2.2 Justification/Basis of Recommendation:

The overriding need for a GST that is easy to administer dictates that a single registration threshold be adopted.

2.3 Level of threshold

It is always important from the onset to get the registration threshold right. Most countries have struggled because of the failure to set a threshold that would produce a manageable number of taxpayers. The level at which the threshold is set determines the following:

- The number of taxpayers.
- The number of tax officers to administer GST.
- Resources required for administration, training, audit, compliance, return processing etc.
- The level of taxpayer compliance.
- The magnitude of the taxpayer education task.

There is a choice between a high threshold and a low threshold. The optimum level will depend on the following factors:

- The capability of a tax administration to handle the numbers of taxpayers registered.

- The record keeping practices, capabilities and tax understanding of businesses will vary from country to country as will the nature of trading.

A low threshold has the potential of bloating the GST register and bringing in traders that lack the capacity to keep records and file returns on a timely basis.

A high threshold on the other hand will tend to limit the number of registered GST taxpayers to a manageable level; and ensure that only taxpayers with a fairly high capacity to comply are registered.

2.3.1 Recommendation:

It is advised that a manageable number of taxpayers are targeted for GST administration at its introduction and as staff skills and competences improve more taxpayers will become registered.

*A relatively high threshold of **Le 200 Million** is recommended.*

2.3.2 Justification/Basis of Recommendation:

At the recommended threshold the number of taxpayers expected to register for GST is between 1,500 to 2,000 taxpayers.

NRA considers the relatively low taxpayer population of 1,500 to 2,000 important for successful launch of GST for the following reasons:

- *Unfamiliarity of taxpayers and NRA with real self-assessment.*
- *Low NRA administrative capacity particularly in the areas of taxpayer services and audit.*
- *Very poor taxpayer education and compliance behaviour.*
- *Experience shows that the largest few hundred taxpayers may account for around 90% of revenue.*
- *NRA can probably not cope with more than 2,000 taxpayers in the first years.*
- *An initial threshold of Le 200 million (US\$66,000) is appropriate in the Sierra Leone context, international experience, and regional (ECOWAS) average.*

2.4 Voluntary Registrations

Voluntary registration provisions in GST legislations provide a window for businesses that do not meet the registration turnover requirements to offer themselves to be registered for GST.

The principal motivation for voluntary registration is normally the need for the medium or small business to retain the custom of a bigger GST registered business that insist on procuring only from a GST registered

business capable of issuing GST invoices. This way the big business is able to recover the input tax embedded in the price at which the medium/small business sells its products.

However, allowing voluntary registrations comes at a price. There is a tendency for the register to be bloated by these voluntary registrations and these businesses generally do not have as high a capacity to comply as those above the threshold. This puts a strain on resources (e.g. audit) required to administer the tax.

The other drawback is that some businesses may voluntarily register just to enable them to claim input tax on a one-off high value transaction and then disappear, particularly in a GST jurisdiction that allows refund of excess input tax.

2.4.1 Recommendations:

- *The PGOC recommends that voluntary registration is provided for in the GST legislation.*
- *Having provided for voluntary registration, it is important Sierra Leone resists the temptation to make registration for GST a necessary requirement for making supplies to Government MDAs.*

2.4.2 Justification/Basis of Recommendation:

- *Without the voluntary registration facility medium/small businesses whose survival depends on their supplies to a few big businesses may lose the patronage of GST registered business and possibly fold up.*
- *Insistence that Government MDAs procure only from GST registered businesses will have the unintended effects of bloating the GST register and complicating the administration of the tax as experience in Ghana and Kenya have shown.*

3.0 TAX RATE

3.1 Introduction/Overview

The rate or rates at which GST is levied is perhaps the most debated policy issue on the agenda of GST introduction. It is the one issue on which views are most divergent between policy makers and tax administrators for whom revenue is an important concern and consumers who will bear the incidence of the tax. There are basically two key aspects to the issue of rate i.e. whether to introduce a multiple rate or a single rate and the levels at which rate must be applied.

3.2 Single Rate vs. Multiple

GST may be operated on a single rate or multiple rates in addition to a zero rate which is applied to exports in almost all GST systems.

3.2.1 Single rate

Principal among the arguments in favour of a single positive rate are:

- (i) **Simplicity of administration**
Deviation from single rate imposes greater administrative costs on the tax authorities and higher compliance costs on traders. Rate differentiation generally requires more information on tax returns (e.g. values of supplies and purchases disaggregated for each of the different rates). Under single rate, the GST forms are much less complicated and less information is required.
- (ii) **Ease of compliance**
Single rate is more consistent with the goal of establishing a tax system which is simple to understand and easy to comply with. Cases of error on the part of traders in computation and recording of the tax is minimized.
- (iii) **Misclassification**
The potential for evasion through deliberate misclassification is minimized under single rate.

There is a worldwide trend towards the unification of tax rates with the ultimate goal of edging closer to single rate. The reduction in the number of rate brackets for income tax and the decrease in the number of customs duty rates over the past decade attest to the value of the unified tax rate.

- (iv) **Interest Groups**
Single rate provides less incentive for interest groups to lobby or petition for reclassification of products or re-definition of the coverage of GST rates.

The main argument against a Single rate is that it is perceived to lack adequate scope for addressing social concerns or mitigation of regressivity.

3.2.2 Multiple Rates

Arguments for:

Arguments employed to back the choice of multiple rates include the following:

- (i) **Scope for meeting social ends**
Multiple rates are perceived to permit the application of a low rate to supplies considered as basic necessities and a higher rate for luxuries in addition to a standard rate. It is therefore considered more flexible for fashioning a tax that meets peculiar social and political needs.

Arguments Against:

- (i) **Costly administration**
A multiple rate system is more costly to administer as tax officials have to expend more materials, time and effort on field audits.
- (ii) **Incentives for evasion**
Invariably the introduction of a lower rate for some category of items calls for a higher rate on others if the same level of revenue is to be raised; but a higher rate of GST provides stronger incentives for evasion.
- (iii) **Weakens the signals of evasion**
Under a single rate GST, persistent repayment position is the most ready signal of evasion and manipulation on the part of non zero-rated taxpayers as output tax is expected to exceed input tax over extended periods. Repayment position is an indication of negative value added (i.e. business losses) where inputs and outputs are taxed at the same rate.

Under a multiple rate regime, however, the average rate of input tax could be higher than that for output tax. Permanent repayment (i.e. refund) position is therefore conceivable even for a non zero-rated taxpayer and does not signal an unusual situation. This presents opportunities for malfeasance and manipulation of books for evasion.

While multiple rates are perceived to offer flexibility for discriminating between luxuries and necessities, the complexity and high cost associated with compliance and administration of multiple rate GST regimes make it an unattractive option.

3.2.3 Recommendation:

It is recommended that GST in Sierra Leone is introduced at a single rate. Single positive rate (in addition to zero rate) is by far the most popular policy choice for GST worldwide.

3.2.4 Justification/Basis of Recommendation:

- *The use of single rate simplifies taxpayer books and invoices, and eliminates the need to open separate records for purchases and sales depending on the rate to be applied*
- *The use of single rate facilitates GST audit*
- *Helps limits the number of refund claims to, essentially, exporters and enterprises purchasing a large amount of capital goods*
- *That rate differentiation creates incentives for deliberate misclassification of items*

3.3 Rate Level

Four key issues impinging on or informing the determination of GST rate in Sierra Leone could be identified as follows:

- the revenue expectations of government;
- the offsetting impact of proposed exemptions; and other features of GST;
- the rates of existing tax instruments that are to be replaced by GST;
- the need for the rate to be broadly in line with those countries in the ECOWAS region, given possible future harmonization of GST rates within this region.

3.3.1 Revenue Expectation

For a post conflict engaged in rebuilding of physical and social infrastructure, the need for revenue to finance reconstruction and to do so at an increasing rate in order to wean the national budget of donor funding support cannot be ignored in such a major tax reform initiative as the design and implementation of GST.

The rapid growth in the annual revenue targets handed down to NRA over the past four years that the Authority has been in existence is symptomatic of the swiftly growing revenue requirements of the governments. It goes without question therefore that the decision on GST rate would take into consideration the potential revenue yield. While revenue neutrality in the inception year of GST may be accepted as a one-off loss of the average year-on-year increases over the past four years, GST would be expected to be a vehicle for enhanced revenue mobilisation in the medium and long terms.

The rate level being one of the key determinants of revenue would be decided with this in mind.

3.3.2 Offsetting impact of exemptions and other features of GST

At a given rate of tax and administrative resources the most important determinant of GST revenue is the range of goods and services on which the tax is chargeable; which in turn depends on the scope of exemptions; zero-rating and reliefs. Exempting or zero-rating of a wide range of goods and services necessitating a higher rate of tax to produce any given level of revenue requirement. Conversely, fairly high revenues could be raised at a low GST rate if the scope of exemption, zero-rating and reliefs was severely restricted.

In Sierra Leone, the switch from sales tax and a range of service taxes to GST will involve two significant innovations. First is the extension of the reach of sales tax from the point of importation and factory gate through the distribution chain to the retail level. Secondly, cascading of tax inherent in the current sales/service tax regime under which the Messages Tax and the Restaurant & Food Tax, for example are charged on prices into which have been built irrecoverable sales tax paid on inputs. With the inception of the invoice credit GST which will allow full recovery of input tax the unintended (nevertheless windfall) revenue from cascading of tax under the current system will be lost. In effect it would not be completely unexpected if mobile phone network providers end up accounting for less revenue to NRA for the same level of sales following the inception of GST which will allow them to take credit for input tax.

On the other hand, the extension of the domestic indirect tax system to the retail level that will come with GST introduction will have the effect of capturing into the tax net for the first time in Sierra Leone the value added in the wholesale and retail sectors.

At the net revenue impact of the input tax recovery facility and the extended reach of domestic indirect tax in the production-distribution chain is not clear, decision on the rate at which GST will be introduced does not have to be made on the supposition that the adoption GST will by itself

lead to automatic revenue increase even if it is applied at a rate well below the average of the taxes it is meant to replace.

3.3.3 Rates of Existing Tax Instruments

In Sierra Leone, GST is to replace the existing domestic and import sales tax (15 percent), the restaurant and food tax (10 percent), the message tax (10 percent), the entertainment tax (10 percent), the hotel accommodation tax (10 percent) and the professional services sales tax (10 percent).

3.3.4 Rates of countries in the Sub-Region

The table below indicates that ECOWAS member countries implementing GST use a single rate ranging from as low as 5% to 18% with an average rate of 15%

Table 1: Sierra Leone: GST Rates in the ECOWAS Region

| ECOWAS Members ¹ | GST Rate % |
|-----------------------------|------------|
| Benin | 18 |
| Burkina Faso | 18 |
| Cape Verde | 15 |
| Côte d'Ivoire | 18 |
| Ghana | 12.5 |
| Guinea | 18 |
| Mali | 15 |
| Niger | 18 |
| Nigeria | 5 |
| Senegal | 18 |
| Togo | 18 |

Source: IMF (2007)

¹Three members do not yet have a GST – Gambia, Guinea-Bissau and Liberia

In the absence of reliable data on which to carry out simulation on the levels of revenue derivable from GST at varying rates, reference could be made to a study reported by FAD policy mission to Sierra Leone in 2004. The study estimated that GST at a rate of 17.5 percent would increase revenue as a percentage of GDP by 2.9 percent; at a rate of 15 percent by 1.9 percent; and at a rate of 12.5 percent by 0.9 percent, **although these estimates must be updated.**

3.3 Recommendations: *The current PGOC proposal is for a GST rate no higher than the current sales tax rate of 15%.*

3.4 Justification/Basis of Recommendation:

The justifications for the selection of 15% include the following:

- *Ties in with comparable GST/VAT rate in West Africa countries i.e. 15%*
- *Expected to be revenue neutral in the first year and in time produce an increase of 1.9% of GDP*
- *Will make for easier compliance and administration*
- *It eliminates opportunities for misclassification*
- *Removes the problem of border-line definition*

4.0 TAX PERIOD/RETURNS

4.1 Introduction/Overview

Tax period is the time span for which the taxpayer is required by law to report their tax transactions to the tax authorities. For example if a taxpayer or group of taxpayers are obliged by law to report their tax related transactions for a period of two months (e.g. from Jan 1 to Feb 28; from March 1 to April 30, and May 1 to June 30 etc.) then two months is said to be the tax period. In short the tax period is the period covered by the tax return filed on normal circumstances. It is the tax period that defines the frequency of return submission by the taxpayer. The longer the tax period the less frequent the taxpayer will have to file returns. Since the deadline for payment of tax declared normally coincides with that for submission of returns, the tax period and therefore the frequency of tax payments and return filing tend to coincide.

The key policy issues on tax periods are the number of tax periods that must be defined for the various classes of taxpayers and the length of the tax period(s).

4.2 Single vs. Multiple tax periods

The following options are available:

- A taxable period that will be adopted for all taxpayers.
- Different taxable periods for the different categories of taxpayers e.g. one for large businesses and the other for small and medium sized businesses.

Adopting a single or uniform tax period for all taxpayers has the following advantages:

- The problem of allocating different tax periods to the different categories of taxpayers is avoided.
- Easier for taxpayers to comply. As all taxpayers have one deadline for submission of returns and making payments confusion on the time of return filing and payment is avoided.
- Easy to administer in terms of the tax officers' knowledge that all taxpayers have the same return period.

However, single tax period for all taxpayers ignores the differential ability to comply among the different categories of taxpayers as taxpayers that are less equipped to file returns or on whom return filing impose greater cost relative to their overall level of operation are subjected to the same frequency of returns submission requirements as large businesses.

The option of having different tax periods for different categories of taxpayers has the following merits:

- Workload of processing returns is spread between the different tax periods. This reduces workload of the tax administration in the area of processing returns. The saving achieved in resource utilisation in this respect can be deployed to other functions such as debt management and audit.
- Large taxpayer group's account for a high proportion of tax revenues, therefore having them on a shorter tax period enhances the time value of revenue.
- Medium/small businesses could be put on longer tax period that reduces their compliance costs.
- Medium/small taxpayer groups will have the advantage of holding on to GST funds for a longer period of time; this is a form of provision of finance by the government to these businesses.

4.2.1

Recommendation:

Large Taxpayers administered by the Large Taxpayers Office (LTO) should be put on a shorter tax period than medium/small businesses.

4.2.2

Justification/Basis of Recommendation:

- The time value of the bulk of GST revenue coming from the large taxpayers is preserved with the higher frequency of returns filing and payment by large taxpayers.
- The longer tax period for Medium/small taxpayer groups gives them access to tax revenue for longer period in compensation for the compliance burden of GST.

4.3 Monthly tax period vs. Bi-monthly/Quarterly tax periods

Regarding the span of tax period a decision has to be made as to the length(s) of tax period(s). The choice of the tax period will determine the amount of workload that will be required on the GST Administration to process all returns effectively before the next wave of returns are submitted by taxpayers.

In Africa, the most widely used GST tax period is one calendar month. Adopting a monthly tax period for all taxpayers minimises the cost to government of taxpayers holding on to government funds for a longer period of time.

However, the main drawback of having a tax period of one month is that it puts increased pressure on the returns, payments and accounting functions of the tax administration to deal with all the returns before the next month's returns are filed in.

4.3.1 Recommendation:

The PGOC recommends that the following tax periods for the different taxpayer groups:

- i. Large Taxpayers administered by the Large Taxpayers Office (LTO) should have a tax period of one month.*
- ii. Small and Medium Taxpayers administered by the Small and Medium Taxpayers Office (SMTO) should have bi-monthly tax periods staggered so that half of this taxpayer population will submit returns in alternate months.*

4.3.2 Justification/Basis of Recommendation:

- *Tax period of two months for small and medium taxpayers grants them enough time to put their books together and complete their returns for submission.*
- *Large taxpayers are well equipped to cope with the monthly return filing requirements.*

5.0 INTEREST AND PENALTIES

5.1 Introduction/Overview

The key compliance requirements underpinning the self assessment regime of the GST is the simultaneous filing of returns and payment of the self-assessed tax for a tax period that is normally much shorter than that of income tax. Invariably, the same deadline applies to returns submission and payments of tax owed. For this reason, the very

distinctive roles/functions of the interest charges on the one hand and penalties on the other are not always clear; since the two are usually triggered concurrently by default in returns filing and payment. It is important however, that the role/function of penalties be distinguished from that of interest as this determines the basis for calculating them and the levels at which they ought to be set.

In general penalties are a compliance tool applied as a stick to discourage tax delinquency and non-compliance. Interest on the other hand is meant to preserve the real value of tax revenue.

5.2 Penalties for late filing/payment

GST legislations tend to define separate penalties for failure to file a return and default in payment of the taxes due. For the purpose of ensuring that the sanction is proportionate to the amount of tax unpaid, penalties for late payment are invariably computed as a proportion of the amount of tax unpaid. Typically, the penalty regime for late payment could provide for an initial percentage penalty on the outstanding tax for the first month of payment default and additional percentage point(s) for subsequent months up to a ceiling. It is not uncommon that a ceiling is set for the level to which the penalty may accumulate in order to prevent the penalty from reaching unacceptable levels. Generally, penalty for late filing does not have to bear any relationship to the amount of tax owed, as the failure to submit a return only denies the tax authorities of information for control of the tax. In this respect a lump-sum penalty to discourage the act of non-filing is often considered adequate, even though a case could be made for a proportionate penalty citing the preservation of the real value and therefore effectiveness of the penalty as deterrence to late filing in the face of inflation.

5.3 Interest for late payment

Charging of interest on tax owed at a punitive rate is often defended on grounds of the need to discourage unauthorised use of tax revenue by the taxpayer in preference to borrowing at the market rate. By this argument, punitive interest rates at one and the same time preserve the time value of unpaid taxes and deter the taxpayer from holding on to government tax revenue. In practice however, this fusion of interest and penalty creates an administrative problem. It makes it impossible to isolate and waive the penalty for late payment even where good grounds exist for waiving it. The problem is exacerbated by the fact that in most jurisdictions interest, unlike penalties cannot be waved.

5.4 Recommendations:

Separate penalties should be set for non-filing of returns on due date and non-payment of tax due. Interest should then be calculated at a rate

designed to preserve the time value of the unpaid tax. More specifically the following are recommended:

- (i) A lump-sum penalty of Le 200,000 for late filing.*
- (ii) Interest at the central bank lending rate charged on the unpaid tax.*
- (iii) A penalty calculated at a quarter of the ruling bank lending rate on the amount of tax owed.*

5.5 Justification/Basis of Recommendation:

The segregation of penalties from interest does not only make it administratively feasible and facilitate waiver of penalties when necessary, but also permit interest to be charged at a rate no higher than bank lending rate; thereby avoiding the artificial bloating of tax debt stock caused by charging interest rate with punitive element.

6.0 REPAYMENTS / REFUNDS

6.1 Introduction/Overview

An effective refund mechanism is essential to preserve the GST as a tax on consumption, and to avoid distorting the allocation of resources. Refunds arise in a tax period when input credits exceed output debits.

In respect to Refunds/Repayments, three vital decisions have to be made. Firstly, within which timeframe refunds are to be paid; the category of taxpayers that qualify for a refund; and crucially what arrangements the Ministry of Finance and Economic Development (MOFED) will adopt to make funds available for refunds.

6.2 Timeframe for paying refunds

One of the main principles of the GST system is to capture all output tax but at the same time ensure that all genuine input tax credits are paid on time. If the GST Administration does not pay refunds/repayments on time, they will virtually be holding on to the working capital of businesses.

There are two main categories of refund claims that are to be considered:

- Claims that arise from zero-rated exports; and
- Claims that arise when input tax exceeds output tax during normal business activities such as building up stock and seasonal variations.

Most GST systems worldwide adopt the destination principle (zero-rating exports); this allows the exporter to claim input tax on his inputs and at the same time not charge GST on his exports (output). This makes Sierra Leone exports competitive in the world market.

To support the exporters, the GST administration should ensure that refunds are paid as soon as possible because businesses that are exporting their outputs will constantly be in a constant refund position. If refunds are not paid on time, the businesses will be in a precarious position as their working capital is held up.

Claims arising from the normal business activities also need particular attention. There is a choice between paying these refund claims after six months of the repayment arising; or carrying the repayment forward until the business folds up.

The main demerit of refunding taxpayers within six months of the repayment arising is that the risk of fraud increases as it is common practice for taxpayers to fraudulently claim refunds. However, on the other hand the merit of allowing refund claims to be paid after the six month period aids businesses to grow as their working capital will not be held up by the tax authority in terms of refunds.

In respect to paying the refund claims only when the business folds up is supported by the principle that a business will not continue to trade if its activities are unprofitable. Seasonal variations and building up of stock are only temporal as it is expected that value added will exceed input tax within a short period of time.

The main deterrent of only paying refund claims when the business folds up is that holding on to the working capital of the business for a long period of time will deepen the cash flow problem of businesses and lead to breakdown in activities.

6.2.1 Recommendations:

The PGOC recommends the following in respect of refund periods for the different category of taxpayers:

- i. In respect to zero-rated export businesses, refund claims are to be made within **two calendar months** of the exporter claiming refunds. For the exporter to be eligible, he must export at least 50% of his supplies. Interest should be paid to the exporter if the refund claim is not paid within the time stipulated.*
- ii. In the case of other normal business refund claims, the input tax credit should be carried forward until the business folds up. The taxpayer is to be refunded within **two calendar months** after deregistration.*

6.2.3 *Justification/Basis of Recommendation:*

- i. For zero-rated businesses, the recommended approach will allow them to be able to get refunds within a short period of time. This will increase their confidence in the GST system and improve compliance.
- ii. For other businesses the recommended approach will reduce the risk of having fraudulent claims as when the businesses finally deregister, audits will be undertaken.

6.3 **Funding of GST Refunds**

Considering the vital decision on how refunds will be provided for, there are two main options that have been adopted worldwide:

- A separate **Refunds Account** is set up which reserves a certain proportion of GST collections to enable NRA to pay refunds on time. This proportion reserved is an estimate of the quantum of refunds that will be claimed over a period of time.

This Account will be managed by the NRA as this will expedite the process of refund claim and this arrangement will not be different from the normal administration of GST.

- The second option is for a GST Account to be operated wherein the arrangement will be for all GST collections and Refunds are set off over a period of one month. The balance outstanding at the end of the month will then be transferred to the Consolidated Revenue Fund (CRF).

Considering the first option of having a separate Refund Account comes with the advantage of the tax administration being able to pay refunds on time and the taxpayers being able to get their monies within the times proposed with no interest paid by the Government on late refunds.

However, there exist risks that if proper estimates are not made for refunds payable over a period of time, the account will dry up and refund payments will delay; or government will be deprived of funds if refund payments are over estimated.

Adopting the second approach will be easier to administer as estimates of refund claims does not have to be prepared. However, the disadvantages with the approach are that government will be deprived of tax revenues for a period of one month; and this option will require legislative change.

6.3.1 Recommendation

*The PGOC recommends that the first approach i.e. a **Separate Refunds Account** is adopted.*

6.3.2 Justification/Basis of Recommendation

The recommended approach will allow NRA to pay refunds within the recommended timeframe of within two months of the refund claims. This will favour businesses as the Government will not be holding on to their working capital in the form of refund claims.

7.0 TREATMENT OF CAPITAL ITEMS/DEFERRAL SCHEME

7.1 Introduction/Overview

In its purity as a consumption tax, GST ought to treat capital items in no different way to other purchases on which input taxes are fully paid and input tax credit taken in the period in which the transaction occurred. In practice however, the situation often arises where the outlay on capital items is so huge that, barring refund, it takes several tax periods to generate enough excess input tax credits to offset the input tax relating to the capital item.

To avoid or minimise the cash flow implication of this phenomenon on businesses and the steep troughs and peaks in revenue flows as huge input taxes are paid on capital items and credit taken for them in subsequent tax periods, various schemes have been used.

7.2 The Deferral Scheme and Alternative Options

7.2.1 Disallowing input tax deduction for capital items:

Motivated solely by revenue considerations, disallowing credit for input tax on capital items does not only contradict the basic tenets of GST as consumption tax, but also vitiates the benefits of transparency and removal of tax cascading and tax bias from investment decisions.

7.2.2 Spreading recovery of capital related input tax over a number of tax periods:

By this, input tax on specified capital items (e.g. plant and equipment in the case of Spain) is recovered as input tax credit over a defined number of tax periods.

7.2.3 The deferral scheme

The deferral scheme is one of the most widely recommended mechanisms for relieving the cash flow problems encountered by GST registered businesses when they acquire capital items in furtherance of their taxable activities. By this, capital item-related input tax incurred by the GST registered business is computed but payment suspended until credit is taken for it on the next return.

The main characteristics of the scheme are as follows:

- The scheme is limited to registered GST taxpayers who import large items of capital goods.
- Capital goods (both imported and domestic) are subject to the standard rate of GST.
- Imports of capital goods by persons who are not registered GST taxpayers are subject to GST at the time of import. GST is paid, as usual, before clearance of the goods.
- Importers of capital goods who are registered GST taxpayers are permitted to defer accounting for the GST liability until their next return is filed.
- In this return, the GST applicable to those goods is reported as a GST liability and, in the same return, the GST input tax credit is claimed for the capital goods.
- If the importer is entitled to 100 percent input tax credit (equipment used exclusively in taxable activities) the GST applicable to the importation, reported as a liability, will be completely offset by the corresponding input tax credit.

Key among the strengths of the deferral scheme is the scope it affords for tackling the liquidity squeeze that payment of input tax on capital items imposes on businesses under the invoice credit GST, while ensuring that capital items remain taxable.

In the Sierra Leonean situation taxation of all capital items with the deferral scheme as mitigation of its impact on GST-registered businesses, means that on commencement of GST, medium and small-scale operators not registered for GST will be confronted with paying GST on their capital items.

The deferment scheme could also be an incentive for medium/small businesses to offer themselves for voluntary registration in order to benefit from relief from GST on capital items. This is particularly true for medium/small businesses in the process of setting up or in expansion (i.e.

capital acquisition) mode. The deferment scheme could therefore have the unintended effect of heightening the risk of the GST register being bloated.

Finally, the administration of the deferral scheme is not entirely simple nor is it risk free. Like every dispensation requiring administrative decision on who qualifies for it and who does not, the deferral scheme requires vigilance to prevent abuse.

7.2.4 Exemption of Capital Items

Exemption of basic capital items such as plant and machinery allows businesses to acquire selected capital items without payment of GST, thereby avoiding the cash flow difficulties that attend payment of input tax on the specified items covered by the exemption. This requires a clear definition and identification of the “basic” or generic capital items, raising classification problems. While identification of individual capital items in the Harmonized Systems (HS) Commodity Tariff could mitigate the problems, it does not completely eliminate them. Multiple end-use items such as computers cannot be brought into the list of capital items qualifying for exemption.

The negative impact of exemption on local manufacturers is perhaps the greatest drawback of the policy option of employing exemption to relieve the cash flow difficulties associated with capital acquisition under GST. While imported capital items qualifying for exemption under such a scheme will be admitted wholly free of tax, locally manufactured substitutes will be burdened with irrecoverable input tax, putting them at competitive disadvantage.

On the other hand, exemption of capital items, even if restricted to only plant and machinery has the advantage of benefiting not only the large and medium businesses registered for GST, but also the small scale operators that are most susceptible to cash flow difficulties.

In the Sierra Leonean situation, exemption of selected capital items as a means of mitigating the cash flow impact of input tax on capital items, provides scope for aligning the list of exemptions to the current list of capital items exempt from Sales Tax. This will minimize the shock of GST introduction to small scale businesses in the acquisition of capital items.

7.3 Recommendation

It is recommended that the deferral scheme be adopted to relieve GST registered businesses of the upfront payment of input tax on capital items which may impose on them undue liquidity squeeze.

7.4 Justification/Basis of Recommendation

The deferral scheme tackles the liquidity problems that payment of input tax on capital items imposes on businesses under GST, while ensuring that capital items remain taxable.

It would also moderate the erratic spikes and dips in revenue trends caused by payment of GST on higher capital items in one period and recovery of the same amount in the next tax period.

8.0 CONCLUSION

While effort has been made to cover the key issues considered important in arriving at decisions on the topics covered in this paper, it is not intended that the paper be a substitute for a meeting of MOFED with the technical team of the NRA for discussion to clarify issues touched on or not covered.

The next paper scheduled for submission to the Minister on 22nd February 2008 will cover the following issues:

- Coverage
- Exemptions
- Zero rating
- Diplomatic and other Reliefs
- Treatment of Supplies to Government