

Considerations for a revision to the Tax Ordinance

Preface

This document does not address details – that is, it does not include suggested levels of taxation, or of tax band boundaries, or of tax allowances or any such like. Neither is it particularly focused on the personal taxation arrangements that interest the general public in the main.

Instead, this document proposes a set of structural goals for taxation that would attempt to address some of the pressing concerns for private enterprise on St. Helena. It is hoped that any review that is undertaken by Legislative Council will recognise the importance of handling taxation issues for the private sector in a positive way, in an effort to protect the existing, albeit small, private sector and stimulate its growth, rather than sidelining the issue as a uncomfortable complication. This document is intended to help a taxation review body understand the needs of the private sector and to help them arrive at an equitable solution that achieves goals.

Introduction

A system of taxation for the private sector offers a range of possibilities along a number of different dimensions. One of the criticisms of the current Tax Ordinance is the high level of complexity, which has been designed-in despite the fact that there are less than 4000 inhabitants, with probably fewer than 2500 active participants in the workforce, and really only a handful of private sector businesses, most of which are sole trader or informal partnerships. Yet it is equally clear that any one-size-fits-all proposal would be grossly unfair and probably doomed to failure. The trick is, therefore, to get the balance right.

First of all, the different sizes of organisation will have different needs. Secondly, the phase in its lifetime will be an important factor. Thirdly, the type of operation will make different aspects more important than others.

Size of organisation

The different sizes of organisations occupy a continuous spectrum, but the following divisions have traditionally been used, and for good reasons:

- Unregistered self-employed
- Sole trader (or informal partnership)
- Small to Medium Enterprise
- Large Enterprise

It can be realistically argued that there are no Large Enterprises on St. Helena. This is not strictly true, however – it is simply a matter of defining “Large” to be significantly smaller than in larger economies. This document works on the principle that an enterprise is Large if there are sufficient employees to warrant the engagement of a person tasked solely with personnel, payroll or accounting issues (i.e. as opposed to a single person who completes all administrative tasks)



Phase within the lifetime

A company's needs are different depending on its lifetime phase. A company that is just starting-up has different needs to a well-established company growing its market share. The following phases should be considered:

- Start-up (local)
- Start-up (inward investment)
- Established (potentially growing or shrinking)
- IPO¹ or sale
- Wind-up or sale

Type of operation

It is possible to categorise the types of operation in a multitude of ways, but in the main, they will have little dissimilarity when it comes to tax considerations. However, the following categorisation is deemed of importance here:

- Service Provider
- Manufacturer or Producer
- Retail or Wholesale

Of course, there are many subdivisions within these categories, but even identifying them would not necessarily be fruitful.

¹ IPO – Initial Public Offering – i.e. turning a private company into a public company by selling shares on the open stock market for the first time.



General concerns

The Chamber believes that the recently introduced Tax Ordinance is excessively complicated and cumbersome for a population and workforce of the size on St.Helena. It is clear and accepted that tax liabilities should be fair and equitable among the private sector organisations, but what is fair and equitable is not at all clear in the current ordinance.

If there is a shortfall between income and expenditure, a private sector organisation has two choices: either, to increase income (by selling more, or by increasing prices) or to reduce expenditure (by doing less, by lowering bills, or by becoming more efficient). The St.Helena Government have similar options. The new Tax Ordinance appears to be an undisguised attempt to maximise revenue without a political aim in mind (other than to maximise revenue!), and fairness and equitability appear to have been of little or no concern.

Further, none of the other options to maximising revenue from within the existing tax base appear to have been contemplated. Instead of simply increasing revenue in this way, SHG should consider:

- a. Sell more i.e. Increase demand for revenue-earning services. SHG could have given primary focus to stimulating economic development and therefore the private sector, so that revenues are increased indirectly through increased demand, rather than extract additional revenue from the current market
- b. Do less SHG might have also decided that it is spending too much, and therefore cut spending (as is the case currently in the UK and Europe) so that additional tax revenues are less necessary
- c. Lower bills SHG might have noted that it is paying over the odds for some services and reduced expenditure on these items
- d. Efficiency SHG may determine that some of its own expenditures are not providing value for money and set about improving productivity and reducing expenditure in this way.

Instead of these options, SHG simply opted to raise prices (i.e. extract more revenue from its existing customers). The Chamber feels that the tax changes are not fair, not equitable and definitely not a long-term survival strategy for St.Helena.

It seems to the Chamber, that SHG are eager to maximise revenues while burdening the private sector with additional tax-collection duties (the cost of which must be paid for somehow). This alone is an inflationary step.

The Chamber's view is that the stimulation of the private sector is of paramount importance to the long-term health of St.Helena. This Tax Ordinance contains nothing that can in any way be described as stimulation of the private sector. Indeed, many provisions are repressive, and the Chamber urges the SHG to make changes to the Tax Ordinance to address these concerns.

One radical option might be to:

- a. Scrap income tax, withholding tax, capital gains tax altogether
- b. Set Customs duties to a level which generates the required revenue

This is an option worth investigating further, as it would reduce the SHG administration costs of tax collection to virtually nothing, would stimulate local workforce, since every penny earned would be retained, and would support import-substitution products (since importation would become more expensive)



Private sector concerns

The Chamber comprises Members, each of which operates some type of business venture in the private sector. Their representatives and employees are also individuals who have their own (very valid) concerns about the Tax Ordinance, but this section is about the private sector organisations themselves, of all shapes and sizes.

Below are some examples of the negative impacts and some serious omissions of the current ordinance. The list is incomplete for the sake of brevity but further examples can be provided if this would be helpful.

Unregistered self-employed

A person who engages in private enterprise, but who is unregistered as a company for tax purposes² is effectively obtaining remuneration for work carried out as if he³ were employed, but on piece-work, hourly or other short-term contracts (even if not documented as such) for potentially many employers.

The standard employed person has his PAYE tax concerns managed for him (except for self-assessment and tax returns) by his employer, whereas a self-employed person needs to manage his own tax affairs completely.

- ❖ Any regulation which requires an employer to submit details of employees must recognise that this type of employee cannot be treated in a standard way
- ❖ A tax regime must recognise that the self-employed rarely see the benefit of spending time and effort complying with tax office requirements, especially when the result will in any case result in total income below any taxable level. [In effect, the current arrangements require such people to keep records, issue receipts, issue tax invoices etc, simply to prove that their income is too low to be taxed.]

A self-employed person does not have the opportunity to identify most expenses incurred in the course of his work as tax-deductible (there are exceptions)

- ❖ A tax regime should widen the scope of self-employed tax-deductible expenses

It should be noted that many people fall into this category even if they are otherwise employed in a standard way. That is, an employed person may very well derive income from other self-employment contract sources as well.

- ❖ A tax regime must recognise that people do not necessarily fall neatly into employment type categories. Unregistered self-employment is common as a sideline activity, but taxation of sideline enterprise (which will occur if cumulated income is considered for taxation purposes) will effectively kill any such enterprise. A tax regime should, instead, encourage these sideline enterprises to become fully-formed private businesses

² This is not the same as registering as a Limited Company in the Companies Register

³ References to male persons (he, him, his) should be construed as implying female persons as well



Sole trader and informal partnerships

To a degree, the plight of the sole trader is the worst of all worlds – yet it is the most common enterprise format on St.Helena. The tax arrangements should be such as to make the start-up and operation of a sole trader enterprise attractive as compared with standard employment.

A sole trader needs to run his business finances separately from his personal finances, with the additional administrative overhead that entails, yet his income is considered, from the tax point of view, as purely personal income. This means that he cannot retain profits within the business for future expansion without it being taxed as income first. Secondly, he cannot claim business losses in one year against profits in following years. In effect, losses are not considered taxable (in a negative sense) while all profits are (in a positive sense).

In a stable or growth phase of a sole trader concern, these situations may not be particularly common, but in the start-up phase, they are almost certain to occur, especially where capital expenditures are required for equipment, stock, infrastructure etc.

- ❖ A tax system must recognise the financial fragility of a sole trader business, especially at start-up and provide tax incentives, including tax holidays, reduced import duties, etc
- ❖ A sole trader must be allowed to offset accumulated losses against profits made in future years
- ❖ A sole trader should be able to consider the administration tasks and preparation of tax documentation as deductible expenses, even if performed by himself, without the ‘payments’ to himself being considered as income.

A sole trader may very well make use of part of his personal living accommodation as a workshop, office or store room. If rent were paid to a third party (or loan repayments made to the Bank), then these payments would be deductible expenses, but if paid to oneself as recompense for the use in a business, the payments are regarded as equivalent rental income, so are not tax-deductible.

- ❖ A sole trader should be able to have business accommodation expenses recognised as deductible expenses even when paid to himself, without the ‘payments’ to himself being considered as income.

Sole traders are frequently offering products and services which are likely to be cheaper if imported (off-shore alternatives generally enjoy benefits of scale). Such import-substitution products should be encouraged. This can be done by recognising the difference between end-product (offered directly to the consumer) and product parts, equipment and tools (used in the manufacture of goods and the provision of service).

- ❖ Sole traders should be able to import product parts, equipment and tools at preferential customs and wharfage rates, in order to stimulate import-substitution end-products.

Unfortunately, sole traders’ efforts fail on occasions. This may be due to all sorts of reasons, such as systemic errors in the start-up phase (e.g. poor business planning), changes to the trading environment, obsolescence of the product offerings etc. If a sole trader operation is wound up, he may finish up with debts, equipment he cannot use, stock he cannot sell (at least not at commercially sensible rates) and the winding-up may prove to be expensive. Of course, such potential expenses should be seen as a risk, but the tax regime could take some of the pressure off the sole trader of a failed enterprise by making the losses at least partially deductible against future profits in another venture or wages or salaries earned in future employments.

- ❖ Tax regulations should make provision, at least in part, by making a proportion of losses incurred in winding-up deductible against future earnings



Provision is made, at the moment, for a small additional tax-free allowance for farmers. There seems to be no particularly good reason why farming (as a way of producing food for St.Helena) should be handled differently to fishing (as a way of producing food for St.Helena).

- ❖ Extraordinary tax allowances for farmers should be extended to all food-producers, in particular fishermen.

Small to Medium Enterprise (SMEs)

Many of the considerations listed for sole traders apply equally to SMEs. There are, nevertheless additional considerations:

An SME has, presumably, as part of its business and operations plan, provision for the administrative tasks of payroll (PAYE) and other tax-related issues (e.g. wharfage, import customs etc). However, an SME has most likely now to come to grips with Withholding Tax in addition to the other tax concerns. Only in the upper end of the SME population is there enough opportunity to absorb the additional administrative duties involved

- ❖ Taxation should not make the administrative task so onerous that private sector organisations must increase prices accordingly (or in some cases, decide to cease trading)

The start-up process for a SME may be a much more complicated process than for a Sole Trader. There are likely to be requirements for significant-scale equipment purchases, for start-up expertise sourced from abroad, for significant borrowing requirements etc.

- ❖ Taxation arrangements for SME start-ups should recognise that entrepreneurs must decide whether St.Helena is the most useful target for their investment. Tax arrangements can be deciding factors in these deliberations.

SMEs are more likely (than Sole Traders) to have a business plan that includes growth, expansion and diversification. Such plans normally identify that start-up-like costs will be incurred in the future.

- ❖ Tax arrangements for the step-wise expansion of SME operations should be considered in similar light to the initial start-up of a new business

SMEs are more likely to have the eventual sale of the business as a business aim. However, if the proceeds of the sale of a business are taxed as capital gains, the entrepreneur is not incentivised to liquidate the business in order to invest in something more adventurous or profitable.

- ❖ Proceeds of the sale of a business should not be considered as Capital Gain if the capital is subsequently used as an investment in another business



Large Enterprises

The current direct taxation regime, as previously stated, does nothing to positively encourage the starting up of new business ventures on the Island. Indeed the economies of scale enjoyed by foreign competition in South Africa and Europe render the potential for the creation of many more local production enterprises unviable. Examples include various forms of agricultural production (e.g. citrus, poultry, dairy farming), bottling plant, brewery, light manufacturing, textiles etc. etc. Current levels of importation are exceptionally high and are set to increase further as small local suppliers of large businesses are driven out of the market by the current onerous and bureaucratic tax regime.

If a switch were made to indirect taxation through import duties, this would act as a major boost to local production. Existing, local larger enterprises would be particularly well placed to take up these opportunities by diversifying into new ventures. Business diversification is a key to long term stability. Smaller businesses and new entrepreneurs would also enter the market. This would in turn build up the local economy and reduce the economic “leakage” that currently happens with money drifting off shore. Foreign investment in the Island’s local business would also be encouraged if income was not taxable and wealthy new settlers would be attracted to reside here.

Large enterprises are more likely to provide additional benefits to its employees, including, for instance pensions. The current tax legislation does not deal with retirement benefits in an equitable way, taxing all benefits as normal income if not converted to an annuity. Since St.Helena does not have a national pension scheme, most private sector employees’ benefits will not be treated fairly compared with those of Government employees.

- ❖ St.Helena must provide a universally applicable pension scheme before exacting taxes from retirement benefit provisions which are not covered by approved schemes.

Large enterprises are more likely to own property in their own right. Property must be handled differently from other assets (from a tax point of view) because it is virtually the only asset whose value can be expected to increase in value (in real market terms). This fact is generally ignored if property can be depreciated and given an ever-decreasing book-value. The re-sale value (i.e. the real market value) of property becomes the main focus when assessing Capital Gains, since the sale of a business may create huge CGT liabilities (the difference between the sale price and the book-value being far greater than the difference the sale price and the purchase price).

Further, depreciation of property assets may not benefit the business on an ongoing basis anyway, (since other losses may in any case reduce annual tax liabilities). So,...

- ❖ A business must be allowed to decide whether, and by how much, to depreciate its property assets according to its own circumstances.
- ❖ A business owner should not be liable to CGT on property assets if the liquidated value is then used in the establishment or purchase of another business.

The payment of taxes due by companies on a quarterly schedule can be seen both as a benefit and as an additional problem. Company cash flow is not generally comparable to individual cash flow (i.e. based on wage, salary or pension). Companies that enjoy relatively constant cash flow, and companies that are shrinking may see the benefits of making tax payments quarterly or even monthly. However, companies with wildly fluctuating or seasonal cash flows, and companies that



are growing (since payments made annually would have attracted interest from the Bank if they were retained by the company, there is a small cost involved in paying quarterly), may very well prefer an annual schedule.

- ❖ Commercial tax payers should be able to elect to pay (or pre-pay) taxes due (or forecast) on a schedule that suits them.

Realistically, a new large enterprise is more likely to be run by an inward investor than by a resident investor. The current Approved Investor Status arrangements provide some relief for inward investors, but other tax arrangements are not consistent.

- ❖ Tax arrangements for Investor status (approved or otherwise) should be incorporated into the standard Tax arrangements, so that circumstances are clear and unequivocal.