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Recommendations on Tax Reform

Aruba Trade & Industry Association

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Background.

The Government of Aruba has, for some years now, been considering a reform of its tax system. The existing system relies heavily on direct taxation which is seen as an impediment to encouraging growth of the economy and the creation of employment opportunities for Arubans.

Within the recent past the Government has been faced with substantial deficits on its operating account and has acknowledged that a more efficient and effective tax system will help in addressing this problem.

The Government intends to reduce and ultimately eliminate these deficits as soon as possible and wishes to reform its tax code, with a new code no later than January 1 2020.

It should be noted that Aruba has a population of about 110,000 persons and has a concomitantly small economy. In 2017 its GDP was estimated to be about US$2.7 billion. The Government's tax income in 2017 is estimated to have been about US$610 million or 22% of GDP.

It should be noted that Aruba's economy depends almost completely upon its tourism industry. It is the wish of the current Government to diversify the local economy. However, it wishes to do this in such a way that any growth meets the social and economic needs of the local population and is sustainable over the long term.

It should also be noted that the Government has a relatively inefficient tax collection department which is in need of modernization of its systems and practices.

The Government also acknowledges that there are substantial problems with non-compliance in the payment of taxes largely as a result of failure to enforce existing regulations and policies. It is thought that possibly as much as 20% of taxes go unpaid.

Basic Parameters of Reform.

Given the above the following parameters need to be taken into consideration: -

- Aruba has a small economy and needs a very simple tax code.
- A revised tax code should assist in encouraging the diversification of the economy of Aruba and to meet the economic vision of the current Government.
- It is generally agreed by all parties that the tax code needs to move from an emphasis on direct taxation to indirect taxation.
- Any change should be revenue neutral, but improved enforcement and collection methods will generate incremental income.
- That the tax department is relatively inefficient and needs to substantially increase the amount of automated collection and processing systems. Any reform will not have the desired outcome if the tax departments does not improve efficiency.

Experiences elsewhere.

In the Working Paper (WP/17/88), the IMF recognizes that Caribbean countries remain extremely vulnerable to both economic and weather related shocks and continue to face significant challenges that have manifested themselves in low potential growth, stagnant productivity, and high cost of business. Aruba is no different in that respect and faces the same challenges.

The VAT is one option which could be considered a good instrument to replace a myriad of inefficient taxes, broaden the tax base, and generate a stable source of revenue. The IMF Working Paper (WP/17/88) on introduction and effectiveness of VAT in Caricom countries concludes however that while VAT can boost revenue, it has not reached its potential. A VAT is intended as a broad-based tax with limited exemptions, a single rate and zero-rating confined to exports. The various VAT systems introduced in the Caricom countries do not meet these vital conditions.

The island of Bonaire has introduced an ABB system of tax collection which, after its initial hiccups, currently seems to be working well.

Grenada and Saint Lucia have introduced, or have planned to introduce, a turnover-based presumptive tax regime with minimal accounting requirements for small businesses which fall below the VAT registration threshold. They have therefore combined both systems complementary to each other. This could be considered by Aruba as well since Aruba has many small businesses.

There are three main options for shifting to indirect taxation.

It is currently thought that there are three main options which Aruba might consider:

1. To continue to rely upon the existing system of import duties, excise taxes and BBO/BAZV/BAVP, possibly with some improvements.
2. To introduce an expenditure tax (ABB).
3. To introduce a VAT system.

Each has its pros and cons, which are currently identified as.

	Pro	Con
BBO/BAZV	Simple	Cascading effect
	Generally accepted in Aruba	BBO on BBO
		Keeps different taxes in place
ABB	Assimilates many other taxes	Internationally not (well) known
	Draft legislation is already present (needs amendments)	Customs plays important role in process
	Levy at the border	
	Customs does what it needs to do (check cargo)	
VAT	Assimilates many other taxes	Aruba is not a production Island
	Invoicing needs to become better to claim refunds	Need limited exemptions and few rates
		Financial constraints for refunds
		Limited capabilities tax authorities

It is ATIA's considered opinion that a simple ABB system will meet the needs of Aruba given its relative simplicity to administrate.

VAT should only be considered if it becomes a broad-based tax with limited exemptions, very few rates and zero-rating confined to exports. Whichever tax is introduced, it should assimilate amongst others the following taxes:

- BBO (currently about 100 million afl per year)
- Foreign Exchange Tax (currently about 50 million afl per year)
- Taxes on services (currently about 50 million afl per year)
- Succession tax (currently about 1 million afl per year)
- Transfer Tax (currently about 20 million afl per year)

This is a total of 221 million afl which should be generated by the new indirect tax. ATIA emphasizes that having the necessary data available to estimate the effects of the shift from direct to indirect taxes is vital and without it, the correct rates cannot be determined properly.
The more detailed the data, the more accurate the calculations and thus the less questions from outside parties can be expected when discussing the income side of the budget of the coming year(s).

Specific Recommendations.

With the introduction of a new, comprehensive indirect tax the following changes should be considered:

Income tax and wage tax

- Inclusion of the social security (AOV/AWW and AZV) into the personal income tax. This would enable the Government to stimulate the purchasing power of the weaker persons in the society. In order to increase interest from entrepreneurs, from Arubans currently living overseas and who might wish to return home, and from the general population at large, it is proposed to significantly reduce personal income and wage tax. A maximum rate of 35% is recommended.
  At the same time, it is recommended to broaden the tax base by:
  - Elimination of the labor expenses (maximum of AWG 1,500) since that deduction has little effect and is void due to the lowering of the rates.
  - Elimination of personal expenses, a.o. the mortgage deduction as this only impacts about 8% of all taxpayers, many of whom would benefit from a reduction in income taxes.
  - Elimination of extraordinary deductions for e.g. child support, study expenses and sickness expenses since these are little used due to the threshold.
  - Aligning the definition of the taxable wage, which is currently different in various levies.

At the same time, it is required to facilitate employers in ways of rewarding their employees tax beneficially, hence it is recommended to:

- Create special, flat, tax rate for performance-based bonuses (preferably included in fringe benefit regulation).
- Expand and update the fringe benefit regulation, which is seriously outdated and limited in use.
- Lower addition as wage in kind for green cars (currently 15%), which percentage could be set on e.g. 2.5% for fully electric cars and 7.5% for hybrid cars.

Corporate income tax

- It is recommended that profit tax be reduced from the current 25% to 20% to stimulate business investment and activity.
- It is recommended to also:
  - Give options for applicable rates, since zero or rates on or below 5% often create tax issues in other countries relating to e.g. deductibility issues or application of withholding taxes.
  - Create special tax incentive program for new pillars of the economy, like temporarily lower rates for corporate income taxes and indirect taxes.
  - Increase the investment allowance with an additional 10% for substantial investments in assets exceeding e.g. Afl. 250,000.
  - Ensure cooperative attitude of tax authorities when dealing with ruling requests, as well as establish legal timeframes for dealing with such requests, preferably with automatic approval should tax authorities not respond in stipulated timeframe.
  - Abolish limitations in deduction of payments and replace with a 2.5% withholding tax on interest, rent, royalties and management/ administrative

fees. The current system looks for a “corresponding levy” at the often foreign recipient and thus does not benefit Aruba.
    - Introduce stimuli for training of employees by e.g. additional deduction of x-percentage of the payroll expenses (working similarly as investment allowance) to be reserved for training, which reserve should be used in y-number of years otherwise will be added back to profit.
    - Create incentives for businesses that have gone or are going to sustainable green construction or renovation of their facilities, whereby the minimum investment threshold in sustainable green goods should exceed e.g. Afl. 200,000. Green goods could for example be solar or wind generating technologies, insulation, recycling of water and materials, energy saving equipment like LED lights and so forth. This could be done by a 10% additional investment allowance on such investments and/or a temporary credit on corporate income tax due (although the latter will be more difficult to achieve unless the IPC activities are expanded.
    - Expand statutory period for offset of losses from 5 to 10 years since many businesses have still not recovered from the financial crisis.
    - Make the transparency regime more flexible, i.e. existing companies can choose to use it as well provided that the change in regime is fiscally “guided”.
- The combined profit tax and personal income tax rate for local entrepreneurs should not exceed the maximum personal income tax rate. That implies the substantial interest levy (“aanmerkelijk belangregime”) needs to be revised. This ensures that the tax treatment of the legal form is no longer decisive but the legal form of the business (e.g. sole proprietorship or corporation) is.
- The hotel and timeshare sector, which are currently the main drivers of the economy, need incentives to keep upgrading/ renovating their facilities, especially due to the aging of our hotels. This could be achieved by:
    - Providing an additional investment allowance of 10% for (locally or abroad) purchased goods for upgrade/ renovation provided the investment per room exceeds e.g. USD 10,000;
    - Providing a lowering of the indirect taxes on purchased goods for upgrade/ renovation provided the investment per room exceeds e.g. USD 10,000;

<u>Gaming tax</u>
It is further recommended: -
- to change the gaming tax to a tax on the “win” (amount played minus pay-outs) as is internationally accepted and applied.

It should be noted that the gaming tax may be included in the indirect levy as well, possibly with a different applicable rate.

Abolish transfer tax and increase property taxes

It is recommended to:

- Abolish the transfer tax and increase the property tax rate to x-percent.
- Convert the property tax into a self-assessment tax with a taxable base equal to x-percentage of the insured value of the house. If the insured value is not present, the fair market value should be used based on appraisal report not older than five years. The self-assessment system will increase compliance and alleviate the burden of the tax authorities.

Motor vehicle tax

It is recommended that:

- The taxes currently paid for motor vehicles (currently about 27 million afl) be eliminated and the 27 million generated by increasing the excise tax on gasoline. This will substantially reduce the costs associated with the tax collection for motor vehicles. It is also a fair system, since the biggest users of the roads pay most. What should be considered are the taxi drivers, busses and heavy machinery using gasoline or diesel to operate. This could be achieved by "capping" the maximum amount paid in additional excise taxes to Afl. X, which excess will be refunded upon a request – accompanied by proof - to be filed within three months after the end of the calendar year.

Dividend withholding tax

It is further recommended to:

- Abolish the dividend withholding tax, since (i) Aruba is one of the few countries in the region that levies such a tax and puts it at a competitive disadvantage, (ii) it creates an administrative burden at the taxpayers and tax authorities and (iii) is – in local situation – nothing more than a pre-levy, while for non-resident shareholders the dividend withholding tax is for all special regimes already abolished (e.g. IPC and Free Zone) and for those few recipients that are left the income is insignificant.

Excise taxes and duties

It is recommended that:

- There be no change in excise duties on beer and liquor.
- Taxes/ duties be introduced or increased on tobacco products and sugar-based sodas for health reasons. At the same time, a deposit charge ("statiegeld') should apply on glass and plastic bottles, as well as e.g. batteries.

Others

It is strongly recommended that new procedures be immediately implemented to collect wage and other taxes from companies working in Aruba which are not based in Aruba. This applies particularly to the construction sector and to the oil and gas sector although other companies will also fall within this umbrella. In the coming changes to the BBO/BAZV/PPS a first step has been taken when local entrepreneurs can be "appointed" as withholding agent for these taxes.

Tax authorities

It is recommended that the tax authorities create a special projects team focused on:

- Compliance in payroll taxes and indirect taxes, which seems to be low for e.g. contractors, cleaning companies, supermarkets, hardware stores, restaurants and jewelers.
- Registration of properties for property taxes by sending out persons to look where properties have been built that have not been registered.
- Create connections with other governmental departments for cross-referencing, e.g. with Kadaster for property taxes, Censo for levy of social security premiums, DIMAS/ DPL for payroll taxes, and Chamber of Commerce for opening of new business.
- More rigorous enforcement of the tax code, including liability laws.
- Online filing of returns for self-assessment taxes.

At the end of the day the success or failure of the revised tax code will be dependent upon changes and improvements made within the tax department itself and we recommend that the greatest attention be paid to improvements both in processing and collection systems as well as personnel in this department. Some suggestions are:

- Create fast-lane for filing of returns which only require a stamp (until online filing occurs).
- Ensure that tax authorities deal with objections filed within one-year mandatory deadline.
- If a deviation from the return is not substantiated, the deviation is voided.
- Cooperate with private sector to create policies and manuals on specific topics like transfer pricing, deduction of payments, fiscal unity.
- Pay interest on overpayments by tax payers (“heffingsrente”).
- Pro-active attitude by calling first what happened before raising assessments with penalties.

Quick wins

A tax reform as envisioned by the Government will need time to draft, convert into legislation, implement and explain to the Aruba population. ATIA feels that an implementation date of January 1, 2019 would be difficult to achieve. But there are some quick wins that could be implemented on January 1, 2019 already that immediately could stimulate the economy that is struggling. These could be:

- Income tax:
  - update of fringe benefit regulation (increase purchasing power);
  - formalization policy of special rate on profit based performance bonuses.
- Corporate income tax:
  - Abolish limitations in deduction of payment and replace with withholding tax;
  - Introduce tax incentive to train employees;
  - Increase investment allowance with 10% for significant investments exceeding e.g. Afl. 250,000, green investments exceeding Afl. 200,000 and investments in hotel rooms exceeding USD 10,000 per room;
  - Expand statutory period of losses from 5 to 10 years;
- Gaming tax: convert to “win” system (draft legislation present);
- Motor vehicle tax: convert into excise tax (draft legislation present)
- Transfer tax: abolish
- Property tax: convert to self-assessment system and increase rate
- Dividend withholding tax: abolish

ATIA hopes to have contributed positively to the discussion about the tax reform with the above and would be willing to discuss it verbally in more detail.