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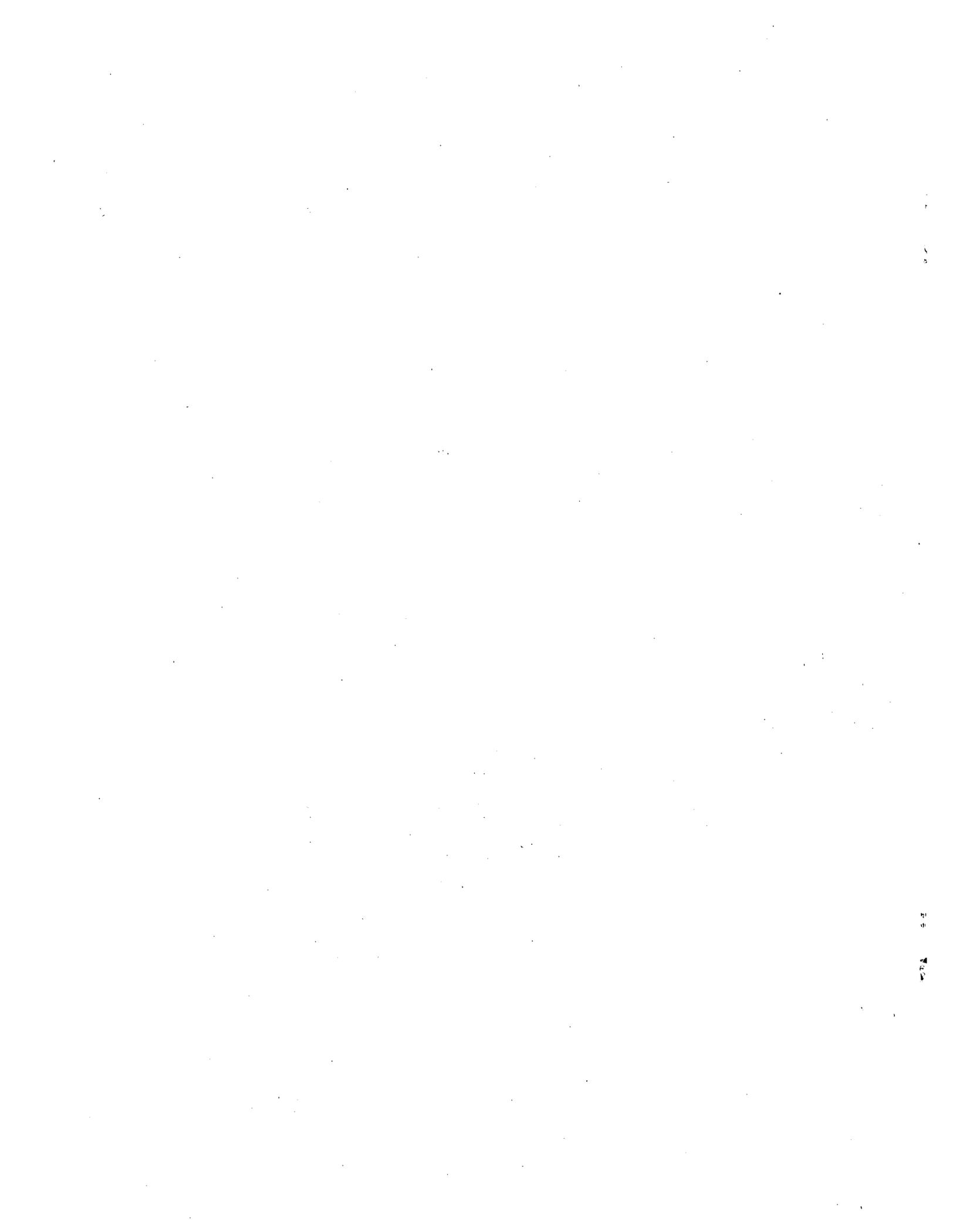
Date: 20 April 1971

ECONOMIC COMMISSION FOR LATIN AMERICA
Office for the Caribbean

A NOTE

ON

HARMONIZATION OF FISCAL INCENTIVES TO INDUSTRIES



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on
Harmonization of Fiscal Incentives to Industries

1. The purpose of this note is to elaborate on some of the points which arose on this subject during the Meeting of Officials at Eighth CARIFTA Council Meeting^{1/}. The note is submitted in the hope that it would be of help in agreeing on the recommendations which the officials make to the CARIFTA Council at its next meeting when the subject comes up again.

I Definition of Local Value Added:

2. There was general agreement that fiscal benefits to be accorded to new industrial enterprises in the Area must be related to the contributions such enterprises would make to the Area's economies. There was also agreement that for this purpose the concept of Local Value Added^{2/} should, notwithstanding the problems that would arise in its measurement, be used to evaluate applications and performance.

3. There were, however, two aspects of the definition of Local Value Added which came up for discussion. One related to the depreciation deductions and the other related to the definition of 'non-resident'.

^{1/} See Annex I to CARIFTA Secretariat Document Rep 5/71. This Annex has since been circulated by the Secretariat and bears its Document No. 65/71.

^{2/} See Appendix IV to CARIFTA Secretariat Document cc 26/70.

(a) Depreciation Deduction:

4. Item (ix) of the definition of Local Value Added originally adopted by the officials read as "depreciation deductions pro rata, with respect to the import-content of depreciable assets".^{3/}

5. The discussion on this item revolved around two problems. One problem was that of the difficulties of measuring the import-content of depreciable assets. The second problem was that the definition did not take account of accelerated depreciation allowance.

6. As regards measuring the import-content of depreciable assets, it is important to remember that under the proposed scheme of harmonized incentives, plant, machinery and equipment are eligible for duty-free importation. Therefore, these items and their CIF values should not be difficult to locate from the records of both Customs as well as the Authority permitting duty-free importations.

7. In fact, one of the advantages of including this particular deduction in the definition of Local Value Added is that it will act as a deterrent to the over-statement of CIF values of imported assets - a tendency otherwise noted to be quite strong with a view to claiming large deductions in the calculation of taxable income.

8. As regards accelerated depreciation allowances, the reason why the original definition of Local Value Added (see Secretariat Document cc 26/70) did not mention them was that the scheme did not envisage the grant of any accelerated depreciation allowance during the currency of the tax holiday period. It will be noted that under the proposed scheme

^{3/} See CARIFTA Secretariat Document cc 26/70.

initial allowance, the allowance is to be granted on tax exempt enterprises only after the end of the tax holiday period and only in respect of the capital expenditure incurred after the end of such period.^{4/} Since this recommendation regarding initial allowance was acceptable to the officials, the reference in the definition of Local Value Added to the accelerated depreciation allowances is bound to be misunderstood and should, therefore, be dropped.

(b) Non-Resident:

9. The recommendation of the UN Experts and the Workshop^{5/} was that wages and salaries paid to non-citizens in the calculation of Local Value Added. The Officials decided to replace 'non-citizens' by 'non-residents'.

10. According to income tax practice now obtaining in the region, physical presence of a taxpayer is used as a criterion for determining residence. Thus any outsider staying in a territory for more than a specified number of days (the minimum period prescribed is 185 days but in some territories the period is shorter) is treated as a resident for purposes of taxation. Under this definition of 'resident', almost all foreigners working in the region, except a few coming to work for short periods, will qualify as residents and, therefore, the amount to be deducted as 'wages and salaries paid during the year to non-residents of CARIFTA countries' would be, if anything, insignificant.

11. It is quite understandable that at their subsequent meeting the officials reopened discussion on this subject. The discussion was, however, inconclusive.

^{4/} See CARIFTA Secretariat Document cc 26/70

^{5/} See UN ECLA Documents E/CN. 12/844 and 845.

12. It might help to go back to the UN Experts' Report^{6/} which suggested the use of the term 'non-citizens'. Their choice of the term was quite a studied choice. The reasons why this term was preferred to any other term were:

- i) The objective underlying the definition of Local Value Added was to underline both local employment as well as income. Even from a strict national accounting angle, it is as invalid to include in a country's national income payments for services made to foreigners residing in the country as to foreigners residing outside of the country.
- ii) Since in the definition of Local Value Added the attempt was made to express items in terms as close as possible to usages for income tax purposes, it was considered inadvisable to use the term 'non-resident' if the intention was to give it a meaning altogether different than the one given for income tax purposes.
- iii) The term 'citizen' was recognized in law. The independent member territories of CARIFTA have their Citizenship Acts. It should therefore present little difficulty in determining citizenship, or the want of it, for purposes of Local Value Added.
- iv) Even in income tax terminology, the term 'citizen' is used in other countries (e.g. U.S.A.) to draw a distinction between resident and non-resident citizens. It was felt that should any difficulty of interpretation ever arise with respect to the use of the term 'citizen' reference could easily be made to practice elsewhere.

13. In finally deciding upon their recommendation to the Council the officials may wish not only to take the above points into consideration but also to remember that the use of the term 'non-resident' in the prevailing income tax sense, or in a sense close to it, will lay open the Local Value Added criterion

^{6/} See UN ECLA Document E/CN. 12/845.

to the objection that it does not attach sufficient weight to one of the most urgent needs of the region, namely the need to create additional employment opportunities.

II Interest Payments:

14. The original recommendation of the officials, as of the U.N. Experts and Workshop, was that unlike profits and dividend paid therefrom, there should be no tax exemption under the scheme for interest payment in the hands of recipients. This was done principally because if interest payments were at the same time allowed in the computation of losses to be carried forward this could lead to 'involuntary extension of tax holiday period'.

15. At the subsequent meeting, the idea of stipulating a minimum ratio of equity to loan capital was mooted. This suggestion can in fact stand on its own merits regardless of whether or not interest payments are granted tax exemption and some member territories might wish to stipulate such a minimum ratio even within the framework of the harmonization scheme. Some territories might wish to go even further and require a minimum of local participation in equity. These additional restrictions, at the national level, will not violate the harmonization scheme whose basic approach is that member territories could be more restrictive, if they wished, but not more liberal in the scheme's implementation.

16. If, however, interest payments are considered for tax exemption as part of the harmonization scheme, it will be necessary, regardless of whether or not a minimum ratio of equity to loan capital and a minimum ratio of local equity participation are set as part of the same scheme, to provide (a) the safeguard that such tax exempt interest will not be deductible as an expense and (b) for the maximum rate at which such tax exempt interest would be payable.

17. As for the second suggestion to treat an agreed part of annual interest payments as subject to taxation at the same rate as dividends, it is not clear if the idea is to revise the original recommendation for the exemption of dividends payable out of tax-exempt profits.^{7/} In any case, the problem will still remain with regard to the admissibility of interest as an expense.

III Performance Appraisal:

18. While the officials continued to agree on the need for performance appraisal, some serious concern was voiced on the question of tax retroactivity should such performance appraisal call for downward reclassification of an enterprise.

19. It is for consideration, however, if the downward reclassification of an enterprise and consequential tax liability could really be regarded as tax retroactivity. Retroactivity in tax arises from lack of advance knowledge of tax laws and rates as, for instance, would be the case when changes in tax law and/or rates were made and applied retrospectively. Tax retroactivity cannot be said to arise when the known laws and/or rates continue to be applied.

20. Under the system of advance quarterly payment of income tax, for instance, an enterprise pays additional tax (or claims refunds) on the appraisal of actual profits at the close of the year. No tax retroactivity is ever said to arise in such a case. Nor can tax retroactivity be said to arise when the

^{7/} The UN Experts had recommended that exemption of dividends should be qualified by the requirement that the distribution of profits does not exceed, in any one year, 10% of equity capital. The objection of this recommendation was to deter large distributions and not to withhold exemption. But this recommendation was not accepted by the Workshop.

