Country Z

Tax Incentives for Investment Promotion

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BACKGROUND

Introduction

The objective of this report is to evaluate the impact of various taxation strategies as a means of promoting investment in Country Z.

Before a detailed consideration of alternative strategies, it is worthwhile reviewing some points about the particular situation of Country Z, investment in general and the role of taxation systems in investment decisions.

Country Z is a small economy operating in the XX region with limited natural resources. The domestic market is small, so economic development has been export led with a heavy reliance on a small number of industries which either exploit natural resources in their raw state or as "value-added" products (e.g. sugar, wood, citrus fruits) or which are "self-contained" industries (e.g. drink concentrate processing, refrigerators and textiles).

In terms of attraction of investment, Country Z has to take cognisance of a number of changes in the worldwide situation namely:

- there is increased worldwide competition for foreign direct investment (FDI)
- the spectacular growth rates of the South East Asian countries in recent years have diverted FDI to this region
- the opening up of the countries of the former Eastern European bloc has also led to increased competition for FDI from this area.

Closer to home major factors to be considered include:

- the change in the political system of Neighbour 1 which has meant that companies who once may have considered Country Z as a base for operations in order to gain access to Neighbour 1 markets may no longer have this imperative.
- uncertainty as to the political and economic future of Neighbour 1 has led to investors adopting "a wait and see" attitude and this has had 'knock-on' effects for investment in Country Z
- increased economic cooperation and integration between the countries of SACU implies that Country Z must appear at least as attractive as the other four countries as an investment location if it is to succeed in its strategy of investment promotion
- in the short to medium term re-negotiation of SACU and progressive implementation of GATT treaty provisions may have negative impacts on revenue generation within Country Z thus exacerbating existing constraints on financial resources.

In the light of the above it is useful to consider the reasons for investment promotion strategies and the factors which have been found to influence investment decisions of both foreign and indigenous investors.

A number of reasons are usually put forward for the attraction of FDI by countries:

- It is seen as a way to attract incremental investment capital where local capital markets are not well developed and unable to meet the capital requirements for large investment projects.
- It can provide access to advanced technologies thus contributing to the ability of firms to compete effectively in export markets and possibly also leading to the 'spin-off' of encouraging innovation among domestic firms.
- It can provide access to advanced or improved management techniques.
- It can enhance access to new markets.
- It can facilitate privatisation and restructuring.

Although these are all potential outcomes from FDI, the achievement of all, or any, of these objectives is not automatic and much FDI internationally has been shown to be of a short term, profit-seeking nature which has had little lasting economic benefit to the countries concerned.

Therefore it is suggested that if Country Z is to pursue a long term strategy toward economic development it needs to consider measures which will:

- attract FDI of a long term nature
- stimulate indigenous investors to invest
- diversify the economic base so as to reduce over dependency on a particular sector (e.g. drink concentrate processing) by increasing the attractiveness of investment in areas which, in the long term, are seen as having economic benefit (e.g. tourism)
- create employment for the fast growing population.

Investment decisions

Consistently research has shown that many factors, other than taxation, are relevant to the decision to invest in a country. The relative importance of different factors will vary in different geographical regions or economic sectors, but fundamentally investment decisions are driven by a comparison of the potential returns from investment as compared to its risks. The most commonly identified factors influencing investment decisions are:

- political stability of a country
- evidence of sound macroeconomic management policies by Government
- available infrastructure e.g. electricity supply, transport, telecommunications
- adequate labour supply, skills base, relative labour costs
- access to raw materials
- access to markets.

These factors apply both to FDI and to indigenous investors as a recent survey of investors in Country Z demonstrates.[1]

[1] Capricorn Africa Economics Associates: A Study of Country Z in the XX Customs Union. January 1995. Quoted in Development Plan 1995/1996 - 1997/8, p.67

Role of taxation system in investment decisions

A number of general points can be made about the role of taxation in investment decisions:

- Within the tax system incentives directed at attracting FDI are often considered of secondary importance to the more general features of the tax law.
- Low tax burdens do not attract FDI, but high burdens and /or unstable rules may repel FDI.
- The overall level of the tax burden does have an impact on investment but this includes all forms of taxation, not simply income tax.
- The primary purpose of taxation is to generate revenue so any changes envisaged to the taxation system must take account of the implications for revenue generation. Changes in taxation which, for example, increase the budget deficit thus reducing the macroeconomic stability of the economy can be counter productive in achieving the goal of attracting investment. Conversely, if taxation revenues are spent on purposes which reduce costs and enhance income generating activities e.g. infrastructure development, education - the expenditures effectively offset the negative impact of taxation.
- Consistently studies have shown that what private sector investors seek is transparency, stability and equity in any tax regime. In other words that they can predict the tax outcomes of their actions, that there is some consistency over time and that the law is applied on a non-discriminatory basis e.g. as between foreign/domestic investors or as between different economic sectors.
- Any changes in taxation envisaged need to take account of the existing system of tax administration. Taxation systems should be simple and efficient to administer, promote compliance and ensure that all avenues for avoidance and evasion are closed off. Furthermore in any system of taxation the tax base should be as wide as possible so as to spread the burden for reasons of economic efficiency.
- Finally, with respect to taxation and investment, consideration needs to be given to the provision of a tax treaty network since tax treaties provide a framework within which companies across borders can plan their affairs. Within the context of the cross border initiative this is an important consideration for Country Z.

Bearing the above points in mind the specific options available to Country Z in respect of taxation strategies to promote investment are discussed in the next section.

ANALYSIS OF TAXATION STRATEGIES

Tax holidays

A tax holiday is a typical form of incentive used by countries to attract foreign direct investment. It is targeted at new firms and not at existing operations. With a tax holiday, new firms are allowed a period of time, after some initial point, when they are relieved from the burden of income tax. Sometimes this initial period is extended to a subsequent period of taxation at a reduced rate of tax.

Advantages

- a simple regime for foreign investors
- believed by some to stimulate investment via attraction of new investment and disincentive to emigration of domestic capital
- believed by some to represent no fiscal cost because the activities which benefit from such concessions would not be in the country without those concessions.

Disadvantages

- badly targeted
- attract mobile investment which makes little or no contribution to national product
- are not cost effective
- subsidise capital over labour
- not normally available to existing and indigenous businesses
- encourage avoidance and reduce respect for the tax system

The tax holiday available in Country Z is a five year exemption from tax. The authority for granting the five year exemption is contained in section 12(5) of The Income Tax Order, 1975 (the Order) which grants the exemption in respect of new manufacturing business or any business exporting manufactured goods.

Generally tax holidays are wasteful because they are badly targeted in that they benefit the formation of new companies rather than the expansion of productive assets in all companies. There is little evidence that they do in fact create additional investment and, if they do, they tend to attract the short-term "foot-loose" type of investment which is highly mobile and which may relocate elsewhere at little cost, or attempt to re-form itself as a new company, once the tax holiday is over. This type of investment forms few linkages or roots and is likely to shut down once the holiday is over. A five year tax holiday is only of benefit to a company which can generate profits in that time - it is of no use to a company which has a long-term view and has high start-up costs and therefore little or no profits in the formative years. Paradoxically the latter type of investment is precisely the type of investment which is likely to be of greater benefit to a country.

According to the files in the Ministry of Finance there are about 60 companies which have been granted tax holidays since 1988. Once the tax holiday period ends companies either attempt new

incorporations, request new holiday periods or request special treatment through the "development approval order" mechanism. It has been estimated that the revenue loss of the tax holiday and concessional regime was in the region of between **14 million and **28 million[2] in the 93/4 year of assessment. This means that these incentives are very expensive, costing between 6% and 12½% of the 93/4 corporate tax take, which may amount to 5 percentage points on the corporate tax rate.

Development approval orders are issued under the general regulation making authority. Section 69(2) of the Order states that "Notwithstanding any other provisions of this Order...." the Minister may, upon application to him by any person, issue a development approval order with the prior consent of Cabinet where he is satisfied that a new business is beneficial to the development of the economy. The development approval order may be issued subject to such conditions and for such period of time as the Minister deems fit. The law states that the Minister shall publish, by notice in the Gazette, the name and address of the business nominated as a development enterprise.

In practice development approval orders have been "open ended" without any time limits and have been issued to companies in a variety of sectors and have included different incentives and conditions. In most cases the orders have not been gazetted. Analysis of the development approval orders granted in 1994 revealed the following:-

- A company was granted a 20% tax rate on its "net" income. The company was told the corporate tax law was under review and once the new policy was decided the company could either continue with the 20% tax or opt for the new regime.

- A company was granted a 27.5% tax rate up to 1999 and a sliding rate between 30% and 37.5% between 2000 and 2003.

- A company was granted a 30% tax rate on net income in perpetuity.

- A company was granted a 30% tax rate on net income in perpetuity on condition that capital investment of between **10 and **20 million would take place. (There is no evidence that the investment has occurred to date.)

- A company was granted a 30% tax rate on net income in perpetuity on condition that it would increase its workforce to 400 by 1997.

- A company was granted an investment allowance of 40% of capital cost on condition that the allowance would be withdrawn if it failed to fulfill phase 1 of its development plan.

- A company was granted a 20% tax rate in perpetuity.

- A company was granted a 15% tax rate with a "floor" amount of tax to be paid based on a previous year's tax payment. The "floor" is to increase by 10% each year or by the general rate of inflation whichever is less.

[2]Country Z: Options For Reform Of Company Taxation, March 1995.

The above analysis illustrates the highly individualistic and discretionary nature of the concessional regime. The companies were all granted the regime they sought indicating that the Ministry of Finance did not pursue a uniform strategy when dealing with the requests for concessions. It should be noted that the concessional regime applies to all income of the companies concerned and not to their business income only.

The fact that the conditions attaching to the orders vary between taxpayers means that there is likely to be a perception amongst taxpayers that the tax system is unfair and essentially amounts to paying the amount of tax for which the taxpayer can bargain. This in turn undermines respect for the tax administration and adversely affects compliance as taxpayers will assume that the concession is granted out of favouritism.

More importantly, having a provision like section 69(2) in the law is a direct invitation for companies to request concessional treatment. This in turn places political pressure on the Minister to grant the concession sought and, as has been seen in Country Z, taxpayers will persist in lobbying until the concession is granted. Therefore the granting of a concessional tax regime is likely to have more to do with the lobbying strength of the taxpayer than with the Government's desire to influence investment in any one sector of the economy. Again, this amounts to a waste of resources.

Given the cost, inefficiency, lack of transparency and other negative features of tax holidays or concessional treatment for specified taxpayers it is recommended that sections 12(5) and 69(2) be repealed with immediate effect. The law provides that the Minister may, at any time, with the concurrence of Cabinet, amend or revoke a development approval order and it is further recommended that the existing development approval orders be revoked at the earliest opportunity, particularly if the government is considering a general tax rate reduction.

Reduced corporate tax rates for various producer categories (e.g. manufacturers, exporters).

A reduced corporate rate can be provided to income from certain sources, or to firms satisfying certain criteria e.g. manufacturers. These reductions differ from tax holidays since the tax liability of firms is not entirely eliminated, the benefit is extended beyond new enterprises to include income from existing operations and the benefit is not time limited.

Advantages

- incentive is more specifically targeted
- some tax revenue is generated
- incentive is non discriminatory between FDI/ indigenous investment and between new/existing operations

Disadvantages

- quarantining of qualifying income may be difficult
- can have significant up-front revenue costs

- less likely to be cost-effective than incentives related to the amount of investment
- discriminatory and leads to pressure from other sectors for special treatment

The issue of a reduced corporate rate for certain sectors is being debated in Country Z. The debate is fueled by the existence of reduced corporate rates for manufacturing activities in Neighbour 2 and Neighbour 3. Country Z is concerned that it too should offer the same inducement or risk losing out in the competition for available foreign investment in the region.

The reduced sectoral rate is to be preferred over tax holidays since some tax at least is paid. Because the concession is offered in perpetuity rather than for a specified period, it is thought that it is more likely to attract long-term investment. Also, a reduced rate for a particular sector or sectors is easier to administer than tax holidays which are dealt with by individual application.

While a reduced corporate rate is better than tax holidays or selective tax concessions as currently exist in Country Z, it too suffers from many disadvantages.

Firstly, the decision to invest should be made on the basis of comparative advantage and not in response to a tax concession. If the decision to invest is made because of a tax concession, rather than for a real gain, it is likely that the investment will be unstable in the long-term, existing only, or mainly, on account of the tax concession. This implies that the Government must attempt to target the reduced sectoral rates at those sectors of the economy where there is, or may be, a comparative advantage. Granting a reduced sectoral tax rate to an area where a comparative advantage already exists, means that the Government is accepting a reduction in tax revenue in order to promote investment in an area where the investment is likely to take place in any event.

Secondly, the introduction of a discriminatory tax regime will not be welcomed by all taxpayers. Those taxpayers operating in the sectors to which the preferential rate does not apply will argue that the rate should apply to them on the grounds that they too are in business, they contribute to the productive performance of the economy and they employ people. This is now beginning to occur in Neighbour 2 where the argument is being made that the concessional 15% tax rate applicable to manufacturing should be extended to the tourism sector. Eventually the reduced sectoral rate could become the norm for all sectors as the demands to widen its applicability persist.

Thirdly, this form of incentive shares some of the negative characteristics of tax holidays. It may breed resentment amongst those to whom it does not apply. With this goes a lack of respect for the tax environment and the tendency towards a cheating culture. The promotion of voluntary compliance is vitally important and policy makers should ensure that actions are not taken which weaken compliance.

Fourthly, if a reduced sectoral rate is introduced the law has to find a way of confining the reduced rate to that sector only. For example, if the policy is to apply a reduced rate of tax to, say, the manufacturing sector, then it will become necessary to include a definition of manufacturing in the tax law. Manufacturing may be rigidly defined to mean the substantial transformation of tangible movable property and may be further defined to exclude construction, installation or assembly, or it may be loosely defined to include assembly operations. Once there is a dual rate structure there

will always be taxpayers who will attempt to argue that they fall within the low tax category. Therefore there will be constant pressure at the policy level to extend the concessional rate to other sectors and at the administrative level pressure in the form of arguments from individual companies that they qualify for the reduced rate. Also, taxpayers may be able to form associated companies trading in different sectors. In those circumstances costs will be inflated in the company operating in the high tax rate sector and profits will be diverted to the company in the low tax rate sector leading to an additional loss of revenue and demanding close perpetual scrutiny by tax officials.

The up-front costs can be significant as existing taxpayers receive a "windfal
between the existing tax rate and the new low sectoral rate. Additional tax revenue will only be produced in these sectors in the medium term if the incentive succeeds in attracting additional new investment.

It is not recommended that Country Z adopt a reduced corporate rate for specific sectors or types of income as an investment incentive at this time.

Investment allowances or credits

An investment allowance or credit is a tax relief based on the value of expenditure on qualifying investments. The investment allowance provides a tax benefit that is over and above the depreciation allowed for the asset. The tax relief can be in the form of an allowance or deduction against the income of the taxpayer or it may be in the form of a tax credit which directly reduces the tax to be paid.

Advantages

- the incentive is correctly targeted at the desired activity i.e. additional investment rather than the formation of a new company
- if correctly targeted to long lived capital it encourages companies to take a long term view when planning investment
- the cost is less than alternatives such as tax holidays

Disadvantages

- how to define eligible expenditures
- the choice between an allowance or credit
- can lead to tax avoidance schemes between related enterprises

The investment allowance needs to be distinguished from the initial allowance which currently operates in Country Z at a rate of 50% of the value of expenditure of an asset. The initial allowance may be claimed as well as the annual depreciation deduction in the year of purchase of the asset. However, the initial allowance is not an additional allowance since both it, and the depreciation charges, cannot exceed the cost of the asset. It is simply an accelerated depreciation charge in the year of asset purchase and, as such, amounts to an interest free loan of the amount of

tax saved in the year of claim. On the other hand, the investment allowance is an additional allowance over and above the cost of the asset and therefore is a real benefit to the investor.

There are major technical issues involved if an investment allowance or credit is to be adopted.

There is the problem of the definition of eligible expenditure to which the relief applies. Is it to apply to all plant and machinery or only to plant and machinery used in specified trades? Is it better to adopt an allowance or a credit? Should there be any restrictions? How are amounts of incentive that cannot be used in the year of expenditure to be treated - should they be carried forward against future years or should there be a tax refund to the taxpayer?

So there must be a precise definition that targets the incentive to the desired activity which will minimize revenue leakage and, at the same time, provide the taxpayer with certainty in the application of the incentive. If the rate of incentive is too high it may give rise to tax planning opportunities, particularly when a credit, rather than an allowance, is employed. For example, if an investment allowance is provided, firms may be able to flow services through a subsidiary and make money simply by increasing the amounts that the subsidiary charges the parent for the services rendered.

To tackle this problem it is necessary to place limits on the investment allowance to ensure that it cannot be used to fully eliminate the tax payable by a firm in a year of assessment.

Another important issue is what to do with investment allowances or credits that cannot be used by a firm in a particular year say because of high start up costs or losses incurred. If the investment allowance cannot be used in the year in which the expenditure is incurred and is effectively lost, this can militate against firms with long-term investment plans who do not, at present, have income against which the investment allowance may be offset. This implies the need to allow a carry forward of the allowance which means there also has to be rules governing the case where the business is sold or re-organised.

While this type of investment incentive is to be preferred over the two previous options it is not without its disadvantages. It can be complex to draft and administer and, if not made applicable to all investment, will have discriminatory aspects. It is recommended that any consideration of an investment allowance or credit as an investment incentive gives due attention to the level of the allowance or credit and the possibilities for tax avoidance if set too high.

A lower tax rate for all taxpayers

A reduced tax rate applicable to all forms of income and all business entities may provide Country Z with a competitive advantage that other incentives cannot. Strictly speaking a low tax rate is not an incentive in the absolute sense of the term but it is very much a contributor to the kind of stable, profitable, climate sought by investors.

Advantages

- Compliance and administration are much simplified, particularly if all forms of avoidance are closed off and if all entities are taxed at the same rate on all income. Government would be able to maintain tax revenues since taxpayers would have little or no tax planning opportunities. If a comprehensive penalties regime were added, there would be no incentive towards evasion or avoidance as the costs of non-compliance would far outweigh the costs of compliance.
- Investors are likely to look favourably on a country offering a low statutory tax rate, particularly one that is well below the worldwide norm of between 35 and 40 percent.
- A low tax rate with no incentives signals to investors that the Government is interested in letting the market determine the most profitable investments without undue Government influence.
- A low tax rate is neutral between indigenous and foreign investors.
- A low tax rate may, of itself, be an incentive as it allows investors to keep a larger proportion of profits.

Disadvantages

- Revenue loss to government may be substantial as all taxpayers benefit from the reduced rates.

It is imperative to stress that a low tax rate cannot be achieved without substantial revenue loss unless there is reform of the tax law to eliminate all opportunities for avoidance. If the tax law is not reformed, taxpayers will take the benefit of the lower rate and continue to use tax avoidance schemes to reduce the rate even further. A low tax rate can only exist in parallel with a regime that closes off the possibilities for evasion and avoidance and treats all taxpayers and all forms of income equally.

There is evidence to suggest that investors prefer a low corporate rate to a regime which offers various incentives. Investors prefer certainty and predictability in assessing the tax outcomes of their investment decisions. During discussions with taxpayers, tax professionals, government officials and investment promotion personnel in Country Z there was widespread support for the idea of reducing tax rates across the board and creating a "level playing field" for all taxpayers.

It is recommended therefore that serious consideration be given to the possibility of reducing both corporate and personal tax rates in Country Z. It is important to consider the personal tax as well as the corporate tax for two reasons. Firstly, foreign companies generally need to induce senior managers and needed technical personnel to live in the country in which they are planning to invest. If the personal rate band structure is higher or steeper than international standards, this will have an adverse effect as companies will be obliged to compensate their personnel for the tax difference. Secondly, the personal tax probably impacts more on small businesses as these are likely to be sole traders or partnerships. The tax system should, as far as possible, encourage capital formation in this sector by ensuring that a reasonable tax rate applies.

However, before a tax rate reduction is contemplated, the authorities will have to recognise the serious leakages that occur under the present law and take appropriate measures to counteract them. The next section suggests the main areas of avoidance which could be closed off relatively easily, the closure of which would provide additional revenue to finance an overall rate reduction.

It is anticipated that reducing the tax rate would produce an additional fiscal incentive as taxpayers would be more likely to comply at a lower tax rate than at a higher tax rate.

It must be borne in mind that, due to a lack of reliable information, the estimation of the revenue effects of alternative actions is impossible to determine with any degree of accuracy.

REVENUE ENHANCEMENT MEASURES

The income tax structure in Country Z is characterised by relatively high nominal rates, an over-dependence on receipts from the corporate sector, substantial leakages due to an ineffective mechanism for the taxation of non-residents with Country Z source income and a steep personal income tax with easy opportunities for avoidance by high income taxpayers. Due to the leakages and avoidance opportunities the tax seems to bear more heavily on residents than on non-residents and on low income taxpayers more than high income taxpayers.

Table 1 shows the amount of income tax collected from various sources.

Table 1: Direct tax revenue as at 30/6/94[3]

Tax from	Budget Estimate	Actual collection	% of Gross actual collection
Companies	273,000,000	224,308,560	65.15
Self employed	1,725,000	2,391,086	.70
Pay As You Earn	68,000,000	92,719,024	26.93
Back tax	6,000,000	5,823,182	1.69
Non-residents - interest	1,610,000	1,468,463	.44
Non-residents - dividends	15,400,000	11,894,264	3.56
Non-residents - Contractors and Artistes	1,150,000	693,221	.20
P.A.Y.E. penalty	115,000	101,780	.03
Directors	1,185,000	289,128	.08
Graded tax	2,493,000	2,223,946	.65
Casino levy	2,167,000	1,235,992	.36
Sugar levy	4,000,000	586,256	.17
Other	-	534,965	.16
Gross Collection	376,845,000	344,269,886	100.00
Less: Tax refunds	-	12,120,367	
NET COLLECTION	376,845,000	332,149,519	

The governing law is the Income Tax Order, 1975 which is amended each year. The law is defective in many ways and there is a strong case for a completely new law based on modern principles. This issue is dealt with later in the report.

The following are the principal areas of defect which provide opportunities for tax avoidance. Closing off these avoidance opportunities will simplify the administration, produce more revenue and provide greater confidence to investors. The additional revenue generated will allow for consideration of a lower tax rate for businesses and employees alike. This in turn will produce a better tax environment and will facilitate compliance leading to a further tax dividend.

[3]Source: Annual report, Department of Taxes, year ended 30 June 1994.

Corporate Tax

A comparison of corporate tax rates in the region is shown in the following table. It should be noted that this is a crude comparison as it does not show how dividends are treated in the hands of shareholders. For example, Neighbour 2 exempts dividends in the hands of resident shareholders but taxes dividends to non-residents by a withholding tax. Neighbour 1 levies a secondary tax of 25% on all declared dividends.

Table 2: Corporate tax rates in the region[4]

	Country Z	Neighbour 1	Neighbour 3	Neighbour 2[5]	Neighbour 4	Neighbour 5
Corporate rate	37½%	35% STC 25% Transition levy 5%.	15% normal tax and 10% additional tax	35%	35%	37½% Drought levy of 5%

Branch profits tax

The law allows a foreign company to trade in Country Z by registering as an external company. This means that the company is not obliged to incorporate in Country Z. Instead it trades as a branch without a separate legal presence. This has two negative effects for Country Z. Firstly, the investment from the foreign company is less secure than if it were channeled through a locally incorporated company. Disinvestment is made easier as the company merely has to stop trading and depart. Secondly, a branch does not have to withhold tax on its profit repatriations to head office whereas incorporated subsidiaries are obliged to withhold tax on dividends. Current law therefore provides an advantage to branches over subsidiaries.

Given the tax and other advantages there are surprisingly few branches in Country Z although they do exist and at least one major taxpayer is constituted as a branch.

To even up the treatment of branches and subsidiaries it is recommended that a simple branch profits tax be introduced which would tax the repatriated profits in addition to the taxable income of the branch. Repatriated profits would be defined as taxable income, less the sum of tax on that income plus profits re-invested in the branch. This treatment means that a branch reinvesting in Country Z pays less tax than if it were repatriating profits out of Country Z.

[4] I am indebted to KPMG, Country Z, for assistance in compiling the figures for Neighbour 3, Neighbour 4 and Neighbour 5.

[5] The current rate is 40% but the authorities are planning to reduce the rate to 35% with effect from 1 April 1995 and a bill to give effect to this change is under consideration.

World wide income of taxpayers

The law follows the Neighbour 1 principle of taxing only source country income. Neighbour 1 has considered the issue of source-based taxation against world-wide taxation within the context of the existence of exchange controls[6]. Whether Neighbour 1 does or does not move to world-wide taxation, it is recommended that Country Z consider changing its taxation principle from source to residency as this will prevent an easy means of avoidance whereby taxpayers merely have to site income or assets outside the jurisdiction to avoid tax.

Withholding tax on payments to non-residents

Country Z is a capital-importing country and therefore has substantial income flows to non-residents. Non-residents are taxable only on their income originating in Country Z. It is therefore extremely important for Country Z to ensure that its rules governing the origination of income in Country Z are drafted in a clear and comprehensive manner so that non-residents are in no doubt as to what constitutes Country Z-source income.

It is essential that a comprehensive withholding tax regime which taxes all income flows to non-residents, ideally at the same rate, be in place so that tax revenue is not lost. Currently dividends and interest flowing to non-residents are taxed at 15 percent and 10 percent respectively, although there is an unnecessary complication in that dividends flowing to Neighbour 1, Neighbour 3 and Neighbour 2 are taxed at 12.5 percent. Other income flows such as management fees and royalties are not subject to a withholding tax and only "professional" services are subject to a withholding tax of 10 percent. Exempting royalties and management fees from the withholding tax serves only to leave an easy means of tax avoidance in the law since foreign investments will be structured towards the non-taxed income flows.

Appendix I (available only in the draft submitted to the Hon Minister of Finance) summarises entries found in a number of corporate tax files examined in the Department of Taxes during the course of this consultancy. As expected, management fees to non-residents are a popular means of extracting value from Country Z without paying tax.

It is recommended therefore that:

- the withholding tax be extended to management fees and royalties;
- that all income flows to non-residents be taxed at the same rate;
- that the exemptions in respect of interest accruing to non-residents available under sections 12(1)(a)(h), (i) and(r) be repealed;
- that dividends flowing to Neighbour 1, Neighbour 3 and Neighbour 2 be taxed at the same rate as dividends to other countries; and

[6] K commission - interim report, page 228

- the word "professional" be deleted before "services" in section 59 so that it is clear that all services rendered in Country Z by non-residents are subject to withholding.

It should be remembered that, with the single exception of dividends, all other income flows are allowable deductions against taxable income. Although obviously non-residents would prefer to receive these income flows free of tax as the withholding tax does affect their cash flows, the imposition of a withholding tax is *not* an additional tax since the Country Z tax qualifies as a credit attaching to the income in the home country of the non-resident. Double taxation does not arise as relief is available, either under a double taxation agreement, or through unilateral relief where a double taxation agreement does not exist.

Domestic withholding

Withholding taxes can also be used to increase revenue and improve administration when applied to income flows of residents. It is suggested here that a withholding tax be considered for application to dividends and interest paid to residents and for payments to resident contractors.

Currently there is no withholding tax on dividends paid to residents and the Commissioner of Taxes is dependent on resident taxpayers declaring their dividend income upon filing the return of income. Clearly the tax on dividend income is easily evaded by omission from, or non-filing of, the return. It is recommended therefore that a withholding tax also apply to dividends paid to residents. The current practice of exempting dividends paid to a resident company from withholding tax should remain although consideration should be given to making the exemption subject to a directive from the Commissioner.

Consideration should also be given to making the withholding tax on dividends paid to non-corporate resident taxpayers a final tax. Making dividends subject to a final withholding tax would then allow for the omission of dividend income from returns filed by resident individuals. Ease of administration would demand that the same withholding rate apply to residents as to non-residents.

Interest income is taxable at the corporate rate and at marginal tax rates for individuals. However there are various exemptions in respect of building society interest, interest on deposits and on loans exempted by the government. The taxation of interest income would be greatly simplified by the application of a withholding tax by financial institutions.

There is an argument for making the withholding tax on interest a final tax in the hands of resident individuals. The amounts of interest held by individuals are likely to be relatively small and will, in any case, have been derived from savings made out of taxed income. However, companies and other taxpayers should be required to return the interest income and claim the withholding tax as a credit against tax at the normal corporate rate. Making interest subject to a final withholding tax of, say, 10% for individuals would also allow for the abolition of the existing exempt amounts. This would again simplify the administration of the personal tax as individual taxpayers would not have to file a return in respect of interest received and the Department of Taxes would not have to police the various exemptions.

The application of a final withholding tax on dividends and interest will mean that individual taxpayers with employment income, dividends and interest will not be obliged to file a return of income where tax has been correctly withheld. The filing of returns of income will therefore be unnecessary in a large number of cases and the Department of Taxes can then free up more staff for audit and investigation work.

There is often very poor compliance from companies and individuals trading in the construction and transportation sectors and the application of a withholding tax to their payments from principals (in many cases the government) can have a positive effect on revenue. In this case the rate of withholding should be set low and should not be a final tax. Also, income subject to withholding should not be subject to provisional tax payments.

Foreign construction companies are notorious for requesting tax exemptions for specific projects. They typically employ a branch structure and often fail to withhold tax on the income and benefits of expatriate personnel. The imposition of a withholding tax obligation on the principal gives the Commissioner more control over such taxpayers. In one case examined in the course of this consultancy the company simply wrote to the Commissioner and informed him that it had been granted a tax exemption by the Ministry of Finance.

Capital gains tax

It is recommended that consideration be given to introducing a limited capital gains tax whereby business gains would be taxed at the rate applicable to other business income. Companies are neutral as to gains received from income or capital and quite often the distinction is hard to make. Furthermore, if the law taxes income and not capital gains, companies have an interest in attempting to characterise income as capital so as to avoid tax. Taxing gains on business or investment assets at the same rate as other income removes this opportunity for avoidance. It also brings a positive, albeit perhaps small, revenue effect. All of the corporate files examined during this consultancy had gains on the disposal of business assets to some degree in their accounts.

Tax holidays and development approval orders

Tax holidays and development approval orders have been discussed earlier. Section 69(2) is the essence of bad law in that no two taxpayers in receipt of development approval orders seem to be treated the same nor does there appear to be a developed policy for dealing with claims for such orders. As was earlier recommended sections 12(5) and 69(2) should be repealed with immediate effect and action should be taken to revoke the existing development approval orders, particularly if the tax rate is to be reduced.

Taxation of parastatals

According to published accounts the operating surplus of the following currently tax exempt parastatals for financial years ending in 1993 were as shown in Table 3 below.

There does not appear to be any justification for continuing with the existing tax exemption for parastatals. By granting an exemption from tax the government is essentially providing the parastatals with a covert subsidy. If the government wishes to subsidise the parastatals it should do so in a more transparent manner by direct grant or subsidy. The payment of tax is an essential requirement of all businesses and the granting of an exemption to public enterprises perpetuates a non-commercial orientation and lack of a business culture. Most of the parastatals currently operate under monopolistic conditions but possibly also face either direct or indirect competition from the private sector e.g. railways vis a vis road transport or the national provident fund vis a vis other providers of superannuation funds. In these circumstances it makes no sense to subsidise the parastatals indirectly with a tax exemption.

Table 3: Operating surpluses of Public Enterprises 1993 figures[7]

Parastatal	Operating surplus ** 000's
Country Z Dairy Board	2,350
Country Z Cotton Board	92
???BOARD	1,616
Country Z Railways	21,203
Country Z Development & Savings Bank	46
Country Z Electricity Board	1,222
Posts & Telecommunications Corporation	4,482
National Industrial Development Corporation	1,226
Country Z Trade Fairs Company	188
TOTAL OPERATING SURPLUS	32,425
Possible Tax thereon	**12,159**

While the E32 million of parastatal income in the table would not translate precisely into taxable income, the figure of **12.16 million is an indicator of the extent of the revenue loss as a result of the tax exemption. It is recommended that the parastatals be brought within the charge to tax with immediate effect for reasons of equity, efficiency and revenue generation.

Depreciation

Under existing rules depreciation is allowable to the extent that the Commissioner "may think just and reasonable as representing the diminished value by reason of wear and tear during the year of assessment of any plant and machinery, implements, utensils and articles used by the taxpayer for the purposes of his trade;" (section 14(1)(c) ITO 1975). In practice the Commissioner has agreed wear and tear rates for about 22 classes of assets. To increase certainty and ease of administration it

[7] Source: Public Enterprise Unit as quoted in Development Plan 1995/6 1997/8, EPO, April 1995, Page 70. Country Z National Provident Fund and Country Z Royal Insurance Corporation are not included as provident fund and life assurance income is unlikely to be taxed. The National Maize Corporation has also been excluded as this appears to be currently taxed.

is recommended that asset grouping be adopted whereby all assets are divided into no more than, say, four categories.

The law provides for an initial allowance of 50 percent of capital expenditure incurred on plant and machinery used in a process of manufacture, on industrial buildings erected and on capital expenditure incurred in connection with a new hotel or on improving an existing hotel. The allowance is granted in the year the expenditure was incurred.

The initial allowance is essentially a deferral of tax due to the timing advantage of being allowed to deduct, say, 60 percent (initial allowance plus depreciation allowance) of an asset cost in the year of expenditure when only the economic depreciation has actually been incurred. It essentially amounts to an interest free loan of the difference between the tax that would have been paid without the initial allowance and the tax that is paid after the initial allowance.

The initial allowance is discriminatory in that it is available only to certain trades i.e. manufacturing and the hotel trade and is therefore contrary to the concept of a level playing field for all investment. It is recommended therefore that the initial allowance be abolished.

Abolishing the initial allowance will, of course, have a positive effect on revenue.

Training allowances

An additional allowance of 100% of the cost of training is made available to taxpayers in certain industries. Again it is not clear as to the economic reason why these industries have been chosen and why, for example, the allowance is not made available for all training. From a practical point of view this allowance is difficult for the Commissioner's staff to control as quite often the claim bears no relation to deductions in the accounts of the taxpayer. The training of staff is an essential requirement of all business and there is no evidence that the existence of the training allowance has resulted in greater skills transfer than would have occurred without the allowance. What is certain is that taxpayers use the training allowance to reduce their tax rate as the examination of corporate tax files showed. It is recommended therefore that the training allowance be abolished.

Taxation of trusts

There are a number of high income earning organisations which appear to be discretionary trusts. In the case of T1 and T2 their origins appear to be as national development organisations. T1 was established in 1968 and currently has shares and loans in 19 enterprises in Country Z. Its annual report for 1993 shows total assets of **307 million and a net surplus for that year of **48.5 million. Copies of the published accounts for T2 or other trusts were unavailable.

A trust is normally taxable on trust income at the rates of tax applicable to resident individuals. Despite the fact that these organisations do not pay tax there does not appear to be any legal basis for their current exempt status. Following on the recommendation in recent IMF reports the government is considering methods of taxing these organisations but these have not yet been implemented.

In the meantime the sheer relative size of these trusts, particularly T1, means that they are forced to seek viable investment opportunities outside Country Z. Although T1 appears to be prevented from investing on the Neighbour 1 Stock Exchange, for example, it is allowed to hold (and does hold) substantial deposits in Neighbour 1. It recently applied for Central Bank permission to purchase shares in a new company being established in Neighbour 1 from U.S. sourced FDI.

If the proposals made above with regard to withholding taxes on dividends and interest are applied it will result in some taxation income being derived from these organisations but it should be noted that the withholding taxes may be avoided by restructuring the income flows or, for dividends, by interposing a resident company. Also, the withholding taxes cannot collect tax on revenue sited outside the jurisdiction. There is no real alternative to imposing full taxation on these entities if they are to play their part in contributing to the economic development of Country Z.

Personal Tax

The personal income tax of Country Z is characterised by a steep structure produced by having 8 tax bands spread over **27,000 of income (**40,000 - **13,000). The top tax rate of 39% is encountered after **40,000 of income. Although the top rate is by no means the highest in the region, the steep structure ensures that average tax rates are very high, even by comparison with Neighbour 1 which has the highest top rate in the region. A comparison of regional top rates and the income levels at which they apply is shown in the following table[8]:-

Table 4: Comparison of regional top tax rates

	Country Z	Neighbour 1	Neighbour 3	Neighbour 2[9]	Neighbour 4[10]	Neighbour 5
Top personal tax rate	39%	45%	30%	35%	35%	40%
Income after which top tax rate applies	**40,000	R80,000	X$60,000 or **75,000	30,000	X$ 80,000	X$60,000 or **25,000
Personal income tax threshold	**13,000	personal rebate applies	resident individuals commence at 15,000 or **18,750	7,992 but this is being changed to a personal rebate of 2,640	$ 20,000	$ 9,000 or ** 3,750

As shown in Table 1 on page 11 the yield from the personal income tax is approximately 28% of the direct tax collection for the year ended 30/6/1994 as compared to about 68% from the corporate sector. The relatively poor yield from personal income tax is partly explained by the fact that a very small number of highly profitable corporate taxpayers contribute a very high proportion of the company tax. However, the disparity is really an indicator of the leakages in the personal tax system. These leakages occur because of: -

- a personal income tax threshold that is too high in relation to the wage rate,
- substantial tax avoidance by expatriates and other high income earners, and
- the ineffective taxation of non-cash benefits.

[8] I am indebted to KPMG, Country Z, for assistance in compiling the figures for Neighbour 3, Neighbour 4 and Neighbour 5.

[9] The current rate is 40% but the authorities are planning to reduce the rate to 35% with effect from 1 April 1995 and a bill to give effect to this change is under consideration.

[10] Figures are as per budget speech and approval by Parliament is awaited.

Personal income tax threshold

Although the threshold does not appear to be too much out of line by comparison with other countries in the region, it is very much out of line by comparison with current wage rates. Of the 24,284 public servants (excluding the defence force but including teachers, casuals and daily paid employees) 10,575, or 44%, have earnings that are below the tax threshold.[11] Effectively the threshold excludes semi-skilled and unskilled workers from the tax net. The threshold has been increased substantially in recent years to the point where it is now effectively too high. The threshold should therefore be held at its present nominal level for some years until it is brought more into line with personal income levels.

Tax avoidance schemes

Of far more concern is the leakage of revenue that is occurring from simple tax avoidance schemes. From an examination of personal tax files in the Department of Taxes it appears that virtually all expatriates have provisions allowing the payment of tax free gratuities upon termination of contract. The gratuity is payable at the end of a two year contract but there is nothing to prevent the taxpayer from continually renewing contracts and obtaining a fresh gratuity with each new contract. The effect is that taxpayers availing of this provision are able to permanently avoid tax on 20% of their taxable income. Given that these taxpayers are invariably top rate taxpayers, the effective top marginal rate of tax is reduced to 31.2% (80% x 39%) for all taxpayers with gratuity clauses in contracts. The justification for this treatment is that the gratuity supposedly compensates for the lack of a pension scheme for expatriate workers. This is erroneous because most expatriates do, in fact, contribute to pension schemes. Although only a small deduction is available to the employee for contributions to a provident fund,[12] an employer is entitled to deduct up to 20% of the employee's salary in respect of such contributions. The employee may withdraw the accumulated value of all contributions, plus interest thereon, tax free, upon termination of contract. The combination of the gratuity and provident fund provisions ensures that the level of taxation applying to taxpayers to whom these provisions are available is significantly below the level of taxation indicated by the nominal rate band structure. This in turn creates a significant disparity of treatment between taxpayers as those with the economic strength to structure their contracts pay much less tax than those who cannot.

An illustration of this disparity is shown below. Consider a taxpayer with a salary of **150,000 p.a. The tax that would be expected on that salary is **49,500 (**6,600 on the first **40,000 + **110,000 @ 39%).

In fact it is possible to limit the tax to **30,000 by restructuring the package as follows:-

Salary	**100,000 (tax thereon **30,000)
Gratuity	**25,000 (tax free upon termination)

[11] Source: Ministry of Finance figures.
[12] There is a small rebate of up to **120 per annum for contributions to an approved provident fund scheme.

Contribution to provident fund **20,000 (tax free upon termination)
Interest on provident fund contributions (say) **5,000 (tax free upon termination)

Under the law only the salary is taxed. The salary, gratuity and provident fund contribution are all allowable deductions to the employer but the gratuity, payout from the provident fund and accrued interest are all tax free in the hands of the employee upon termination of contract. In the above example the employee receives gross remuneration of **150,000 but only pays tax of **30,000 which is an average tax rate of 20% (or a marginal rate of 21.27% on the top **110,000 of income).

All of the personal files examined in the Department of Taxes contained contract gratuity exemption clauses. It was not possible to determine whether they were all in receipt of provident or pension fund benefits as the deduction is taken by the employer but the examination of company files indicated that all companies provide pension arrangements for staff. Certainly from conversations with tax professionals the evidence is that all expatriates have gratuity and pension/provident fund clauses in contracts.

Although the Department of Taxes no longer separately identifies expatriate taxpayers it was possible to derive a reasonably accurate figure of their number from a computer print-out of all employees on the register of the Department. This gave a figure of 4,235 expatriates. Assuming an average income level of between **100,000 and **150,000 the expatriate income base could very well be between **423 and **635 million. If a conservative approach is taken and the figure of expatriates is reduced to 3,000, the income range is between **300 and **450 million. Even if only 20% of this income is being sheltered from tax, the revenue loss at current rates is probably at least **23 million (**60m x 39%) or about 25% of the P.A.Y.E. collection in 93/94. If we assume there are 4,235 expatriates but use the lower income figure of **100,000 for average salary this would imply a current tax loss of **33 million (**423m x 20% x39%). Of course this particular form of avoidance is not confined to expatriate taxpayers but is available to all taxpayers with gratuity and provident fund provisions in contracts. Many higher income Country Z nationals are employing the same techniques to reduce their tax levels.

It is recommended therefore that the exemption in respect of contract gratuities be withdrawn with immediate effect. If this is not possible then, at the very least, an exempt gratuity should be denied to a taxpayer contributing to a pension or provident fund.

It is further recommended that, if a deduction is granted in respect of contributions to pension and provident funds, the lump sum payouts be taxed in the hands of the recipients as is the case for pensions. It makes no sense to provide a tax deduction for contributions to pension and provident funds and then to allow the lump sum payout to go untaxed. There should be one taxing point for lump sum payouts as there is for pensions.

Benefits in kind

Non-cash benefits paid to employees are ineffectively taxed in Country Z. In the past benefits were not subject to the P.AY.E. tax collection mechanism and employees in receipt of benefits were

obliged to file a return of income declaring their benefits received from employment. Effectively this was the only way that the Department of Taxes knew of the existence of taxable benefits. Following examination of the return the Department would then enter an assessment on the individual in receipt of the benefit and then attempt to recover the tax.
A recent positive change following on from the introduction of the Final Deduction System was the obligation placed on the employer to withhold tax on benefits. This evens up the treatment of cash and benefit forms of remuneration and is producing increased revenues from this source. Nevertheless benefits in kind are ineffectively taxed due to: -

- taxable values of benefits being set well below the market value of the particular benefit;
- monetary limits being set on these market values which may or may not rise with inflation; and
- a failure to tax all benefits comprehensively.

The failure to tax non-cash benefits to the same extent as cash remuneration is a highly regressive feature of the personal tax structure of Country Z given that such benefits are in the main received by higher income taxpayers. The following tables show the taxable values attaching to the more common classes of benefits per annum. Where possible a more realistic value based on market rates is suggested. The comparison illustrates how unrealistic are the existing values.

Table 5: Taxable/market values of housing benefit

Housing Benefit	Taxable value Area "A"	Market value Area "A"[13]
4 bedroom house	**6,134	**30,000
2/3 bedroom house	**4,089	**22,000
Basic (bedsitter or 1 bedroom)	**3,067	**18,000

Table 6: Taxable/market values of vehicle benefit

Vehicle Benefit	Taxable value	Market value	Revised taxable value at, say, 15% of cost
Vehicles below 1600cc	**3,681	Say **40,000	**6,000
Vehicles between 1600 and 2000 cc with a value less than E60,000	**4,908	Say **50,000	**7,500
Vehicles between 1600 and 2000 cc with a value over E60,000	**6,134	Between **60,000 and **80,000	Between **9,000 and **12,000
Vehicles of 2000 cc and over with a value less than E80,000	**6,134	Between **60,000 and **80,000	Between **9,000 and **12,000

[13] Area "A" is within a radius of ten kilometres from the centres of City 1 or City 2.

Vehicles of 2000 cc with a value more than E80,000	**11,042	Between **80,000 and, say, **300,000	Between **12,000 and, say, **45,000

Table 7: Taxable/market values of utilities and domestic assistance benefits

Utilities and Domestic Assistance Benefits	Taxable value	Market value
Free electricity	**545	Actual amount (typically **4,000)
Free telephone	**545	Actual amount paid
Free gas, coal, water, etc. (per service)	**273	Actual amount paid
Household domestic servants	**682	Actual amount (typically **4,000 to **5,000)
Gardener	**341	Actual amount (typically **3,000)

Table 8: Taxable/market values of other benefits

Other Benefits	Taxable value	Market value
Education	80% of the total cost of school fees and other expenses paid by the employer	100% of the cost of school fees and other expenses paid by the employer
Entertainment and traveling	Actual amount paid by the employer, less justifiable official expenses	Actual amount paid by the employer.
Free or subsidised fuel supplied for employee's transport	Actual amount paid by the employer, less justifiable official expenses	Actual amount paid by the employer.
Other benefits	Dealt with on an individual basis	Market value of benefit.

If an employer is paying for benefits such as utilities, domestic assistants, school fees, fuel for transport, etc. then their costs are known and the law should treat these costs as the taxable values and P.A.Y.E. tax should be deducted accordingly.

Similarly, if an employer is renting accommodation for an employee then the taxable value should be the rent paid for that house or, if owned, the rent that would have been paid if the employer were forced to rent it.

There is no need to complicate the vehicle valuation with a rating based on engine size when value is also used. The taxable value of a vehicle could be set as a proportion of the market value of the vehicle, including sales tax thereon, (say 12% or 15%) and not an arbitrary monetary amount related to engine size and value. It is worth bearing in mind that the provision of a vehicle, for example, includes not only the cost of the vehicle but the financing charges, fuel, tyres, repairs, maintenance and depreciation all of which are charged as business deductions. Under current law the provision of a Mercedes Benz costing **250,000 with all its attendant running costs would cost a taxpayer **4,306 p.a. (**11,042 @ 39%) or **359 per month. This cost is minimal by comparison with actual costs. Establishing the taxable value of the vehicle as 15% of cost would produce a tax cost of **14,625 per annum (**250,000 x 15% @ 39%) or **1,219 per month which is much closer to the real cost.

Using market value will have the effect of curbing the tendency of high income taxpayers to choose remuneration in the form of benefits over cash in order to obtain a tax advantage and will produce a positive effect on revenue as either benefits are "cashed out" or more tax is paid due to the imposition of realistic taxable values.

The authorities should produce a list of the most common benefits provided to employees in Country Z. Consideration should then be given to establishing the most effective taxing regime for benefits, the options for which are:-

- denial of a deduction for fringe benefits,
- fringe benefits taxed under P.A.Y.E. and F.D.S. as at present, or
- imposition of a separate Fringe Benefits Tax on the employer (as Neighbour 2 has done).

It is not recommended that benefits be taxed by denial of a deduction to the employer as this places an additional obligation on the Department of Taxes to effectively scrutinise all accounts filed to ensure that benefits are not being deducted. The choice therefore boils down to taxing benefits under the P.A.Y.E. and F.D.S. system as at present or imposing a separate Fringe Benefits Tax on the employer. If there is a comprehensive list of all benefits and rules for their calculation which reflect market values, then taxing the benefit through the P.A.Y.E. system without the withholding obligation on the employer, will probably yield a satisfactory result. Imposing a separate Fringe Benefits Tax on the employer does bring additional benefits. Firstly, it forces the employer to evaluate the real cost of the benefit including the tax thereon. Although both the tax and the benefit cost are allowable items, the employer is still forced to bear the gross cost of both and this is likely to lead to a "cashing out" of benefits which will have a very positive effect on P.A.Y.E. revenues. Secondly, because the employer is bearing both the cost of the benefit and the tax thereon, there is no incentive for the employer and employee to collude and ensure that benefits are not reported or tax not withheld. Thirdly, it may suit employers to pay the cost of the tax on benefits rather than attempt to force it back to employees as the P.A.Y.E. system does. Finally, benefits payable to public servants must be taxed in exactly the same way as benefits paid in the private sector for

reasons of transparency and to promote compliance in the private sector. Since government is both the paymaster and the collector of revenue, it might find it easier to pay the benefits to its employees, rather than pass the tax on to them through the P.A.Y.E. system.

Home ownership and improvement interest

The deduction is between 200 percent and 50 percent of interest paid to a building society for the purchase building or improvement of a house in Country Z, depending on the income of the taxpayer. This is another complication and distortion in the personal tax system the removal of which will simplify the administration of the tax.

Summary of base broadening measures

The suggested base broadening measures are summarised as follows:-

- Introduction of branch profits tax
- Taxation of residents on income from all geographic sources
- Imposition of withholding tax on management fees and royalties paid to non-residents
- Abolition of exempt interest income
- Dividends to Neighbour 1, Neighbour 3 and Neighbour 2 to be taxed at the same rate as dividends to other countries
- Final withholding tax to apply to dividends paid to residents (except resident companies)
- Final withholding tax to apply to interest paid to resident individuals
- Non-final withholding tax to apply to interest received by all other taxpayers
- Non-final withholding tax to apply to resident contractors
- Limited capital gains tax to be introduced
- Abolition of tax holidays under section 12(5)
- Abolition of development approval orders under section 69(2)
- Existing development approval orders to be revoked or amended
- Taxation of parastatals
- Withdrawal of initial allowances
- Withdrawal of training allowances
- Taxation of trust income either fully as trusts or partially by withholding on dividends and interest
- Freezing the personal income tax threshold at **13,000 or as a **3,000 tax rebate
- Abolition of tax exempt status of contract gratuities
- Taxation of lump sums paid from provident funds out of employer's contributions
- Effective taxation of benefits in kind through separate Fringe Benefits Tax or by P.A.Y.E.
- Abolition of deduction for home ownership and improvement interest

It is not possible to estimate the revenue effect of implementing some or all of the above proposals because of a lack of adequate data. There will be differing time lags attaching to each proposal either because of the necessity to draft legislation or because of the time before taxation of the income produces additional tax revenue. It is however possible to say that the overall result will be positive with some proposals being especially valuable in terms of revenue enhancement.

TAX RATE POLICY CHOICES

It is emphasised that the following section is not meant to suggest a particular rate of tax which Country Z should adopt but is rather an attempt to indicate possible courses of action which may be financed from the base broadening measures suggested earlier.

Corporate tax rate

A range of possible policy choices showing Country Z effective corporate tax rates (and a comparison with Neighbour 1) is shown in tables 9 to 13 inclusive. A corporate rate of 30% combined with a dividend withholding rate of 20% produces an effective rate of 44% whereas at the other end of the scale a corporate rate of 20% combined with a dividend withholding rate of 15% produces an effective rate of 32%. Country Z has an effective rate advantage over Neighbour 1 at all of the policy choices shown below.

Table 9: Country Z corporate rate 30%; withholding rate 20%

	Country Z corporate rate 30% Withholding rate 20%	Neighbour 1 current rate
Taxable income	100	100
Less: Normal tax	30	35
Retained	70	65
Withholding and STC	14	13
Available for shareholders	56	52
Effective rate of tax	44%	48%

Table 10: Country Z corporate rate 30%; withholding rate 15%

	Country Z corporate rate 30% Withholding rate 15%	Neighbour 1 current rate
Taxable income	100	100
Less: Normal tax	30	35
Retained	70	65
Withholding and STC	10.5	13
Available for shareholders	59.5	52
Effective rate of tax	40.5%	48%

Table 11: Country Z corporate rate 25%; withholding rate 15%

	Country Z corporate rate 25% Withholding rate 15%	NEIGHBOUR 1 current rate
Taxable income	100	100
Less: Normal tax	25	35
Retained	75	65
Withholding and STC	11.25	13

Available for shareholders	63.75	52
Effective rate of tax	36.25%	48%

Table 12: Country Z corporate rate 20%; withholding rate 20%

	Country Z corporate rate 20% Withholding rate 20%	Neighbour 1 current rate
Taxable income	100	100
Less: Normal tax	20	35
Retained	80	65
Withholding and STC	16	13
Available for shareholders	64	52
Effective rate of tax	36%	48%

Table 13: Country Z corporate rate 20%; withholding rate 15%

	Country Z corporate rate 20% Withholding rate 15%	Neighbour 1 current rate
Taxable income	100	100
Less: Normal tax	20	35
Retained	80	65
Withholding and STC	12	13
Available for share holders	68	52
Effective rate of tax	32%	48%

Personal tax rate and tax band structure

An example of a much simplified personal rate band structure is shown in table 14. The maximum personal tax rate of 30% would correspond roughly to the effective corporate rate shown in table 13 (32%). This however assumes that all corporate profits are distributed each year which is not a likely scenario.

Table 14: Simplified personal tax band structure

Taxable income	Rate of tax
Between 0 and **30,000	20%
Over **30,000	30%

To provide greater progressivity in the system the exempt amount (currently **13,000) could be replaced with a personal rebate of **3,000 or **250 per month. The personal rebate should apply only to resident taxpayers regardless of marital status, number of children or any other personal criteria.

The **3,000 personal rebate is calculated to compensate taxpayers for the move to an initial rate of 20%, and the computation is as follows:-

					**
Exempt amount	**13,000 at 20%	=			2,600
First tax band 12%, now taxed at 20%	=	3,000 @ 8%	=		240
Second tax band 16%, now taxed at 20%	=	4,000 @ 4%	=		160
		Rebate	=		3,000

A personal rebate rather than an exempt amount is suggested because it is more beneficial to lower income taxpayers and is therefore more progressive. An exempt amount of income provides an equal income exemption to all taxpayers and is therefore more valuable to a high income taxpayer than to a low income taxpayer. The exempt amount is worth **3,900 to a taxpayer whose tax rate is 30% (**13,000 x 30%) but only **2,600 (**13,000 x 20%) to a taxpayer whose tax rate is 20%. A personal rebate provides an equal tax credit to all taxpayers and is therefore proportionately more valuable to low income taxpayers.

The value of the Neighbour 1 rebate is **2,625 for the current tax year (95/96) and Neighbour 2 is proposing a rebate of **2,640 for this year also. Assuming an inflation rate of about 12% a rebate of **3,000 introduced in 96/97 would equate to about **2,679 in 95/96 and is therefore very comparable.

As noted earlier the existing structure has provided the impetus for various personal tax avoidance schemes, particularly amongst expatriates, which have tended to undermine the base of the tax and which in turn contribute to the need for high tax rates.

It is submitted that the existing structure is a serious impediment to the attraction of foreign investment because it is unnecessarily complex and because employers have to engage in tax avoidance schemes in order to provide senior managers and technical personnel with a competitive remuneration package.

It is further submitted that the existence of the eight band rate structure does not materially contribute to progressivity in the system. Progressivity can also be achieved by a two band rate structure incorporating relatively wide tax bands and a single exempt amount or personal rebate. Simplification of the personal rate band structure would be a positive signal to investors and would also bring benefits to indigenous small business and employees.

A standard rate of tax

Some countries specify a rate of tax as the standard rate of tax and this rate is then used for the taxation of non-residents, low income residents and other withholding taxes. If the 20% rate were taken as the standard rate, this rate would be applied to all dividends, interest, royalties and management fees to non-residents and to dividends paid to residents. The initial band of personal income to which it is applied could be substantially widened in later years, (depending on revenue forecasts), so that it includes the majority of local employees and small businesses.

It is recognised that Country Z would prefer to grant lower withholding rates to the countries with which it has double taxation agreements and, in fact, the rates applicable in the agreements with Neighbour 1, UK and Mauritius are lower than 20%.

It is suggested that a 10% rate could be applied to interest paid to residents, services income (other than management fees) to non-residents and, possibly, to resident contractors.

Financing of tax rate reductions

It has already been estimated that abolition of the initial allowance and tax holidays and taxation of the parastatals and trusts would provide sufficient funding to reduce the corporate rate to 30%[14].

The following method attempts to derive an estimate of the gross tax loss incurred in reducing the corporate rate to 30% by taking the actual corporate tax collection in 1993, removing the effect of the largest corporate taxpayer (in receipt of special treatment under a development approval order) and making an estimate of the value of the initial allowance and training allowance.

The computation is as follows:-

			** (millions)
Corporate tax collected in 1993			236[15]
Remove large taxpayer		80	
Remaining corporate taxpayers contributed			156
Gross up @37% =			416
Add: Estimate of initial allce and Training Exps.			35
Gives taxable income before initial and training allces		451	
Tax this income @ 30%			135.3
Add back large taxpayer			80
Revised tax collection at 30% rate			215.3
Revenue loss			20.7
% revenue loss	20.7/236	=	8.8%

The above calculation assumes a training allowance deduction of **10 million and capital expenditure qualifying for a 50% initial allowance of **50 million, which would not be unreasonable on an income base of **416 million. Abolition of the tax holidays and preferential tax regimes and taxation of the parastatals should be sufficient to cover this loss.

An estimate of the gross loss arising from a change in the personal rate band structure was derived by inserting the two band structure outlined above into a model of the existing salary structure pertaining in Country Z using an estimate of 95/6 income levels[16]. The indication is that the gross tax loss is about **15 million on a projected personal tax revenue of **112 million[17] or 13% of revenue. This loss of revenue would be more than offset by freezing the personal exemption, taxing gratuities and using market values for benefits.

[14] Country Z: options for reform of company taxation, March 1995, page 10.
[15] Source: Department of Taxes
[16] Source: The model used was developed by KPMG, Country Z and I am grateful to the senior partner for assistance in estimating the revenue implications.
[17] The model appears to be reasonably accurate as its forecast for tax revenues at existing tax rates corresponds closely with official estimates.

SALES TAX/VAT

The existing sales tax is levied on imports, sales by domestic manufacturers, certain services, and accommodation and food supplied by hotels and restaurants. There are specific exemptions for personal shoppers, basic foodstuffs, medical and surgical supplies, educational supplies, manufacturing and agricultural inputs and plant and machinery. There are opportunities for additional revenue by taxing services at 10% instead of the present 5%, subjecting services to the same turnover threshold as taxable goods for registration purposes and by broadening the base of the tax to include electricity and communication services. Consideration should be given to removing or reducing the existing exemptions. Improved administration of the sales tax including a substantial increase in the penalty provisions would likely produce additional revenue. These actions should all be taken to improve the yield from the sales tax.

There is also the issue of whether or not VAT should be introduced. A VAT would seem to be the logical choice given the trading relationship with Neighbour 1 and the fact that a VAT operates in Neighbour 1. A VAT is generally regarded as a more efficient tax than a sales tax because the tax is collected at each stage of the production and distribution chain, thus lessening the chance of revenue loss through evasion. VAT also prevents cascading of tax because the tax on purchases is credited against the tax on sales.

A VAT levied in Country Z at the same rate as Neighbour 1 would produce significant additional revenue. It would also allow for introduction of the proposed direct transfer mechanism whereby exports from Neighbour 1 to Country Z would not be subject to VAT. Exports from Country Z to Neighbour 1 would be treated in the same way and the VAT would be accounted for, say, monthly by direct payment from Neighbour 1 (the net exporter) to Country Z.

On the negative side the weakness in tax administration would be an argument against the introduction of VAT at least for the moment until the administration is significantly improved. Since a VAT is a self-assessed tax it must be combined with an effective tax administration capable of identifying and registering liable traders, processing their returns, inspecting traders' books and records and levying penalties for non-compliance. This skill does not appear to exist to the required extent in the Department of Customs at the moment. A related issue is where the VAT administration should be located. The logical location would appear to be the Department of Taxes which already has records of traders and experience of inspecting traders' records, P.A.Y.E. returns etc. and where the information from the VAT returns could be cross-referenced to the income tax returns and vice versa.

The authorities should decide quickly on the issue of a VAT and, if it is decided to implement a VAT, a VAT working group should be set up to produce an implementation plan and oversee the move to the VAT. It is likely that the move to a VAT will take about 2 years including the time taken to train staff and prepare traders, etc.

ADMINISTRATION

If the Income Tax law is altered in the manner suggested earlier most of the main income flows will be subject to withholding tax i.e.

- Dividends, Interest, Royalties, Management fees to non-residents;
- Services income to non-residents
- Payments to non-resident contractors;
- Employment income of non-residents;
- Dividends and Interest to residents;
- Employment Income and Fringe benefits to residents; and
- Payments to resident contractors.

To make the withholding obligation effective, the law must specify, as it does for F.D.S., that any person with an obligation to withhold tax (a withholding agent) is liable for any tax not withheld. This provision exists under section 59 for non-resident contractors and under 31(4) for interest but needs to be added for payers of dividends, interest, royalties and management fees.

Penalties

There must also be a severe penalties regime for withholding offences. Most tax administrations reserve their heaviest penalties for offences by withholding agents. This is because in many cases the only means of securing a tax payment from a taxpayer, say, a non-resident, is by placing a withholding obligation on the person making a payment to the non-resident. A withholding agent failing to pay over tax withheld is cheating, not only the tax administration, but also the person from whom the tax was withheld.

Most penalties levied are fines, or for more serious offences, there is the possibility of a fine and a prison sentence as well as additional tax which may be a multiple of the actual tax payable, usually two or three times the tax. Fines alone may not pose a serious threat to a large corporation although the possibility of having to pay additional tax is a significant threat. Consideration should therefore be given to the idea of deeming corporate offences to have been committed by every person who, at the time of the commission of the offence, was a public officer, director, general manager, secretary, etc. or who was acting, or purporting to act, in that capacity. To balance this rather stringent provision the law should provide that the person can offer a defence by proving that he or she did not consent to, or know of, the commission of the offence and that he or she exercised reasonable diligence to prevent the commission of the offence.

The Commissioner should be given the power to seize assets of taxpayers where tax is owing without first having to obtain a court order. The Commissioner should be able to issue an order in writing specifying the taxpayer against whose property he is proceeding, the location of the property, and the assessment to which the proceedings relate. Property upon which a distress is levied should be kept for, say, two weeks either at the premises where the distress was levied, or

wherever the Commissioner deems appropriate. If the taxpayer does not pay the tax within the two week period, the property is then sold.

Audit

In addition to the penalties regime the Department of Taxes must be able to effectively audit withholding agents to ensure that they are complying with their obligations.

The main classes of income not subject to withholding would be:-

- Business and rental income of resident companies; and
- Business and rental income of resident individuals

The filing of these returns, and indeed all returns, should be on a self-assessment basis, with heavy penalties for non-compliance. This will allow the Department of Taxes to focus its activities on persons not complying with the law i.e. persons who have not filed a return, or persons who have filed in previous years and not filed in the current year (stop-filers), as well as auditing a selection of those who have filed.

The Department therefore needs a well-trained and effective audit section capable of conducting simple and complex audits. Currently there is a lack of sufficiently well-trained staff especially for this type of work. In addition, staff of the Department of Taxes are poorly remunerated in relation to private sector employment. Poor rewards and, possibly, a poor career structure makes the Department an unattractive location for the type of people the Department needs most - young, qualified accountants well-trained in audit work.

Table 15 shows the cost of running the Department of Taxes. This is very low by international standards. Typical collection costs around the world are in the range of 1.5 - 2.5 percent of tax collected. The Country Z rate of about 0.77 percent is more a reflection of a lack of resources than high efficiency within the Department of Taxes.

Table 15: Cost of operations - Year Ended 30/6/1994[18]

Item	Estimated Budget	Actual Expenditure
Personnel	2,239,300	1,909,609
Transport	221,700	216,642
Services	283,250	262,302
Consumables	93,600	92,221
Durables	68,150	68,100
External transfers	10,000	7,567
TOTAL	2,916,000	2,556,440

Personnel costs are 75% of total costs and the total cost of operations amounts to .77% of income tax collected.

[18] Source: Annual report, Department of Taxes, year ended 30 June 1994.

CONCLUSION

The purpose of this paper was to examine tax strategies for investment promotion. It was recognised that tax incentives may have little impact in attracting new investment by comparison with other non-tax factors affecting investment. The government's need for tax revenues must be the paramount concern in the light of the existing ***U negotiations.

Nevertheless, there are many inequities and leakages of direct tax revenue under the existing law which, if corrected, will lead to additional income tax revenue which can then be used to finance a cut in tax rates. Additional revenue would also be generated by abolition of sales tax exemptions, a fuel levy and the sugar export levy. Strengthening the tax administration will also produce a significant revenue gain.

It is recommended therefore that the income tax base be broadened and that the other measures to raise revenue be implemented as soon as possible. An overall rate reduction to 30% can likely be implemented in 96/7 provided the tax loss is financed by base broadening measures, which should be implemented in any case. Further rate reductions may be considered at a later date when the revenue effects of the base broadening measures can be evaluated.

STRATEGY

Some of the base broadening measures can be implemented immediately. These include taxation of the parastatals, repeal of sections 12(5) and 69(2), abolition of the training and initial allowances, imposition of the withholding taxes on income flows to non-residents and on interest and dividends paid to residents, abolition of exempt interest amounts, introduction of market values for benefits, abolition of home ownership interest and taxation of contract gratuities. With regard to the taxation of contract gratuities it would be necessary to announce a date after which new contracts would no longer be exempt. Existing contracts would be deemed to fall into two parts, before the cut-off date and after the cut-off date. The accumulated value of the gratuity relating to services performed up to the cut-off date would remain exempt from tax and the portion of the gratuity relating to services performed after the cut-off date would be liable for P.A.Y.E. tax as would gratuities contained in all new contracts entered into after that date.

Request assistance to redraft income tax law

A new modern income tax law drafted in plain English, aimed at broadening the tax base and removing all opportunities for avoidance should be produced as soon as possible. Work on this should begin immediately by placing a request for assistance.

Review double taxation agreements

Existing double taxation agreements should be reviewed to ensure that they are compatible with the new withholding taxes charged to non-residents (e.g. the existing agreements appear to prevent the taxation of royalty payments to residents of Neighbour 1 and to Country U) and to ensure that a branch profits tax is not regarded as discriminatory. Requests to re-negotiate the agreements should be made as soon as possible as there is usually a long "queue" of countries waiting to negotiate agreements with Country U and Neighbour 1.

Request assistance to improve audit facility in the Department of Taxes

The move towards a self-assessment system implies that the Department of Taxes must be able to effectively inspect the books and records of taxpayers. Taxpayers must be made to realise that there is a reasonable chance of evasion and non-compliance being detected and, once detected, will be severely punished. This strategy can only succeed if the Department has a substantial, well trained, audit department. This is an area where XX would, in principle, be willing to offer assistance.

Recognise need to recruit qualified accountants into the Department of Taxes

An effective audit strategy will require tax officers with good accounting knowledge. The government should ensure that the Department of Taxes is able to recruit and retain such personnel by improving the relative attractiveness of working as a tax professional within the Department. This would involve paying a "professional allowance" to tax officers as is available to professionals

working elsewhere within the government. This is a very small cost relative to the value of the taxes lost through evasion and non-compliance.

Request assistance with forms design

New forms will be required to cover the payments of income subject to final withholding taxes. This is particularly important for non-residents who will use these forms for claiming tax credits in their home countries. It is a good idea to ensure that all forms currently in use in the Department of Taxes are as user-friendly as possible. This implies they should be drafted in plain language, use active rather than passive speech and have a unique corporate style. A forms design expert should be recruited for this task and, again, this is an area where XX would, in principle, be willing to offer assistance.

Establish Working Group to decide on introduction of VAT and prepare implementation strategy

A decision should be taken once and for all on VAT and if the decision is to move to a VAT a working group should be established to plan the move to the new tax. There is considerable VAT expertise available and either the YY, XX or Neighbour 1 should be able to provide technical assistance to the working group.

Place administration of Sales Tax/VAT within the Department of Taxes with Customs continuing to operate on an agency basis at the border posts

If a move to Value Added Tax is to be contemplated then efficiency would demand that the Department of Taxes be made responsible for the administration of the tax. Placing the administration of the tax in the Department of Taxes is logical given that that Department has, or will have, an audit and inspection capability. The Department of Taxes would then be responsible for doing VAT inspections on traders' premises. The Department would also be able to include multi tax-head audits (whereby all the taxes for which a business is liable are examined at the same time) as part of its audit strategy.

Regional discussions

Discussions should take place with the other countries in the region to ensure that countries do not attempt to "outbid" each other in their efforts to attract FDI, thus placing their budgetary positions at risk. There must be an end to companies threatening the government that they will relocate unless they receive favourable treatment, although the earlier recommendation to repeal section 69(2), if adopted, will lessen this problem particularly if the tax rate is lowered. Nevertheless, consideration should be given to the development of a regional strategy with regard to investment promotion.