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Honduras’ Tax Justice Law: Increasing tax collection to achieve the SDGs without increasing tax rates

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In April 2023, the government of Honduras submitted a tax reform bill called the “Tax Justice Law” to the National Congress through which it intends to reform the Honduran tax system with potential for improved revenue collection, that too, without introducing new taxes or increasing tax rates. The law aims at Constitutional recognition that tax collection must be progressive, change the principle of taxation from territorial to worldwide taxation of income, introduce Ultimate Beneficial Ownership requirements that *inter alia* aim to repeal bearer shares, facilitate exchange of information with other jurisdictions, eliminate banking secrecy for tax purposes, implement credit method in domestic legislation to eliminate double taxation, amend the Constitution so as to limit tax exemptions to a maximum period of 10 years, restore transfer pricing audits to check abusive claim of tax incentives and eliminate the possibility of forgiving tax debts. The provisions contained in the Tax Justice Law are timely and welcome, particularly in light of the Global Minimum Tax. They can improve government revenues, reduce public debt and create the fiscal space for achieving the Sustainable Development Goals.

En abril de 2023, el gobierno de Honduras presentó al Congreso Nacional un proyecto de reforma fiscal denominado "Ley de Justicia Tributaria" mediante el cual pretende reformar el sistema tributario hondureño con potencial para mejorar la recaudación de ingresos sin la necesidad de implementar nuevos impuestos o aumentar los existentes. La ley busca el reconocimiento constitucional de que la recaudación de impuestos debe ser progresiva, y propone cambiar el principio de renta de territorial a mundial, introducir criterios para la determinación del Beneficiario Final con el fin, entre otras

SOUTH CENTRE

cosas, de derogar las acciones al portador, facilitar el intercambio de información con otras jurisdicciones, eliminar el secreto bancario para fines tributarios, implementar el método de crédito en la legislación interna para eliminar la doble tributación, modificar la Constitución para limitar las exenciones fiscales a un período máximo de 10 años, restablecer las auditorías de precios de transferencia para verificar reclamos abusivos de incentivos fiscales y eliminar la posibilidad de condonar deudas tributarias. Las disposiciones contenidas en la Ley de Justicia Tributaria son oportunas y bienvenidas, especialmente a la luz del Impuesto Mínimo Global. Pueden mejorar los ingresos gubernamentales, reducir la deuda pública y crear el espacio fiscal para alcanzar los Objetivos de Desarrollo Sostenible.

En avril 2023, le gouvernement du Honduras a soumis au Congrès un projet de réforme fiscale intitulé « Pour une justice fiscale» visant à réformer le système fiscal hondurien en renforçant les mécanismes de prélèvement, sans introduire de nouveaux impôts ni augmenter les taux d'imposition. La loi entend consacrer dans la Constitution le principe de la progressivité de l'impôt et prévoit de modifier les règles applicables en matière de domicile fiscal en passant d'une imposition nationale à une imposition mondiale, d'introduire des exigences en matière de propriété en dernier ressort dont l'objectif est notamment *de supprimer les actions au porteur, de faciliter l'échange d'informations avec d'autres états, de mettre fin au secret bancaire à des fins fiscales, d'instaurer un crédit d'impôt dans la législation nationale afin d'éliminer la double imposition, de modifier la Constitution de manière à limiter les exonérations fiscales à une période maximale de 10 ans, de rétablir les audits des prix de transfert afin d'éviter les demandes d'incitations fiscales abusives et de supprimer toute possibilité d'annulation des dettes fiscales. Les dispositions contenues dans la loi sur la justice fiscale sont opportunes et bienvenues, en particulier au regard de l'adoption à l'échelle mondiale d'un impôt minimum. Elles sont de nature à permettre un accroissement des recettes publiques, une réduction de la dette et la création de l'espace fiscal nécessaire à la réalisation des objectifs de développement durable.*

In April 2023,[1] the Government of Honduras presented to the National Congress a "Tax Justice Law" aimed at reforming the Honduran tax system for improved revenue collection without introducing new taxes or increasing tax rates. Indeed, there is significant potential for countries to raise revenues in this manner by addressing illicit financial flows (which include both tax avoidance and tax evasion), strengthening tax administration and eliminating wasteful tax incentives. Research by the International Monetary Fund (IMF) shows that an increase in the overall strength of the tax administration is associated with an increase in tax revenues by 1.8 percentage points of gross domestic product (GDP), and if the reforms are sustained then this can increase over time to more than 3 percentage points of GDP after the 6th year.

Similarly, the passage of the Organisation for Economic Co-operation and Development (OECD)'s Global Minimum Tax (GMT) now means that developed countries or tax havens will be able to collect the taxes exempted by developing countries who give excessive or wasteful tax incentives to multinationals. A recent Policy Brief by the South Centre proposed that the urgent reform of these tax incentives is now essential for developing countries.

Like many developing countries, Honduras faces the aforementioned problems of illicit financial flows and wasteful tax incentives, and introduced the Tax Justice Law to address them. The law, which is yet to be passed by Parliament, aims to address certain defects in the tax system which lead to tax regressivity (the poor paying more and the rich paying less), inequality, banking secrecy, tax evasion and avoidance, the grant of excessive tax exemptions for a long time to large companies and forgiveness of tax debts. For these reasons the prevailing tax regime required major reforms in order to provide the revenues required for investments in vital public goods and achieving the Sustainable Development Goals.

[1] Refer to EY, "Honduran Government to file new tax reform before the National Congress", 22 March 2023 at https://globaltaxnews.ey.com/news/2023-5347-honduran-government-to-file-new-tax-reform-before-the-national-congress (accessed on 1 July 2024).

The Tax Justice Law contains policy reforms based on international best practices for a more progressive and transparent tax system.

Constitutional Recognition of Tax Progressivity

To begin with, it is proposed to provide Constitutional recognition that tax collection must be progressive, meaning higher taxes are imposed on those who earn more and lower taxes on those who earn less. The principle of tax progressivity is endorsed in Article 2.1 of the International Covenant on Economic, Social and Cultural Rights (ICESCR) which states that, "Each State Party to the present Covenant undertakes to take steps, individually and through international assistance and co-operation, especially economic and technical, to *the maximum of its available resources*, with a view to achieving progressively the full realization of the rights recognized in the present Covenant by all appropriate means, including particularly the adoption of legislative measures." (emphasis added)

The meaning of "maximum available resources" has been clarified by several United Nations (UN) Special Rapporteurs and Independent Experts. The former Special Rapporteur on the Realization of Economic, Social and Cultural Rights Danilo Türk noted that:

Progressive (as opposed to regressive) measures of taxation can, if supported by adequate administrative machinery and enforcement mechanisms, lead to gentle and gradual forms of income redistribution within States without threatening economic stability or patterns of growth, thereby creating conditions that enable a larger proportion of society to enjoy economic, social and cultural rights.

Further, the need for tax progressivity is also a high priority for the entire Latin American and Caribbean region, and for this reason was highlighted as one of the four priorities of the newly formed Platform for Taxation in Latin America and the Caribbean (PTLAC).

Measures to Curb Illicit Financial Flows

Honduras follows a territorial system of taxation, which means taxpayers pay tax only on the income earned in Honduras. However, this meant that if a company shifted profits abroad, it would not be taxed. Between 2017 to 2023, it is estimated that this led to a loss of 57 billion Honduran lempiras (around USD 2.3 billion). To address this, broaden the tax base and discourage profit shifting to tax havens, the Law proposes to change the principle of taxation from territorial to worldwide taxation of income, which is followed by many countries around the world including Chile, Mexico, India, South Korea, etc. It is expected that with this change, 503 companies and individuals will begin to pay taxes on income earned abroad.

Similarly, the introduction of the Ultimate Beneficial Ownership requirements will address tax evasion by high net worth individuals who hide their income and assets through complex chains of ownership. As a consequence, Honduras aims to repeal bearer shares. Incidentally, in Central America, Honduras is the only country to have bearer shares in its legislation. In 2022, the income tax paid by natural persons was equivalent to 7% of that paid by companies, which is indicative of the facilities that have been granted to owners of companies to evade taxes.

To facilitate the exchange of information with other jurisdictions, the Tax Justice Law includes the rules provided for in the Convention on Mutual Administrative Assistance in Tax Matters (MAAC) which was signed by Honduras on July 11, 2022.[2] This is a step closer towards the ratification of MAAC so that all relevant information required to ascertain the income of taxpayers and determine tax payable could be exchanged automatically, spontaneously or on request.

[2] Refer to EY, "Honduras joins the Multilateral Convention on Mutual Administrative Assistance in Tax Matters",18 July 2022 at https://taxnews.ey.com/news/2022-1088-honduras-joins-the-multilateral-convention-on-mutual-administrative-assistance-in-tax-matters (accessed on 8 July 2024).

The current tax system contains information requirements that practically prevent the tax administration from accessing banking information to verify tax evasion. The Tax Justice Law thus proposes to eliminate banking secrecy for tax purposes. These measures will promote transparency in the tax system and address aggressive tax planning and tax evasion.

Though, Honduras has not entered into any double taxation avoidance agreement yet, nevertheless, as a matter of policy, under the Tax Justice Law it aims to implement the credit method to eliminate double taxation, as provided for in the United Nations Model Double Taxation Convention between developed and developing countries. This shows that countries have options to eliminate double taxation even outside of tax treaties. These can also be perhaps more beneficial for developing countries as tax treaties for the most part serve to restrict taxing rights, and there is as yet no empirical evidence to decisively prove that they lead to increased foreign investment.

Reform of Inefficient Tax Incentives

As mentioned earlier, the implementation of the Global Minimum Tax now means that multinationals who do not pay taxes in a developing country due to its tax incentives will now have to pay those taxes in either their headquarter jurisdiction or the tax haven where they shift profits. Thus, it is imperative for all developing countries to urgently reform their tax incentive regimes to prevent loss of taxes to developed countries and tax havens.

Honduras' Tax Justice Law provides a stellar example of what developing countries can do.

Very significantly, the Law provides for amending the Constitution to limiting tax exemptions to a maximum period of 10 years as against the current practice of exemptions being granted for much longer durations. Although tax incentives are a policy tool to promote infant industries or to seek to unleash the potential of critical sectors of the economy, however, after 10 years of tax incentives, beneficiary companies should begin to pay their fair share of tax revenues. There is no rationale for the prolonged continuation of tax exemptions for economically unsustainable companies.

The Law also repeals existing certain inefficient tax exemptions and proposes to cancel the benefits in case of abuses or non-compliance with the objectives contained in the laws.

In addition, the Law repeals Decree No. 117-2021 that was introduced to prevent inspections and audits in transfer pricing matters by the Tax Administration of enterprises that have tax incentive regimes. This allowed blatant tax avoidance and evasion and profit shifting. The repeal of this decree is a significant step as restoring transfer pricing audits to check the abusive claim of tax incentives can immediately boost revenue collection for Honduras.

The policy of forgiving tax debts – essentially forgiving corporations and other taxpayers who refuse to pay taxes – has also been deeply costly. Honduras is the second country in Latin America that has forgiven the most taxes in the last 12 years, at 7% of GDP. There was also a rapid increase in these debts which grew by 242% between 2017 and 2022, indicating more and more taxpayers simply refused to pay their taxes. This explains part of the budgetary shortfall; between 2017 and 2021, only 53 out of every 100 Honduran lempiras spent were collected in taxes. Further, such a policy is damaging to tax morale as it sends the message that powerful taxpayers can simply refuse to pay and get away with it with no consequences. This can discourage other taxpayers from tax compliance and trigger a downward spiral.

The Tax Justice Law addresses this by proposing to eliminate the possibility of forgiving tax debts. As a result, companies will have no choice but to submit and pay their declarations, adjustments, and fines in a timely manner, increasing the perception of default risk and consequently tax collection.

The Law also limits companies operating in the free trade zones to sell up to a maximum 5% of their total sales into the domestic market. This would make companies operating in such zones truly export oriented and earn foreign exchange required for a stable macro-economic environment.

Way Forward

Predictably, the business sector in Honduras expressed concerns[3] about potential negative economic impacts from the draft law and contended that it could impede the nation's economic progress, drive inflation, increase job losses, and reduce investment flows. In reality, the reverse is most likely to be the case if the Law is implemented, monitored and its impact evaluated as envisioned. These welcome reform efforts will encourage the growth of more efficient and competitive firms who draw their sustenance from providing high quality goods and services rather than relying on state incentives, tax avoidance and tax breaks.

In summary, the provisions contained in the Tax Justice Law are timely and welcome, particularly in light of the Global Minimum Tax. They can improve government revenues, reduce public debt and contribute to create the fiscal space for achieving the Sustainable Development Goals. The approach of Honduras can be an example worthy of emulation by other developing countries, particularly in Latin America.

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[3] Refer to "Tax Justice Law Stirs Controversy in Honduras" by Roberto Ramos Obando (dated 18 March 2024) at https://www.taxnotes.com/tax-notes-international/tax-reform/tax-justice-Law-stirs-controversy-honduras/2024/03/18/7j918 (accessed on 2 July 2024).