Fundamental Incentives Reform

...accompanied by challenges for compliance

The draftsman has been particularly busy in crafting new tax legislation since early 2012. Never in the past 20 years have we seen so many dramatic changes to the tax legislation, to the point where some amendments have been overtaken by subsequent amendments since they were implemented in 2012 and early 2013.

The foregoing was discussed in detail in our previous Newsletters and a recap of some measures is provided on page 8.

Summary:

In continuation of the pursuit of the programme of major reform of the tax system, the following Bills were tabled in Parliament recently:

- The Fiscal Incentives (Miscellaneous Provisions) Bill 2013 (FIB)
- Income Tax Relief (Large-Scale Projects and Pioneer Industries) Bill 2013

The Reforms in a Nutshell:

- **Several Sectoral Tax Incentives withdrawn**
- **Capital Allowance Regime revamped**
- **Large Non-Regulated Entity tax rate eliminated**
- **Employment Tax Credit introduced**
- **New Incentive Regime introduced to promote Pioneer Industries and large scale projects**
- **Restriction on utilization of tax losses introduced**

The tabling of the FIB in Parliament within the time-frame agreed with the International Monetary Fund (IMF) is significant in that it represents the achievement of one of the major structural benchmarks under the terms of Jamaica's current programme with the IMF.

The programme also generally requires the GoJ to cease granting incentives under legacy incentive legislation by 31 December 2013 so that tax incentives are granted pursuant to the Fiscal Incentives Act (FIA) or related Resolutions/Orders on or after 1 January 2014.

We perceive that the reforms have been crafted to accomplish the important policy objective of reducing the loss to the exchequer of what was described as a discretionary waiver system gone out of control, whilst encouraging enterprises to increase their spend on wages, hence encouraging increased employment. They also generally favour manufacturing and innovation.

However, they will be accomplished at the possibly unavoidable cost of the introduction of a degree of complexity into the system. For example, the calculation of the Employment Tax Credit discussed in detail below, which is capped at 30% of the tax payable in any year requires an analysis of an employer's net income between "active" and "passive" income, since the credit may be utilised only against tax payable on the former. Taxpayers operating active trades which provide meaningful levels of employment will however weigh the additional effort in computing the ETC against the opportunity to reduce the effective income tax rate on their trading profits to as low as 17.5%.

Furthermore, the credit or part thereof is clawed back when a dividend or other distribution is made. The clawed back amount is reduced to the extent that shareholders pay tax on the distribution.

The long sought-after restriction in the deductibility of tax losses has also been included in this suite. Importantly, as has been promised for some time, the FIB provides for the repealing of a number of incentive laws that facilitated the granting of "Discretionary Waivers" and proposes to replace them with more objectively determined incentives, in the form of an Employment Tax Credit, the provision of fiscal incentives under the Income Tax Relief (Large-scale Projects and Pioneer Industries) Act 2013 and increased capital allowance rates.

Tax Incentive Regimes to be Radically Overhauled

Legacy Incentives

The FIB provides that the *inter alia* following incentives (hereinafter referred to as 'legacy incentives') will be repealed with effect from 1 January 2014:

1. The Export Industry (Encouragement) Act
2. The Hotels (Incentives) Act
3. The Resort Cottages (Incentives) Act
4. The International Finance Companies (Tax Relief) Act
5. The Petroleum Refining Industry (Encouragement) Act
6. The Shipping (Incentives) Act
7. The Cement Industry (Encouragement) Act
8. The Motion Picture Industry (Encouragement) Act
9. The Income Tax Act (Approved Farmer Rules)
10. The Industrial Incentives Act
11. The Industrial Incentives (Factory Construction) Act

No new approvals will be granted under these legacy incentives on or after 1 January 2014. A person who has been granted approval under any of the above legacy incentives before 1 January 2014 shall continue to be entitled to the benefits afforded under that legacy incentive until they expire. Such a person will however be afforded an opportunity to elect to forgo their remaining entitlement under that legacy incentive in order that they may benefit under the Fiscal Incentives (Miscellaneous Provisions) Act 2013.

We understand that it is proposed to initially retain the following incentives (referred to as 'retained incentives'):

1. The Jamaica Export Free Zones Act

2. The Income Tax Act (Junior Stock Exchange)
3. Bauxite and Alumina Industries (Encouragement) Act.

Free Zones:

The retention of the Free Zone regime will primarily benefit BPO/ICT activities, as well as the proposed transshipment/logistics hub. As Jamaica is required to dismantle export-driven incentives by 31 December 2015, we understand that Jamaica is likely to seek to migrate to a WTO-compliant special economic zone (SEZ) regime from which licensed activities may be carried on.

The Junior Market of the Jamaica Stock Exchange– Income Tax Incentive:

Under current tax rules, where a company meets the requirements of the Junior Market Rules for admission to the Junior Market and its participating voting shares are admitted for trading thereon, the company qualifies for the following remission of income tax (subject to certain conditionalities):

1. 100% of the income tax payable in the first five years from the date of its admission to the Junior Market;
2. 50% of the income tax payable by the company in the five years next following the period specified in 1 above.

It is proposed that the above income tax incentive will be modified as follows:

(a) A company listed on the Junior Market prior to 1 January 2014 shall continue to benefit from their incentive in the manner described above (i.e. over the 10 year period).

(b) A company listed on the Junior Market on or after 1 January 2014 shall benefit from relief of 100% of the income tax payable by the company in the first five years from the date of its admission to the Junior Market – no relief will be granted thereafter.

Bauxite Industry Encouragement Act:

It is proposed that producers of bauxite will continue to be taxed in accordance with the current tax regime and subject to benefits afforded under the Bauxite Industry (Encouragement) Act.

Incentives for Pioneer Industries & Large-Scale Projects:

The Income Tax Relief (Large-Scale Projects & Pioneer Industries) Bill provides a mechanism through which additional income tax incentives can be offered in circumstances where the Minister of Finance designates a project as a large-scale project or an economic activity as a pioneer industry. The Minister shall make this designation subject to affirmative resolution in Parliament. Participants in either a designated large-scale project or a pioneer industry may subsequently be approved by Ministerial Order which will stipulate the extent of relief granted. The income tax relieved under all orders issued pursuant to this mechanism in any year will be capped at 0.25% of the country's Gross Domestic Product (GDP) for the previous financial year.

Key Income Tax Reforms:

The following summarises the key income tax reforms contemplated by the FIB which will come into effect on 1 January 2014:

General Headline Rate of Income Tax - 25%:

- It is proposed to apply an income tax rate of 25% to all Jamaica resident taxpayers (other than regulated companies), as well as non-resident companies carrying on business in Jamaica. Individuals will continue to enjoy a threshold below which they will not be taxable. "Regulated Companies" (as they were since the category was introduced into the Income Tax Act *vide* Provisional Collection of Tax Order on 31 December 2012) are those regulated by: The Bank of Jamaica, the Financial Services Commission, the Office of Utilities Regulation and the Minister of Finance.

- Large unregulated companies, which are currently liable to income tax at the rate of 30% will, therefore, see their tax rate fall back to 25%, in line with most other taxpayers.

- Where the year-end is other than 31 December, this rate reduction will apply as of 1 January 2014 to a fraction of the entity's income that is reported in its income statement for a period ending in 2014. The fraction specified is the number of months falling in calendar year 2014 divided by the number of months included in the company's income statement. So that for example, if a company prepares accounts for 15 months ending on 30 June 2014, 40% (6÷15), representing January to June 2014, of the profits reported in that income statement, would be taxable at 25% with the remaining 60% being taxable at 30%.

- The special rules applicable to life assurance companies and building societies will remain in force.

Employment Tax Credit:

Taxpayers including self-employed individuals & partnerships (referred to as "Eligible Persons"), but excluding regulated companies will be entitled to a non-refundable employment tax credit (ETC) in computing their income tax liability.

The ETC is the total of the statutory payroll levies (Education Tax, NHT/NIS and HEART contributions).

The following conditions apply to the availability of the credit:

i. It is capped at 30% of the income tax payable on profits from business operations. The ETC may not be claimed against any income tax chargeable on non-trading income (e.g. passive investment income). The legislation makes separate mention of tax on income from the rental of a hotel or resort cottage that is licensed as tourism accommodation under the Tourist Board Act as being tax against which the credit may be applied.

ii. The monthly statutory returns reporting the statutory payments must have been filed on or before the due dates (i.e. by the 14th of the month following that to which they relate).

iii. The payments must have been made by the due dates.

iv. Where a company makes a distribution (dividends and certain other benefits to shareholders) the credit is withdrawn to the extent of 10% of the distribution, less the tax payable by the recipient of the distribution. The withdrawn credit must be repaid to the Revenue within 14 days of the end of the month in which the distribution is made.

v. The owners of a service company are eligible to claim the ETC in respect of statutory levies paid on behalf of the employees of the service company, subject to the above conditions.

Given a headline rate of income tax of 25%, an employer who claims the maximum ETC available (i.e. up to the cap of 30% of the tax chargeable on active trading activities) will therefore be subject to an effective income tax rate of 17.5% on such trading activities pending distribution of such profits. Where all the after tax profits are distributed, the claw back mechanism results in the effective tax rate reverting to a maximum of 25%.

The FIB contains anti-avoidance rules which seek to prevent regulated companies from migrating their activities and profits into unregulated companies in order to benefit from the ETC.

Illustration:

	Assume Div. Tax @ 15%	Assume Div. Tax 0%
Taxable trading Profits (say)	1,000,000	1,000,000
Tax @ 25%	250,000	250,000
ETC (max 30%)[1]	75,000	75,000
Net Tax Payable	175,000	175,000
After Tax Profits	825,000	825,000
Distribution	825,000	825,000
Tax withheld (assume)	123,750	NIL
ETC claw back		
Maximum 10% of distribution	82,500	82,500
Less tax paid on distribution	123,750	-
Net ETC claw back	-	82,500
Capped at ETC	-	75,000
Net Tax Payable	175,000	175,000
ETC claw back	-	75,000
	175,000	250,000
Effective tax rate %	17.5	25

[1] Subject to the number of months falling in calendar year 2014 and other restrictions.

It is proposed that the ETC should be introduced with effect from 1 January 2014 i.e. it would be applicable to the 2014 year of assessment and subsequent years. As a transitional measure (and in the interest of revenue protection) the ETC will apply to a fraction of the entity's income that is reported in its income statement for a period ending in 2014, where the year-end is other than 31 December. The fraction specified is the number of months falling in calendar year 2014 divided by the number of months included in the company's income statement. Please see example under Key Income Tax Reforms above.

Capital Allowances Reform:

As a part of the income tax reform, it is proposed that the capital allowances regime should also be updated. This will include the discontinuance of the various incentives embedded therein e.g. investment allowances and accelerated tax depreciation to agriculture and manufacturing etc. as a *quid pro quo* for introducing the Employment Tax Credit (ETC), which affords tax compliant businesses the opportunity to reduce their effective income tax rate to as low as 17.5% until they distribute their after-tax profits. A table summarising the proposed capital allowances regime is set out in Appendix I.

The Bill provides that the new capital allowances regime will apply to capital expenditure incurred on or after 1 January 2014. Capital expenditure incurred prior to 1 January 2014 will continue to be written off for income tax purposes in accordance with the current prescribed rates.
Key features of the proposed reform include:

1. Expanding the definition of industrial buildings to include :

    * a building or structure used directly in the production of "primary" products, which term is defined elaborately;
    * a hotel or resort cottage within the meaning of Section 2 of the *Tourist Board Act*;
    * a hospital or other healthcare facility primarily for the care of in-patients;
    * a multi-storey car park constructed exclusively for parking motor vehicles;
    * a building located in a free zone defined in Section 2 of the Jamaica Export Free Zones Act (or in due course a Special Economic Zone); and
    * subject to the approval of the Commissioner General, a building or structure constructed pursuant to an arrangement between a public authority and another person for the provision of public goods or services.

    This will enable capital expenditure on the construction, <u>alteration or renovation</u> of such buildings to qualify for a 20% initial allowance.

2. Increasing the rate of initial allowance to 25% for machinery that is used directly in the production of primary products or in the manufacture and automated packaging of such goods. However, there will no longer be initial allowances on office equipment, telephones and most other types of assets.

3. Significantly reducing the number of asset categories in the Machinery and Plant category and associated annual allowance write-off rates. There will now be only two rates viz. 12.5%, 20%, calculated on the cost.

4. Enhancing the write-off rates of non-industrial buildings (from 2.5% reducing balance to 4% straight-line and up to 12.5% for wooden buildings).

The old rates will continue to apply to capital expenditure incurred before 1 January 2014.

5. Increasing the allowable base cost, on which annual allowances are calculated, for private motor vehicles, to the Jamaican dollar equivalent of US$35,000. Certain anti-avoidance provisions are also proposed with a view to preventing abuse of this increase in tax relief granted.

   Extending tax relief by way of capital allowances for capital expenditure on a wide list of intellectual property rights, as well as extending relief to pure or applied scientific research, as well as R&D costs.

6. Repealing of various capital allowances that were designed to provide incentives to particular activities with effect from 1 January 2014:

   - Investment Allowances for Basic Industries
   - Investment Allowance for the Sugar Industry
   - Investment Allowances for Agriculture (Husbandry)
   - Investment Allowance on Ships
   - Special Annual Allowance (for factories operating in shifts)
   - Special Capital Allowance (for qualifying businesses)

7. Repealing of the tax deduction currently available under Section 13(1)(n) of the Income Tax Act in respect of wear and tear on a building owned and occupied by the taxpayer, for expenditure after 31 December 2013.

8. Allowing a taxpayer who currently benefits from a legacy incentive under a repealed Act (see page 2) to elect to forego his remaining entitlement to such incentive by 30 June 2014, in which event capital expenditure incurred by him before 1 January 2014 (in respect of which no capital allowances were previously claimed) will be deemed (for the purpose of applying the new capital allowances rates) to have been incurred on 1 January 2014 subject to the following:

   (a) Where the legacy incentive forgone would otherwise have expired on or after 1 January 2019, both initial allowance and annual allowances may be claimed in accordance with the new regime.

   (b) Where the legacy incentive forgone would otherwise have expired before 1 January 2019, only annual allowances may be claimed in accordance with the new regime.

   (c) The foregoing will not apply to capital expenditure incurred on private motor vehicles acquired prior to 1 January 2014.

Restriction of Tax Losses Carried Forward:

The Bill provides that, commencing in 2014, any claim for deduction of tax losses incurred in a prior year will be capped at **50%** of the taxpayer's chargeable income (before deduction of tax losses) of the year in which the claim is being made.

This cap will not apply:

(a) for the five years of assessment following the first year of operation of a new trade, profession or business, **or**

(b) where the taxpayer's gross revenue from all sources for the relevant year of assessment is less than the amount referred to in section 27(1)(*b*)(i) of the *General Consumption Tax Act* (currently J$3m per annum).

Proposed General Consumption Tax (GCT) Reforms:

We understand that a number of concomitant GCT reforms are currently under consideration by the GoJ.

The FIB contains a provision that allows the enterprises that operate hotels and resort cottages to continue paying General Consumption Tax (GCT) at the concessionary rate of 10%, PROVIDED that they elect to forego the benefits to which they are entitled under the Hotel Incentive Act and the Resort Cottages Incentives Act, no later than the 30 June 2014.

Recap – Measures introduced in 2012/13

1. Dividend Tax payable by residents increased to 15%.
2. Dividend Tax withheld at source is a "final tax", hence expenses incurred in earning dividend income are not deductible.
3. "Group Relief" introduced for intercompany dividends.
4. Introduction of an additional 5% on incomes of large unregulated companies (following the reduction in the general corporate tax rate to 25% and the retention of the $33^{1/3}$% rate for regulated companies).
5. Increases in Education Tax (to 2¼% for employees & self-employed persons and 3½% for employers) and increase in the maximum emoluments on which NIS is payable.
6. Increases in property tax rates.
7. Increases in transfer tax on the transfer of chargeable property and stamp duty on conveyances.
8. Revision of Assets Tax Regime for Specified Regulated and other Entities.

Appendix I

Table of Proposed Prescribed Capital Allowances Rates

Categories	Initial Allowance Rate	Annual Allowance Rate
Buildings:		
Initial Allowance:		
Industrial buildings	20%	See below
Non-industrial buildings	0%	See below
Annual allowance – (All Commercial Buildings):		
a) Buildings & structures primarily constructed of concrete, steel, brick, stone, cement or similar materials	0%	4%
b) Buildings & structures primarily constructed of other inorganic materials such as galvanized iron, corrugated metal or similar materials	0%	10%
c) Buildings & structures primarily constructed of wood or other organic materials	0%	12.5%
Plant & Machinery:		
Machinery directly used in the production of primary products or the manufacture or automated packaging of goods	25%	12.5%
Automatic data processing equipment, calculators, cash registers and other equipment falling within (Tariff Headings 84.70 and 84.71), as well as parts/accessories thereof	25%	20%
Equipment falling with Tariff Headings 84.69, 84.72, as well as parts/accessories thereof. Telephones and other equipment falling within Tariff Heading 85.17, as well as parts and accessories thereof	0%	20%
Other plant & machinery (excluding Motor Vehicles)	0%	12.5%
Motor Vehicles:		
a) Private motor vehicle based on a cap of US$35,000	0%	12.5%
b) Trade vehicle including	0%	20%
c) Rent-a-car /Tour bus /Public Passenger Vehicle (PPV)	0%	20%
Research & Development:	n/a	20%
Intellectual Property Rights:	0%	
General	0%	$\frac{1}{\text{Lower of 14 years and the period rights may be used.}}$
Expenditure less than J$1 million		5 years

If you have any further questions in connection with the above or would like to explore further how the above proposed amendments to our tax regime may impact your business or personal arrangements, please feel free to contact any member of our specialist tax team listed below or your usual PricewaterhouseCoopers Jamaica contact.

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