THE 1841 FOUNDATION

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To whom it may concern,

We have been tasked with analyzing the bill known as the "Bill on Tax Justice" through which the government of Honduras intends to change the local tax system from one based solely on territorial income to one based on worldwide income, and to provide our opinion on the matter. We hereby present our conclusions:

1. Exemption of foreign income: Under a Territorial Tax System, income earned outside the country of residence is not subject to taxes in that country. This means that if a taxpayer has foreign income, it will not be taxed in their country of residence, which can significantly reduce their tax burden, increasing the portion available for savings, investment, consumption, job creation, etc. **On the other hand, in the case of Honduras, a country that, according to our metrics, already qualifies as a "tax hell," increasing taxes is a very bad idea, one that will likely result in lower tax revenue instead of an increase.**

2. Simplification of tax compliance: Under a Territorial Tax System, only income earned within the country of residence needs to be reported for tax purposes, which simplifies the tax filing process. In a Worldwide Tax System, taxpayers must provide detailed information about their income worldwide, which can be more complex and require more time and resources, not only for individuals but also for the tax administration of the country in question. **This reduces fiscal efficiency (total revenue collected over the cost of collecting that revenue). It is common in countries with Worldwide Tax Systems for their respective tax agencies to have to postpone deadlines to allow taxpayers to calculate and prepare the necessary tax information.** This, obviously, reduces revenue and generates financial costs.

3. Promotion of foreign investment: The Territorial Tax System can be attractive to foreign companies wishing to invest in a country as it allows them to retain a greater portion of their profits. This can encourage foreign investment, which can have a positive impact on economic growth and job creation. **In the case of Honduras, since the rest of Central America has this system, transitioning to a Worldwide Tax System will undoubtedly lead to the departure of foreign companies and investments, including some of national origin.**

4. Stimulating competitiveness: Under a Territorial Tax System, the sovereign jurisdiction over economic activity has the right to tax it. If someone benefits from doing business in France, they must pay taxes to the French treasury, regardless of whether they are a French, American, or Japanese multinational. Even most countries that have adopted a Worldwide Tax System conveniently subscribe to this logical approach when it comes to foreign companies doing business there. For example, foreign companies pay corporate taxes in Washington on income earned from their operations in the United States. **The fact is that the Territorial Tax System can make domestic companies more competitive in the global market as they are not burdened with additional taxes on income earned abroad.** This allows domestic companies to invest more in research and development, which can improve their competitiveness in the global market. **Similarly, in the case of transitioning to a Worldwide Tax System without a network of treaties to prevent double taxation with the rest of the world, something that does not currently**

exist in Honduras, many cases of double taxation will arise, resulting in a reduction of this competitiveness. Let's look at a specific example: imagine the case of a coffee producer based in Honduras competing worldwide against a coffee producer based in Nicaragua. Both are doing well and aggressively competing in South America, paying taxes on the income earned there. The problem is that, if the global income tax is approved in Honduras, the Nicaraguan competitor will be able to reinvest those profits in their home country without paying additional taxes, but the Honduran competitor won't. In fact, it is possible that under a Worldwide Tax System, if it is not applied in all countries, entrepreneurs and companies may decide to not only change their tax residency but also relocate to another country. This has happened in Argentina, where many entrepreneurs moved to Uruguay due to tax increases, and in the United States, where many companies and individuals have relocated and renounced their citizenship (the US is currently experiencing record levels of this phenomenon).

5. <u>Main affected parties:</u> History shows that in countries where a change like the one proposed in Honduras has taken place, the most affected have been middle-class families, not the wealthiest. This is because these families do not have the resources to create legal or trust structures in third countries that allow them to counteract the effects of this change. Examples of this have been seen in Argentina and Bolivia. In the case that the final text of the law intends to tax larger companies, what is known as "fiscal dwarfism" will occur, which means that when companies reach a certain level of growth, instead of continuing to grow, they create other companies or individual taxpayers to avoid surpassing the parameters included in the regulations. This is obviously highly inefficient.

6. <u>Reduction of the income tax rate:</u> **The only way to partially mitigate the aforementioned negative effects, not eliminate them, is to substantially reduce the tax rate currently paid by taxpayers before transitioning from a Territorial Tax System to a Worldwide Tax System.** This was, for example, what happened in Argentina in 1990. By 1989, the Income Tax in Argentina reached a maximum marginal rate of 49%, considering the normal rate of 35% and the "forced savings" tax implemented by Raúl Alfonsín. The fiscal wedge had even reached 63% throughout the radical administration. The Menem administration eliminated all surcharges for forced savings and reduced the maximum rate to 30% starting in 1990. This drop of up to 19 percentage points in taxation in just one year had never been seen before in Argentine history. The average tax rate for income taxpayers dropped from 28% to 18%. The following year (1991), Argentina adopted the Worldwide Tax System.

We trust that the arguments outlined in this brief report will be taken into account by the authorities of Honduras and that the proposed reform will be set aside.

Yours sincerely,

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