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Tax aspects of donor-financed projects

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Panel

Chair: Victoria Perry, Assistant Director, Fiscal Affairs Department, IMF

Speakers

- Liselott Kana, Head of Department of International Taxation, Internal Revenue Service, Chile
- Olav Lundstøl, Policy Director Tax and capital flight, NORAD
- Cathal Long, Senior Research Officer, Overseas Development Institute (ODI)
- Jacques Sasseville, UNDESA Financing for Development Office

Why should we discuss the tax aspects of donor-financed projects?

- Many ODA-funded projects enjoy tax exemptions that were required by donors
- These exemptions, however, often create difficulties for the tax administrations of partner countries
- Such tax exemptions may be contrary to the objective of supporting improvements in domestic revenue mobilisation in these partner countries

What will be covered

1. Overview of the issues and work done by the UN Committee of Experts in that area
2. Examples of problems created by the tax exemptions
3. The pros and cons of seeking tax exemptions for ODA-funded projects
4. The views of some donors and tax administrations of developing countries
5. A possible way forward

1. Overview of the issues and work done by the UN Committee of Experts

- The sums at stake in the tax treatment of aid are substantial (in Tanzania, customs exemptions for donors accounted for around 17 per cent of the gross value of imports in 2005)
- Specific tax exemptions relating to international aid take various forms, for example
  - Imports of goods may be exempt from customs duties, VAT, excises and other indirect taxes
  - Goods or services procured locally may be exempt from VAT or sales tax
  - Income tax exemption may be extended to persons working under contracts (for example, employees and enterprises)

How are specific exemptions provided

- Specific exemptions are provided through a variety of legal instruments and administrative mechanisms, e.g.
  - by the general domestic tax rules
  - by general rules of double tax treaties
  - by specific exemptions in domestic law directed to international assistance
  - by bilateral agreement

Specific exemptions for aid-assisted projects are different from general exemptions

- Taxation has limits based on internationally-agreed standards; for example:
  - Temporary imports are often exempt from customs duties
  - A nonresident who sells goods without having a permanent establishment in a country is normally not subject to income tax

- Specific exemptions relating to international aid go beyond these general exemptions

There are good reasons for moving away from specific exemptions for aid-assisted projects

- Developments in a number of partner countries have weakened some of the reasons for insisting on specific tax exemptions
- In the absence of compelling reasons to insist on tax exemption, there is a growing recognition that the general rules of taxation should apply to aid-financed projects

ODA-funded projects only

- This panel will only deal with the tax treatment of assistance by governmental agencies and intergovernmental organizations
- Note, however, that many of the issues are also applicable to assistance by NGOs and there are good reasons for the like treatment of public and private assistance, e.g. where donors use NGOs as implementing agents

Work done by the UN Committee of Experts

- UN Committee of Experts started work on this in 2005
- The work was done by the staff of the International Tax Dialogue Steering Group
- A first paper (UN Committee web site E/C.18/2006/5) set up the background
- This was followed by another paper (UN Committee web site E/C.18/2007/CRP.12) which put forward draft guidelines, stressing that these were only draft proposals for further discussion with donor agencies
- Despite significant interest from the UN Committee's members from developing countries, no such discussion took place

2. Examples of problems created by the specific tax exemptions

A bilateral agreement for the building of schools concluded between a donor agency and the Ministry of education of a partner country provides that "no taxes will be payable with respect to the project"

- What are the taxes specifically covered? Would that cover to a fee or user charge or a social security contribution payable by an enterprise involved in the building of the schools?
- Are the supplies related to the project zero-rated or exempt for VAT? An exempt supply would require an allocation of input credits; a zero-rated supply would create a VAT refund claims for the suppliers, which would place a strain on weak tax administrations

Examples of problems

- Does the exemption apply to the income tax on income earned by local enterprises? If yes, a local building company that would otherwise be building a hospital financed with domestic resources may prefer to work on building the schools
- Does the exemption applies to the income tax payable by all suppliers? All subcontractors?
- How does the exemption interacts with the exemption method of an applicable tax treaty? Is there potential for double non-taxation?
- How will the VAT exemption be applied in practice? {presentation of a card, refund system, voucher system etc.)

Examples of problems

- What is the legal status of the agreement? Will the tax administration, which was not involved in its negotiation, be legally bound to apply it?
- Who will interpret the agreement in case of disputes?

3. The pros and cons of seeking tax exemptions for ODA-funded projects

- Theoretically, if the sole concern is the welfare of a recipient of support, a gift in cash is better than a gift in kind because the recipient, knowing best its own needs, can put the money to what the recipient considers its best use
- Applied to the provision of international aid, this suggests that donors should be content to pay taxes on the support they provide, since that is akin to a simple cash transfer

Arguments for specific exemptions

- Might be easier to mobilize political support for targeted assistance (e.g. building schools, vaccinating children, etc.) than for the provision of untargeted budget support resulting from the payment of taxes:
  - donors may feel they do not get the same recognition for budget support as for project aid
- In some cases donors may actively oppose providing any aid to the government that can be used directly for general budgetary purposes (e.g. a donor may want to provide support directly to refugees but may wish to provide no support to the government because of corruption or security concerns)

Arguments for specific exemptions

- Donors may also be concerned that if the money available for the projects that they finance is reduced by tax costs, there will be less tangible results directly associated to their development budget, which may have an impact on the amount of public support for their development activities
- There might also be concerns that the recipient's tax policy, and/or its implementation, is unreasonable in some way. This concern may be magnified in situations where there is no tax treaty in place

Arguments against specific exemptions

- Specific tax exemptions lead to a number of problems:
  - Increase the transaction costs relating to international assistance
  - Facilitate tax fraud
  - Lead to economic distortions.
  - Implementation of the exemptions complicate tax administration (either with direct exemption or refund mechanisms)
  - Negotiation and implementation of the exemptions involve additional costs for the tax administration
  - Badly-designed exemptions create uncertainty
  - Creation of special tax regimes encourages taxpayers to seek preferential tax regimes

4. Views of donors and tax administrations of developing countries

- Experience of the tax administration of Chile: Liselott Kana, Head of Department of International Taxation, Internal Revenue Service, Chile
- Experience of Norway’s NORAD: Olav Lundstøl, Policy Director Tax and capital flight, NORAD
- Views from of the Overseas Development Institute: Cathal Long, Senior Research Officer, Overseas Development Institute (ODI)

Other donors that have changed their practices

- In 2004, the World Bank changed its policy to allow financing of reasonable, nondiscriminatory
- tax costs.
- The Inter-American Development Bank (IDB) and the Asian Development Bank (ADB) have adopted similar policies.
- The French Development Agency (Agence Française de Développement) has included the financing of taxes in certain aid agreements (“Contrat de désendettement et de développement”)

5. A possible way forward

- The main option put forward in the note discussed by the UN Tax Committee in 2006 was to “develop guidelines towards a more coordinated approach that countries would be free to adopt”
- The 2007 Draft Guidelines were prepared for that purpose
- As was recognized in 2007, these guidelines need to be discussed at the technical level with stakeholders, including primarily donor agencies and tax administrations of developing countries

The 2007 Draft Guidelines

- The Draft Guidelines recognize that the issue of whether or not tax exemptions should be provided arise differently in different situations:
    - some exemptions seem appropriate for emergency relief
    - similar exemptions might be inappropriate in cases of infrastructure development or entry into the financial markets

The 2007 Draft Guidelines: Introduction

- Donors are free to establish the conditions under which they provide international assistance but should recognize that tax exemptions may create significant difficulties for recipient countries
- Overall, where there is sufficient confidence in governance structures and in the tax system in recipient countries, countries and international organisations providing aid should therefore be encouraged not to insist on exemption from tax for transactions relating to aid projects, ***unless the rules in the recipient country for taxing aid-related transactions fail to comply with internationally accepted standards***.

The 2007 Draft Guidelines: Introduction

- The Guidelines deal exclusively with the tax treatment of assistance provided by, or on behalf of, governments and international organisations
- The Guidelines incorporate a number of existing international tax standards that are reflected in multilateral and bilateral instruments such as tax treaties
- The Guidelines have been prepared for purposes of assisting donor and recipient countries in determining the appropriate tax treatment of donor-financed projects
- They should provide greater uniformity and facilitate the discussion of tax issues between donors and recipients;

The 2007 Draft Guidelines: Introduction

- The Guidelines are not binding in any way and are drafted in general terms to facilitate their understanding by non-experts
- Care should be taken when incorporating their principles in binding instruments
- To the extent that the Guidelines reflect what is already found in domestic laws or legally binding instruments, no need to adopt them legally
- If that is not the case, partner countries may consider conforming their tax laws to the Guidelines (alternatively, the principles reflected in the Guidelines could be adopted through bilateral instruments that would be given force of law)

The 2007 Draft Guidelines: General Considerations

- Principle that exemptions from taxes levied in recipient countries should not be requested unless serious deficiencies in the governance structure, tax system or tax administration of a recipient country justify otherwise or the tax rules in the recipient country that would apply to these transactions are not consistent with these Guidelines.
- Principle that Recipient countries should ensure that their tax treatment of transactions relating to donor-financed projects is consistent with these Guidelines

The 2007 Draft Guidelines: General Considerations

- Officials from the Ministry of Finance or the tax administration of the recipient country should be involved in the negotiation and drafting of any tax provisions dealing with donor-financed projects
- The recipient country should ensure that all legal requirements necessary to give force of law to any agreement dealing with the tax treatment of donor-financed projects are satisfied
- Where tax reliefs for transactions related to donor-financed projects are granted, countries are encouraged to use mechanisms that minimise administrative burdens and reduce fraud

The 2007 Draft Guidelines: Income taxation of employment remuneration

- Remuneration for employment by the government of a country, international governmental organization or governmental agency that finances a project should not be taxable in the recipient country if the individual is not a national or resident of that jurisdiction
- Remuneration for employment related to an assistance project financed by a country, international governmental organization or agency thereof should not be taxable in the recipient country if the employee is a non-resident employed by a non-resident and does not spend more than 183 days in any twelve month period

The 2007 Draft Guidelines: Income taxation of business profits and payments

- Payments to, and profits of, a non-resident enterprise related to a donor-financed project should not be subject to any income or profit tax in the recipient country unless such payments or profits are attributable to activities carried on in the recipient country during a period or periods exceeding 183 days in any twelve month period

The 2007 Draft Guidelines: Income taxation of business profits and payments

- Any specific exemption from income or profit tax granted with respect to activities of enterprises that carry on activities in connection with a donor-financed project should not be available to enterprises that are residents of the recipient country
- Such exemptions should be designed in a way that does not result in an unintended exemption of a foreign enterprise in its State of residence

The 2007 Draft Guidelines: Indirect taxation - humanitarian crises

- No indirect taxes, including custom duties, should be imposed on the import of goods to be used to respond to humanitarian crises such as natural disasters, famine, or health emergencies [reference to Chapter 5 of the Revised Kyoto Convention and Annex 9.B. to the Istanbul Convention].
- Domestically supplied goods and closely connected services that would – if imported - qualify as “relief consignments” or “goods for humanitarian purposes” should be relieved from domestic indirect taxes

The 2007 Draft Guidelines: Indirect taxation – personal property and household goods of workers

- Personal property and household goods of workers coming to a recipient country for the purpose of an assistance project should be exempt from indirect taxes, including import duties, as long as these workers' stay is merely temporary and is related to that project.

The 2007 Draft Guidelines: Indirect taxation – temporary admission

- No indirect taxes, including custom duties, should be imposed on the temporary admission of goods to be used for the purposes of an assistance project *[reference to the rules of Annex G of "the Revised Kyoto Convention" and the parts of the Istanbul Convention that relate to temporary admission]*
- For all other aspects, the general domestic rules on temporary importation should equally apply to imports carried out under such projects, in particular with respect to procedural aspects and the imposition of duties, taxes, interest and penalties in case of disposal or diversion of temporary admission goods

The 2007 Draft Guidelines: Indirect Taxes – exemptions related to donor-financed projects

- Where it is considered that tax relief from indirect taxes, including custom duties, must be granted in other cases with respect to goods used in relation to an assistance project
  - the relief should be restricted to clearly identified goods that are strictly necessary for the project, and, in the case of goods acquired specifically for that project, restricted to goods that are not available in the recipient country;
  - the taxes covered by the relief should be clearly identified
  - the relief should be granted through a reimbursement or voucher method rather than through a direct exemption.

The 2007 Draft Guidelines: Indirect Taxes – exemptions related to donor-financed projects

- The tax administration of the recipient country should also adopt procedures to ensure that goods and services on which indirect tax will be relieved are used for the purpose of the relevant project
- Any agreement concerning such relief should stipulate that when the relevant goods are disposed of in the recipient country or otherwise diverted from their intended purpose, the indirect taxes become payable on these goods under the provisions in force in the recipient country

The 2007 Draft Guidelines: Detailed Explanations

- Detailed explanations on each part of the Draft Guidelines are provided in the 2007 document prepared for the UN Tax Committee

Next steps

- Are the 2007 Draft Guidelines a useful starting point?
- If yes, how can we improve them at a technical level and achieve greater consensus on the underlying principles?
- If no, should the UN Tax Committee continue work on this issue?

Thank you

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