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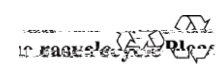

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DRAFT GUIDELINES ON THE TAX TREATMENT OF ODA PROJECTS

Annotated version of the draft guidelines prepared in 2007

[For ease of reference, the numbering of the paragraphs of the Draft Guidelines included in this note (starting at paragraph 8) is the same as that in note E/C.18/2007/CRP.12. The annotations, which appear in shaded boxes under the relevant parts of the draft guidelines, were not part of note E/C.18/2007/CRP.12 and have been prepared by the Secretariat in order to assist the discussion of changes that could be made to the guidelines.]

INTRODUCTION

Background

8. International assistance provided by, or on behalf of, governments and international governmental organisations takes a variety of forms and serves different purposes, including the facilitation of development or reform and the response to natural disasters or other humanitarian crises.

9. In many cases, tax exemptions have been granted by recipient countries for various transactions that take place under international assistance projects. These exemptions are typically granted at the insistence of the donors and may apply to different transactions and taxes.

10.

significant difficulties for recipient countries. Also, the Paris Declaration on Aid Effectiveness[4] reaffirmed the commitment, by various donor and recipient countries, to accelerate progress in ³LQFUHDVLQJ DOLJQPHQW RI DLG ZLWK SDUWQHU FRXQWU WR VWUHQJWKHQ WKHLU FDSDFLWLHV´ 2YHUDOO ZKHUH 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 guidelines. This is in line with the fundamental principle that underlies these Guidelines. The Guidelines are not, however, intended as requirements. It is ultimately up to each donor, in light of its own foreign policy and other considerations, to take decisions on how to proceed.

> Does paragraph 11 strike the right balance?
>
> The Guidelines document should probably UHIHU WR VRPHWKLQJ PRUH UHF Declaration on Aid EffHFWLYHQHVV´ $ Also, a reference to the SDGs and to DRM would seem appropriate.
>
> More generally, is the background provided in the explanations sufficient or should we expand this ³%DFNJURXQG´ VHFWLRQ PD\EH E\ DGGLQJ SDUWV RI WK Annex?
> Alternatively, should an updated version of the note included in the Annex that would be separate from the Guidelines and/RU Da D 0 Da Du‘%TAk U Da D 0 Aac4D 0 Aac4 HBJ° HSUHëö%.£"H7P

They should also avoid a proliferation of different rules, which would reduce transparency and increase the administrative and compliance burden of both donors and recipients.

15. The Guidelines are not binding in any way and are drafted in general terms to facilitate their understanding by non-experts. Care should therefore be taken when incorporating their principles in binding instruments. To the extent that the Guidelines reflect what is already found in the domestic laws of recipient countries or in relevant treaties (including tax treaties) concluded by these countries, there is no need to adopt them through legally binding instruments. It is recognized, however, that the existing network of tax treaties is far from comprehensive, especially as regards developing countries, and that a large number of countries are not yet parties to the multilateral instruments in the field of indirect taxes that are referred to in these Guidelines. It may therefore be quicker for countries that are aid recipients to unilaterally conform their tax laws to these Guidelines. Alternatively, a recipient country could adopt the standards reflected in these Guidelines through bilateral instruments that would be given force of law in that country.

> 6KRXOG ZH UHSODFH WKH ³DLG´ ³SDUWQHU FRXQWULHV´ WKUR
>
> Is there agreement with the proposed status of the Guidelines described in paragraphs 14 and 15?

GUIDELINES

A. General considerations

1. Donor countries, international governmental organisations and their aid agencies should not require exemptions from the taxes levied in recipient countries with respect to transactions relating to their assistance projects, unless

    a) serious deficiencies in the governance structure, tax system or tax administration of a recipient country justify otherwise; or

    b) the tax rules in the recipient country that would apply to these transactions are not consistent with these Guidelines.

    For that purpose, these countries, international organisations and agencies should engage in dialogue with each other and with recipient countries, concerning relevant aspects of the governance structure, tax system and tax administration of recipient countries.

2. Recipient countries should ensure that their tax treatment of transactions relating to donor-financed projects is consistent with these Guidelines.

3. Officials from the Ministry of F236(M)-20(i)-17(n)-18(i)-7(s12 re W* n i)-7(1)-246(t)-17(h)-18(e

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 in the aggregate 183 days in any twelve month period beginning or ending in the relevant tax year.

> 7KH SKUDVH ³HQWHUSULVH WKDW LV QRW D UHVLGHQW´ person that is not a resiGHQW´
>
> Is there agreement to use the 183 days period as a proxy for the concept of permanent establishment?

9. 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:

   a) should not be available to enterprises that are residents of the recipient country; and

   b) should be designed in a way that [illegible] enterprise in its State of residence.

D. Indirect taxation

from exempting local purchases from VAT. If the contractor is allowed to make purchases VAT-free upon presentation of an exemption card, the exemption is likely to be abused. Given the significant size of foreign aid, this potential for tax fraud can have a significant adverse effect on the domestic tax system.

8. Second, tax exemptions imposes costs on tax administrations of recipient countries in keeping track of the various exemptions provided and administering them. This difficulty is amplified by the diversity of the practices and expectations of the multiple donors that recipient countries may need to deal with. The administrative burden and the risk of fraud can vary depending on the way that exemptions are structured. Reducing this burden and risk of fraud for recipient countries is one of the factors that have motivated some donors to review their policies.

9. Third, the granting of tax exemptions can be legally problematic. In some countries, there is no proper

prospective private sector investors ask for such exemptions as an encouragement to invest on their territory. Many donors have actually urged developing countries to cut back on exemptions in their wider tax systems. This does not sit comfortably with continuing to press for exemptions for donor financed projects.

13. These difficulties that tax exemptions pose for recipient countries often undermine the development objectives that the aid itself is intended to serve. And any scaling up of aid will amplify these difficulties.

14. These difficulties combined with the improvement of tax systems in recipient countries and a greater recognition of the need for general budget support in r

recipient country seeks to levy taxes that are discriminatory or are clearly excessive (as regards the rate or structure) compared to what similar countries would levy in similar circumstances. A third example would be where corruption in the tax administration of the recipient country would be so endemic that it would likely result in a large part of the taxes paid not being available to finance the budgetary expenditures of that country.

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2. Recipient countries should ensure that their tax treatment of transactions relating to donor-financed projects is consistent with these Guidelines.

20. As a quid pro quo for donors not insisting in specific tax exemptions for donor-financed projects, recipient countries need to ensure that their tax treatment of transactions related to these projects is consistent with standards that are typically found in widely-subscribed international agreements. These Guidelines include a list of such standards.

3. Officials from the Ministry of Finance or the tax administration of the recipient country should be involved in the negotiation and drafting of any provisions dealing with the tax treatment of transactions related to donor-financed projects, including where another ministry or government agency is taking the lead in the negotiations.

21. Guidelines 3 to 5 deal with procedural aspects of the drafting and implementation of specific tax provisions related to donor-financed projects in case it is decided to agree bilaterally on such provisions.

22. Agreements covering donor-financed projects are often negotiated between representatives of the donor country, international governmental organization or aid agency thereof and officials of the recipient country. Depending on the nature of the project, these officials might represent different ministries of the government of that country. There is no guarantee, however, that officials representing the tax authorities of that country will be consulted.

23.

4. The recipient country should ensure that all legal requirements necessary to give force of law to any agreement, letter, memorandum of understanding, or other document dealing with the tax treatment of transactions related to donor-financed projects are satisfied.

25. Tax exemptions for donor-financed projects may be provided through a variety of legal instruments and may require different administrative practices being applied to a substantial number RI GLIIHUHQW WUDQVDFWLRQV LQ WKH FRQWH[W RI HDFK granted by the general domestic tax rules, by general rules of double tax treaties, by specific exemptions in domestic law dedicated to international assistance, or by bilateral agreement, letter or memorandum of understanding.

26. In many jurisdictions, however, the constitution or the law impose restrictions as to how tax provisions may be adopted. Frequently, there will be rules according to which any tax charge or tax exemption must be authorized by law in order to be enforceable. Such rules will often apply regardless of the instrument in which the tax exemption is granted (e.g. in a bilateral treaty).

27. There have been cases where tax exemptions included in a bilateral agreement concluded between a donor and the government of a recipient country have been found not to be enforceable because such rules had not been complied with. It is therefore necessary to ensure that any agreements providing for tax exemptions with respect to a donor-financed project will be implemented in accordance with these rules. In cases where tax exemptions for transactions related to donor-financed projects are contemplated, the parties are encouraged to use legal instruments that support the rule of law in recipient countries by:

- Making sure that the exemption is provided by law or, if provided under agreements, that th

Is there anything that could be said about mechanisms that could minimise administrative burdens as regards income tax exemptions?

Income taxation - employment remuneration

6. The remuneration, including employment-related benefits, for employment services UHODWHG WR DQ DVVLVWDQFH SURMHFW WKDW DQ LQG
by the government of the country, international governmental organization or agency thereof that finances that project should not be taxable in the recipient country if the individual

a) is not a national of that jurisdiction, and

b) is not a resident of that jurisdiction or became a resident solely for the purposes of rendering these services.

31. This Guideline is based on paragraph 1 of Article 19 of the OECD and UN Model Tax Conventions, which is found in almost all bilateral tax treaties currently in force. As noted in the &RPPHQWDU\ RQ WKHVH PRGHOV ³>V@LPLODU SURYLVLRQV WR FRQIRUP ZLWK WKH UXOHV RI LQWHUQDWLRQDO FRXUW
The principle that a State should not levy income tax on the remuneration of employees of another State who perform governmental services on the territory of the former State is now universally accepted and has therefore been included in this Guideline.

32. The Guideline extends that treatment to an employee of an international governmental organization who renders services in the context of an assistance project financed by that organization or an agency thereof. While there is less international consensus on the tax treatment of employees of international organizations, it seems appropriate to recognize that such an employee should be treated like any employee of the States that are members of that international organization and that provide its funding.

33. Nothing in these Guidelines affect the exemptions to which various members of diplomatic missions or consular posts are entitled under the general rules of international law or under multilateral instruments such as the Vienna Convention on Diplomatic Relations and the Vienna Convention on Consular Relations. These exemptions are applicable regardless of whether or not specific exemptions are granted with respect to government employees providing services in the context of a particular donor-financed project.

34. Like paragraph 1 of Article 19 of the OECD and UN Model Tax Conventions and like the two Vienna Conventions mentioned in the previous paragraph, the Guideline provides an exception that allows a recipient country to tax the remuneration paid to local personnel who are permanent residents or nationals of that country.

7. The remuneration, including employment-related benefits, that an individual derives from employment services related to an assistance project financed by a country, international governmental organization or agency thereof should not be taxable in the recipient country if all the following conditions are met:

a) the individual is not a resident of the recipient country,

b) during the project, the individual is not present in the recipient country for a period or periods exceeding in the aggregate 183 days in any twelve month period beginning or ending in the relevant tax year;

c) the remuneration is paid by, or on behalf of, an employer who is not a resident of the recipient country and is not borne by a permanent establishment which the employer has in that country.

35. This Guideline provides for an exemption from income taxation in a recipient country in a case where a person employed by a foreign enterprise exercises his/her employment in the recipient country for a short period of time in connection with a donor-financed project. That exemption is based on a rule found in almost all bilateral tax treaties and incorporated in paragraph 2 of Article 15 of the OECD and UN Model Tax Conventions.

36. This exemption would typically apply to employees of foreign commercial enterprises that are performing work in the recipient country pursuant to contracts concluded with the donor country, organization or agency thereof. Since these individuals would not be employed directly by that country, organization or agency, they would not be entitled to the exemption referred to in Guideline 6 and should be subject to the normal taxation rules of the recipient country, subject to this exemption for short-term employment activities.

37. Since the wording of this exemption is derived from that used in tax treaties, it should be LQWHUSUHWHG LQ WKH VDPH ZD\ 7KH UHIHUHQFH WR ³UH it generally has for the purposes of tax treaties and the interpretation of the 183-day rule should be in accordance with the guidance found in the Commentary on the OECD and UN Model Tax Conventions.

Income taxation of profits and payments to foreign enterprises

> 8. Payments made to an enterprise that is not a resident of the recipient country in connection with a project funded by a country, international governmental organization or agency thereof, as well as profits derived by that enterprise from activities exercised in connection with a project funded by that country, organization or agency, 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 in the aggregate 183 days in any twelve month period beginning or ending in the relevant tax year.

38. The negative form in which this Guideline is drafted is intended to recognize that, under the existing international standards incorporated in bilateral tax treaties, income taxation of the profits of foreign enterprises should only be allowed to the extent that the profits are attributable to activities carried on in the recipient country and only as long as the enterprise maintains sufficient physical presence in that country for that purpose.

39. Indeed, bilateral tax treaties, and the UN and OECD Model Tax Conventions on which they are based, provide that foreign enterprises should only be taxable in a country on profits that are attributable to activities carried on in that country through a permanent establishment, fixed base or, in some cases, a presence of a sufficient duration (typically 6 months).

40. This Guideline is based on that approach but, given the differences of formulation and
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formulate a simple test that can be easily applied by the tax administrations of recipient countries, it includes a single criterion, i.e. whether the profits are attributable to activities carried on in the recipient country during a period or periods exceeding in the aggregate 183 days in any twelve-month period.

41. This Guideline applies to enterprises that are not residents of the recipient country. The term
³HQWHUSULVH´ DSSOLHV WR DOO IRUPV RI EXVLQHVV RUJ
company as well as to an individual consultant providing services as a sole proprietorship. The Guideline is intended to cover, among other things, situations where an individual who is not a resident of the recipient country performs work in that country in a non-employment relationship as part of a donor-financed project.

42. $V LV WKH FDVH IRU RWKHU *XLGHOLQHV WKH UHIHUH
that it generally has for the purposes of tax treaties.

9. Any specific exemption from income or profit tax granted wit-7(e)-21(i)-7(s)-12()-24(p)-1

Indirect Taxes- Humanitarian crises

10. 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. For that purpose, countries should implement the rules of, or become parties to,

a) Chapter 5 on Relief Consignments, Specific Annex J to the International Convention on the simplification and harmonization of Customs procedures, as amended (commonly UHIHUUHG WR DV ³WKH 5HYLVHG .\RWR &RQ

b) Annex 9.B. concerning goods imported for humanitarian purposes, to the Istanbul Convention.

45. Supplies by donor countries, international governmental organizations and agencies thereo to respond to acute humanitarian crises constitute a category of donor-financed projects that has the following characteristics:

to be effective, such consignments must be delivered rapidly to their ultimate recipients, i.e. those affected by the crises, and

the case for relieving such supplies from taxes and duties is particularly strong, as there is little economic sense in taxing such supplies (the recipients do not have ability-to-pay), and the revenue risks involved in exempting such supplies are equally small.

46. The existence of transparent and harmonized rules regarding the tax treatment of emergenc aid that would already be in place before a crisis occurred is paramount for swift and efficient donor intervention.

47. Many FRXQWULHV KDYH DGRSWHG GRPHVWLF WD[SURYL there is substantial variation in their scope of application, both with respect to the type of taxes and with respect to the type of supplies. Few countries appear to have specific provisions on temporary admission for relief consignments, although there is usually a general regime for temporary admission in the customs laws.

48. In addition to these domestic law provisions, a number of countries have entered into bilateral assistance agreements with donor countries, international aid organizations or other dono or aid agencies. While these agreements may cover many of the issues discussed below, they m not systematically address all of them. Moreover, these agreements often show differences, minor or major, between them both regarding the duties and taxes as well as the nature of activitie covered. Furthermore, by their nature, such agreements only cover activities by the contra

domestic transactions. Also, these instruments have not been universally adopted. The main international instruments in this area are managed by the World Customs Organization[5] (WCO). They are:

> Chapter 5 on Relief Consignments, Specific Annex J to the Revised Kyoto Convention,[6] the Guidelines to which also comprise the Recommendation of the Customs Co-operation Council to expedite the forwarding of relief consignments in the event of disasters, and the UN Model Agreement on Customs Facilitation in International Emergency Humanitarian Assistance; and

> Annex 9.B. concerning goods imported for humanitarian purposes, to the Istambul Convention.[7]

50. The Revised Kyoto Convention entered into force on 3 February 2006 and, as of 10 January 2007, had 52 contracting parties. However, so far only 7 countries have accepted Chapter 5 of Specific Annex J on Relief Consignments, one of which made reservations.[8] The Istanbul Convention entered into force on 27 November 1993 and, as of 1 July 2006, had 50 contracting parties. However, so far only 37 countries have accepted Annex 9 B concerning goods imported for humanitarian purposes (and one of these countries made reservations).[9]

51. This Guideline recommends that countries implement the principles of these existing international instruments as a minimum standard either by becoming a party to the relevant multilateral conventions or by unilaterally incorporating their principles in their domestic law. This would overcome the need for countries to enter into bilateral agreements to deal with humanitarian crises.

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5 The WCO is the working name adopted by the Customs Co-operation Council, an intergovernmental organization established in 1952 to enhance the effectiveness and efficiency of customs administrations; See http://www.wcoomd.org/ie/En/en.html

6 International Convention on the simplification and harmonization of Customs procedures (as

52.

Temporary admission of such goods should not be subject to stricter conditions than the following:

- o In order to qualify for that exemption, the goods should be owned by a person established outside the territory of temporary admission and should be made available free of charge.
- o Medical, surgical and laboratory equipment should be intended for use by hospitals and other medical institutions which, finding themselves in exceptional circumstances, have urgent need of it, and must not be readily available in sufficient quantity in the territory of temporary admission; and

The time period for temporary admission should be determined in accordance with the needs for medical, surgical and laboratory equipment; and should be at least twelve months for relief consignments.

11. Domestically supplied goods, and services closely connected with such supplies, tha would ±if imported- TXDOLI\ DV ³UHOLHI FRQVLJQPHQWV´ RU ³JR for import duty and tax exemption on temporary admission, should be relieved from domestic indirect taxes such as VAT, GST and other broad-based or specific sales or consumption taxes.

53. There are currently no international standards with respect to the exemption of relief consignments from domestic transfer taxes (VAT, GST, other broad-based or specific sales or consumption taxes). To avoid distortion, it would be appropriate to grant the same favorable tax

Indirect Taxes- Personal effects and household goods of workers

> 12. Personal property and household goods of workers coming to a recipient country for the purpose of an assistance project of a country, international governmental organization or agency thereof should be exempt from indirect taxes, including import duties, as long as these ZRUNHUV¶ VWD\ LV PHUHO\ WHPSRUDU\ DQG LV UHODWH

559 It is an internationally recognized[14] practice not to impose import duties and taxes on personal effects of non-resident travellers subject to specified limits as to type and quantity of the goods, and the time-limit during which such goods may stay in the country concerned. This is a particular form of temporary admission. In addition, persons who move their place of residence to a country are often allowed to import their household goods into that country free of import and export duties and taxes, again subject to limitations as to type and quantity of the goods concerned;[15] that exemption is specifically recognized in various international instruments for diplomats, consular personnel and staff of international organisations.

56. The situation of non-resident workers dispatched to a recipient country in the context of a donor-financed project does not necessarily fall into any of these broad categories of exemptions: they are not the typical tourist travellers that are primarily targeted by the former category of exemptions, they typically do not enjoy diplomatic status, and they typically do not transfer thei

Guideline therefore recommended that such exemption be generally provided. This should be don
subject to the following conditions:

> the scope of the exemption be defined by recourse to the internationally established
> notioQV RI µSHUVRQDO HIIHFWV¶ DQG µUHPRYDEOH DUW

and taxes on goods imported for a specific purpose and on the condition that they be exported in the same state is commonly known as temporary admission.

61. Temporary admission plays a central role in the tax treatment of donor-financed projects, as many of the goods that are imported for the purpose of carrying out such projects are not intended t stay in the recipient country beyond the completion of the project (e.g., construction tools and equipment imported for the purpose of carrying out a construction project).

62. Most countries have provisions on temporary admission in their domestic legislation. In addition to these domestic law provisions, a number of countries have entered into bilateral assistance agreements with donor countries, international aid organizations or other donor or ai agencies which contain provisions on temporary importation. These agreements often show differences, minor or major, between them and compared to the corresponding domestic law provisions. Furthermore, by their nature, such agreements only cover activities by the contracting donor country, organization or agency, and their facilities are thus not available to other donors. Finally, such agreements are usually not published or publicly disseminated, or at least not systematically or in the same way as ordinary tax laws and regulations, thus lacking transparency andadding complexity.

63. There are also a number of multilateral agreements and conventions regarding temporary admission. The main instruments in this respect are the previously-mentioned Istanbul Convention[17] and Chapter 1 on Temporary Admission, Specific Annex G to the Revised Kyoto Convention.[18] The Revised Kyoto Conventions contains the basic provisions for all customs procedures, including the fundamental principles concerning temporary admission. The Istanbul Convention, on the other hand, contains more details regarding specific categories of goods, and regarding custom documents and guaranteeing associations. It is also more liberal than the Revised Kyoto Conventio in that it also provides for relief from economic prohibitions and restrictions for temporary admission goods;[19] specific Annexes B.1 to E of the Istanbul Convention include the list of goods that should be granted temporary admission with total relief from duties and taxes.

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17 The Istanbul Convention combines into a single instrument all the existing provisions on WHPSRUDU\ DGPLVVLRQ LQ D PXOWLWXGH RI HDUOLHU FRQYH is a combLQDWLRQ RI WKH)UHQFK ³DGPLVVLRQ WHPSRUDLUH´ DGPLVVLRQ´ FDUQHW ZLWK UHVSHFW WR VSHFLILF W\SHV RI the most important internationally accepted systems for the movement of goods under temporary admission through multiple Customs territories. It relies on an international chain of guaranteeing associations that provide the security for any duties and taxes which may become liable on the temporarily admitted goods.. The acceptance by signatory countries of the 13 specific annexes to that Convention ranges from 33 (for Specific Annex B.4 concerning goods imported in connection with a manufacturing operation, and Specific Annex E concerning goods imported with partial relief from import duties and taxes, the latter albeit with 22 reservations) to 49 (for Specific Annex B.1 concerning goods for display or use at exhibitions, fairs, meetings or similar events). See http://www.wcoomd.org/ie/En/Conventions/PG0139E1.pdf for the latest status of acceptance regarding the Annexes.

18 So far only 9 countries have accepted Chapter 1 of Specific Annex G on Temporary Admission, two of which made reservations. See http://www.wcoomd.org/ie/En/Conventions/PG0137E1.pdf for the latest status of acceptance regarding the Specific Annexes and/or Chapters.

19 7KH .\RWR &RQYHQWLRQ RQO\ HQFRXUDJHV SDUWLHV WR DGRSW economic prohibitions or restrictions with respect to temporary admission goods.

64. To ensure maximum transparency, predictability and harmonization, it is recommended that countries implement the principles of the Istanbul Convention and the Revised Kyoto Convention as a minimum standard either by becoming a party to these conventions or by unilaterally applying their principles. This would alleviate the need for countries to enter into bilateral agreements which, as noted above, hamper transparency and harmonization in this area.

65. Only if and to the extent a need still exists with respect to donor

unambiguously defined scope of application is also a prerequisite for efficient administration by the

governmental organization or agency thereof, that relief should be granted through a reimbursement or voucher method rather than through a direct exemption. 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.

75. Countries use different procedures for granting import duty and indirect tax exemptions. Some countries grant immediate exemption while other countries require some or all exempt importers to pay import duties and taxes and file for reimbursement at a later date. Also, a number of francophone African countries have introduced a treasury voucher system to monitor exemptions, in particular for donor-financed projects. Existing instruments generally do not advocate a particular method for granting or controlling exemptions in general or in relation to donor-financed projects in particular.

76. From an administrative perspective, the reimbursement or voucher methods are generally to be preferred and the above guideline recommends the use of these methods. A reimbursement system offers a number of advantages, including relieving the strain on the verification stage, which has the double advantage of speeding up the clearance process and making more customs personnel available for post-clearance controls (audits, physical checks) that are both more efficient and more trade-friendly. Experience shows that reimbursement systems can be successfully implemented, leading in some cases to an increase of government revenue.[21]

77. When implemented and administered properly, the voucher system used by some francophone African countries[22] can also be an effective method for eliminating or greatly reducing abuse and revenue loss from this type of exemption. Under this system, import duties and taxes in connection with qualifying projects are payable by way of treasury credit vouchers issued by the government. Donor-financed public procurement bids must be submitted on a tax-inclusive basis, which thus requires the bidders to carefully plan and calculate their projects. When the contract is

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4. The next section of the paper summarizes current practice in the taxation of foreign project assistance. Section III then asks why donors might seek tax exemption in the recipient countries for the projects that they finance. Section IV argues that now is a good time to reconsider the presumption that such projects should be tax exempt, and section V develops some options for change. Section VI contains the conclusions.

II. Current practice

5. The sums at stake in the tax treatment of aid are substantial. In the Niger, for example, tax expenditures on vouchers[3] one method by which exemptions may be implemented (see para. 21 below)[4] amounted in 2002 to about 18 per cent of project financing, and 10 per cent of all tax revenue. In the United Republic of Tanzania, customs exemptions for donors accounted for around 17 per cent of the gross value of imports in 2005. With any scaling up of aid, the quantitative significance of the issue will increase still further.

6. Tax exemptions relating to international aid take various forms. Imports of goods may be exempt from customs duties, VAT (or other general sales tax), 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). There may be exemptions from other taxes as well.

7. Recently, some donors have changed their policy. Previously, the policy of the World Bank had been that it would not use its loans to finance taxes.[5] Recipient countries therefore had a choice. They could provide exemption for goods and services procured under Bank financed projects or they could provide budgetary funds to pay for the portion of the project costs representing tax. On 13 April 2004, the World Bank changed its policy to allow financing of reasonable, non-discriminatory tax costs.[6] Going forward, therefore, recipient countries will not have to face the choice of providing exemptions for Bank-financed projects where their taxation system has been determined to be a reasonable one for purposes of this policy. The determination by the World Bank as to which taxes are treated as costs that can be financed by loans is made on a country-by-FRXQWU\ EDVLV DV SDUW RI WKH %DQN¶ country assistance strategy. Thus far, experience with applying the policy shows that in only very limited cases are taxes found to be unreasonable and therefore ineligible for Bank financing. The net result is that virtually all taxes have been considered eligible for financing (of course, if a country were to introduce an unreasonably high tax, the Bank could consider it ineligible). The Inter-American Development Bank (IDB) and the Asian Development Bank (ADB) have recently adopted similar policies.[7] Similarly, the French Development Agency (Agence Française de

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exemptions are accorded by a network of treaties, such as the Vienna Conventions, and customary international law which are motivated by policy reasons that differ from those applicable to the aid process, they are not considered in this paper.

5 *HQHUDO &RQGLWLRQV $SSOLFDEOH WR /RDQ DQG *XDUDQWHH Loan shall be withdrawn on account of payments for any taxes levied by, or in the territory of, the Borrower ... on goods or services, or on the importation, manufacture, procurement or supply WKHUHRI´ DV LQ HIIHFW EHIRUH $SULO

6 6HH %3 >%DQN 3URFH 43.00000912 0 612 792 re6-7(r)-15(s)-23(a)43.0000097>-37<00137-34<0

'pYHORSSHPHQW KDV LQ UHFHQW \HDUV LQFOXGHG LQ

non-

assistance is exempt, it will thus devote $100,000 of its own resources to building another school to add to those provided by the donor. If tax is imposed, however, additional two schools will need to be built to offset the reduced foreign provision. But the additional tax revenue of $200,000 that the recipient receives ($25,000 on each of the eight schools financed by the donor) will provide it with exactly enough additional resources to do precisely that (though it may choose not to spend all the receipts in this way). The real outcome is thus the same whether or not tax is imposed. While the empirical evidence on the extent to which aid is indeed fungible is mixed,[10] the implication is that when donors care not about their own warm glow of giving but about the real goods and services that the recipient enjoys, insisting on tax exemption may ultimately serve little real purpose.

14. In some cases, of course, donors may actively oppose providing any aid to the government that can be used directly for general budgetary purposes. For example, the donor may be responding to a humanitarian crisis and providing support directly to refugees, but may wish to provide no support to the government. Such an unwillingness to provide general budgetary support to the recipient may arise from any number of foreign policy reasons or PLJKW UHODWH IRU H[DPSOH WR D MXGJHPHQW E\ WKH G management framework is so flawed (e.g., involving substantial corruption) that direct budgetary support runs the risk of being largely wasted or diverted. This type of concern is very important for many donors, who consider that given their limited development budget, it is important that this budget be fully available for the implementation of the projects that they select, especially when these projects involve substantial transfer of know-how that can be used by the recipient country to promote further development

15. Donors may also be concerned that if the money available for the direct implementation of 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

IV. Reasons for change

17. As a general matter, the reasons that some donors are reviewing their policy concerning tax exemption are twofold:

(a) First, there is a recognition that tax exemption leads to a number of problems: it increases the transaction costs relating to international assistance, facilitates tax fraud, and leads to economic distortions. The implementation of bilateral agreements providing for tax exemptions also tends to complicate tax administration and involve uncertainty as to which enterprises, goods or services are covered or how the exemption should be granted (direct exemption or refund mechanisms).

(b) Second, developments in a number of recipient countries have weakened some of the reasons for insisting on tax exemption. In the absence of compelling reasons to insist on tax exemption, there is a recognition that the general rules of taxation should apply to aid financed projects.[11]

18. There is, it should be noted, an important difference between these two sets of reasons. To address the first, practical set of concerns, it would be enough that the exemption be eliminated: it does not matter, for this purpose, whether it is the donor or the recipient country that is responsible for paying the tax. The second set of concerns, in contrast, relate to precisely the question of whether it would not be appropriate for the donor to pay the tax[12] (bearing in mind, of course, that, at least as a first approximation,[13] the overall budgetary envelope of donors is likely to remain unchanged: paying tax will displace an equal amount of direct project finance). The following subsections elaborate on these two considerations.

A. The difficulties created by exemption

19. Depending on how they are structured, tax exemptions can result in substantial transaction costs. Because they involve departure from the generally applicable rules,

suppliers, which places a strain on weak tax administrations). There will also be substantial costs in terms of administrative overhead (legal, monitoring and budgetary) on the part of the GRQRU WKH GRQRU¶V EXGJHW UXOHV PD\ SURKLELW ILQD checking reimbursable expenses to see whether they include taxes; agreements need to be drafted and contracts reviewed). Where problems arise, human resources have to be devoted to dealing with them. In other words, the requirement to operate a special regime, as compared with the generally applicable tax regime, makes the contracts in question more expensive to administer.

20. Given the weakness of tax and customs administrations in most countries that are aid recipients, fraud is always a concern where tax exemptions are made available. Where tax or customs exemptions are granted, there is a substantial possibility of abuse of such exemptions. The abuse is likely to be more serious for indirect taxes. In the case of direct taxes, the issue is whether a particular contractor pays tax on its income from a project. The amount of tax at stake is relatively contained. However, in the case of indirect taxes, goods that have entered the country on an exempt basis can find their way into domestic commerce. If there is fraud in

obligations, delaying projects and adding to the tasks of an already struggling tax administration.

22.

27. On balance, there is little doubt that the distortions and practical difficulties that exemptions pose for recipient countries undermine, to some degree, the development objectives that the aid itself is intended to serve. And any scaling up of aid will amplify these difficulties.

B. The changing aid environment

28. 7KH FRQFHUQV DERXW ³XQUHDVRQDEOH´ WD[DWLRQ LQ 16 (above) have to some extent been overtaken by developments in many developing and transition countries. As a general matter, the level of tax rates has come down; income tax rates in virtually all developing countries are much lower than they were, say, 30 years ago. Likewise, tariffs have been decreased with trade liberalization, thereby reducing the number of cases where high rates would apply. As far as the issue of tax jurisdiction is concerned, many developing countries have unilaterally retrenched their taxing jurisdiction to what would [illegible] in the jurisdiction are typically taxed only where they have a permanent establishment. Of course, there are instances where taxing jurisdiction goes beyond what is normally allowed under treaties. Concurrently, however, developing countries have entered into an increased number of double tax treaties. To the extent that the concern remains, the remedy might lie not in total exemption from tax of activitivies a1j0( )-20-26(e)-10(a)-10(s)-23(e)-2 ET Q EMC /Sh(a)-10(n

receiving targeted support, the targeted support may, at least in part, have the same effect as general budgetary support.

32. Budget support has become an increasingly important part of overall aid flows over recent years, rising from 10 percent of total aid commitments in 2000 to 20 per cent in 2005.[17] This reflects debt relief and, more widely, increased awareness of the fungibility issue and an appreciation of the potential inefficiencies that project-based assistance can create given the better information that recipients may have on their own needs.[18] This increased willingness to provide budgetary support points to a potential incoherence in simultaneously insisting on tax exemption.

33. To the extent, nevertheless, that the donor is under a budget constraint and wishes to

V. Options

36. As noted earlier, the two broad sets of considerations set out in the previous section are in a conceptual sense distinct. The operational difficulties posed by exemption in principle can be resolved by measures — such as a voucher system — that levy tax but pass the cost of this to the recipient government (which would thus have a net revenue gain, apart from any owing to reduced abuse, of zero). Whether tax should be payable by the donor, on the other hand, depends on a range of political and economic considerations. Current trends, however — an increased awareness of the difficulties created by exemption and an easing of some of the concerns that have traditionally made donors reluctant to pay tax — in support — mean that both considerations point increasingly towards systematic payment of tax in connection with projects financed by donors.

37. In some cases, of course — as stress q 0.00000912 11.04 Tf dsing o ed a ne en-GBd s —

carried out by others, to the extent that those reviews are supported by credible documentation and analysis.

40. An alternative woud be for donors and recipients to enter into discussions setting out a framework under which some exemptions for international assistance might be lifted.

41. The two alternatives are not mutually exclusive. Different donors may want to move at different paces. The approach of coordinated donor discussion might also be tried in a few countries on a pilot basis.

42.

discriminatory or unusually burdensome compared with the otherwise applicable tax regime in the recipient country.

44. Several of these guidelines would duplicate the exemptions typically available under bilateral tax treaties, and would not be needed in cases where such a treaty existed between the donor and the recipient country. However, the existing treaty network is far from comprehensive and is unlikely to become so at any time in the near future. If countries that are aid recipients wished to follow such guidelines in their domestic law, the implementation would of course be quicker.

VI. Conclusions

45. One of the findings of the present paper is that there is an emerging movement towards an expansion of the situations where project assistance activities are subject to tax under the normal tax rules of the recipient country. This paper suggests that a group of donors and recipients of assistance, together with the member organizations of ITD, could further explore these issues and possibly develop guidelines towards a more coordinated approach that countries would be free to adopt.

46. It is recognized that some donor countries would not be in a position to adopt the D S S U R D F K R I D O O R Z L Q J U H F L S L H Q W F R X Q W U L H V W R W D [V
Clearly, each donor country must remain free to establish the conditions under which it is willing to provide international assistance. But, and while there will no doubt be exceptions, there are good reasons for limiting the extent to which tax exemptions are provided. Where there is sufficient confidence in governance structures in recipient countries — not least in relation to public expenditure management — countries and international organizations providing aid may wish to consider not to insist on exemption from tax for transactions relating to aid projects, except in the areas where the rules in the recipient country for taxing aid-related transactions fail to comply with internationally accepted guidelines or are considered to result in excessive taxation.

47. By the same token, recipient countries should be encouraged to strengthen their public expenditure management systems and review their tax/tariff structures so as to provide donors with the assurance they will need that any taxes paid on aid will be reasonable in amount and put to good use.

48. While e co aid will be