United Nations

E/C.18/2005/9

Economic and Social Council

Distr.: General
22 November 2005

Original: English

Committee of Experts on International Cooperation in Tax Matters
First session
Geneva, 5-9 December 2005

Tax aspects of donor-financed projects *

Summary

Projects involving development, humanitarian, and other assistance provided by governments or international organisations often enjoy tax exemptions. Exemptions may apply to imports and procurement of goods and services, and may extend to both direct and indirect taxes (including customs duties). Discussions among donors and recipients have identified problems with current practice and have led to a review of policy in some instances. This note summarizes the issues and options, as well as recent developments. It concludes that further study and discussion are warranted, but makes no specific recommendations

* This document was prepared by Victor Thuronyi, Senior Counsel (Taxation), International Monetary Fund. The views expressed in this paper are those of the author and should not be attributed to the International Monetary Fund, its Executive Board, or its management. They also do not necessarily reflect those of the United Nations.

Contents

1. This note discusses tax exemptions applicable to international assistance projects. The note benefits from discussions at the first global ITD[1] conference held in Rome in March 2005, and draws on work currently underway by participants in the ITD. It is intended to provide background information to the Committee of Experts on International Cooperation in Tax Matters and to stimulate further discussion. International assistance may be provided by governments, government-controlled agencies, international organisations, non-governmental organisations, and individuals. Assistance may be designed to facilitate development or reform, may respond to natural disasters or other humanitarian crises, or may advance other purposes. Because private charitable assistance raises its own set of issues, this note focuses on assistance provided by or on behalf of governments and international organisations (although some of the arguments are applicable to charitable assistance as well). Assistance may take the form of grants, may be provided in kind, or may be financed by concessional loans. The form in which the aid is provided typically does not affect the tax treatment. Exemptions for various transactions under international assistance projects apply in many countries, often at the insistence of donors.

I. Existing practice

In general

2. Tax exemptions relating to international aid are varied. 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. There may be exemptions from other taxes as well.

3. The legal instruments for providing exemption vary as well. In some cases, domestic tax laws set the conditions for exemption. In other cases, the terms for exemption are provided by treaties or other agreements entered into by recipient governments.

4. Exemptions are not always provided. The World Bank, for example, has not sought exemptions. Rather, the policy of the Bank has been that it would not use its loans to finance taxes.[2] Recipient countries therefore have a choice. They can provide exemption for goods and services procured under Bank-financed projects or they can 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, nondistriminatory tax costs.[3] Going forward, therefore, recipient countries will not have to face the choice of providing exemptions for

[1] The International Tax Dialogue (ITD) is an initiative by the IDB, IMF, OECD, World Bank, and UN to encourage and facilitate discussion of tax matters among national tax officials and international organisations. See www.itdweb.org.

[2] General Conditions Applicable to Loan and Guarantee Agreements, sec. 5.08: “no proceeds of the 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 thereof.” (as in effect before April 13, 2004)

[3] See BP [Bank Procedure] 6.00 (April 2004); OP 6 (“The Bank may finance the reasonable costs of taxes and duties associated with project expenditures.”)

Bank-financed projects, where their taxation system has been determined to be a reasonable one for purposes of this policy.

5. Where exemptions are provided, the question arises as to which specific transactions qualify for exemption. As discussed below, exemption might be granted by the general domestic tax rules, by general rules of double tax treaties, by specific exemptions in domestic law directed to international assistance, or by bilateral agreement. Possible transactions and taxes include the following:

- Goods are imported by a nonresident on a temporary basis (regime for temporary imports may apply) (possible exemption from customs duties, VAT, and other indirect taxes);
- Goods are imported by a nonresident, but will not be reexported (possible exemption from customs duties and VAT);
- Goods are imported by a resident, to be paid for using project funds (possible exemption from customs duties and VAT);
- Goods or services are purchased from a local supplier, using project funds (possible exemption from VAT);
- A nonresident individual comes to the country to provide services to be paid for using project funds and stays in the country for only a limited period of time (possible exemption from individual income tax and social contributions, perhaps under a general provision of domestic law, under treaty provisions, or under a bilateral agreement);
- A nonresident contractor without a permanent establishment in the country provides services under a contract financed with project funds (possible exemption from profit tax, perhaps under a general provision of domestic law, under treaty provisions, or under a bilateral agreement);
- A resident company is hired to provide services to be financed using project funds (possible exemption from profit tax);
- Resident individuals are hired to work for a resident or nonresident contractor with project funds (possible exemption for individual income tax and social contributions).

6. The list in the preceding paragraph is not complete. It is intended to illustrate that the question of potential tax exemption arises in different contexts and requires drawing a line at some point. (Few if any countries, for example, would exempt from tax the income earned by local permanent residents who are working for a company that is providing services under a contract that is financed by aid funds. In some cases, the general tax rules would apply an exemption, without the need for a specific exemption for aid-financed projects. For example, a nonresident importing goods might qualify under the terms of a customs regime for temporary imports. A nonresident which provides services without having a permanent establishment in the country might not be subject to income tax under the general rules (many countries refrain from imposing income tax in such a situation, even where there is no double tax treaty in effect.) Or the terms of a generally applicable treaty for the avoidance of double taxation might provide for an exemption for a nonresident

providing services without constituting a permanent establishment, again without specific reference to the project being aid-financed.

Why might donors not want to finance taxes?

7. There may be several reasons for donor reluctance to finance taxes imposed in connection with their international assistance.

8. The broadest reason is a desire to maximise the provision of aid that is intended to be targeted to specific uses, subject to a budget constraint. It might be easier, for example, to mobilise political support for such targeted assistance (building schools, vaccinating children etc.) than for the provision of untargeted budget support. (There is, however, a downside: if targeted assistance turns out to be wasteful or unsuccessful it is more vulnerable to political criticism.)

9. In some cases, donors may actively oppose providing any aid to the government that can be used 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.

10. In yet other situations, a donor may have no objection in principle to providing budgetary support to the aid recipient, but may have concerns about the public expenditure management framework in the recipient country. There may be concerns that in an environment of substantial corruption a significant portion of funds that are supposed to be paid as taxes and then find their way into the budget and be spent in a proper manner in fact will not reach their final intended destination. There may also be a concern that the budget formulation process does not result in a sensible allocation of funds. The extent of these concerns will, of course, depend on the situation in the recipient country and will vary over time, as tax collection and public expenditure management improve (or deteriorate).

11. A final reason for a reluctance to finance taxes is a concern that the recipient's tax policy is unreasonable in some way. The concern may relate to: (i) the rates of taxation; (ii) what is felt as an unduly aggressive assertion of tax jurisdiction; or (iii) taxation that actually discriminates against aid-financed projects. This concern may be magnified in situations where there is an absence of a treaty for the avoidance of double taxation between the donor country and the recipient country. Imposition of customs duties may be considered unreasonable, since customs are designed to provide protection for domestic industry, and this policy reason may be absent in the case of aid. Imposition of indirect taxes such as VAT may be considered unreasonable, since the incidence of the tax may either fall on the aid recipients or on the donor, neither of which may be considered an appropriate subject of taxation as a matter of policy.

II. Reasons for change

12. As a general matter, the reasons that some donors are reviewing their policy concerning tax exemption are two-fold. First, there is a recognition on the part of donors that tax exemption undermines the budgets of aid recipients, increases the transaction costs relating to international assistance, facilitates tax fraud, and leads to economic distortions. 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.[4]

13. In some cases, the reasons for insisting on tax exemption remain valid. There is therefore no single correct answer as to whether donors should insist on exemption or not, and for which transactions. The appropriate balance of policy interests may call for different policies in different countries and by different donors.

14. The concerns about unreasonable taxation in recipient countries (paragraph 11) 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 liberalisation, thereby reducing the number of cases where high rates would apply. As far as the assertion of tax jurisdiction is concerned, many developing countries have unilaterally retrenched their taxing jurisdiction to what would be typically be permitted under treaties. For example, nonresidents providing services 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, we can also see an expansion of treaties to which developing countries have become party. To the extent that the concern remains, the remedy might lie not in total exemption from tax of activities financed by donor aid, but a more limited exemption as would be called for by typical double tax treaties (for example, exemption from income taxation for nonresidents who do not have a permanent establishment in the country).

15. The concerns about public expenditure management remain in many countries. However, other countries have made substantial progress. This suggests that, to the extent that the main concern of a donor is weak public expenditure management, this concern can be addressed on a case-by-case basis by reviewing the situation in the particular countries where the donor is delivering aid. A review of the public expenditure management framework could convince donors, in relation to certain recipients, that this concern has been satisfied. Such a review could take advantage of the public expenditure management initiatives currently under way in a number of countries, with the participation of the IMF, World Bank, and other agencies.

16. Finally, the concern to target aid funds to specific projects rather than providing overall budgetary support can be addressed by recognizing the countervailing argument that overall budgetary support allows the recipient country to choose the most effective use of funds according to its needs.[5] Standard economic analysis suggests that overall budgetary support is more efficient than in-kind assistance, assuming a benevolent donor.

[4] See generally Gerard Chambas, Foreign Financed Projects in Developing Countries and VAT Exemptions (March 2005 presentation) (available on www.itdweb.org); Operations Policy and Country Services, World Bank, Eligibility of Expenditures in World Bank Lending: A New Policy Framework (March 26, 2004) (available on World Bank website).

[5] The same general consideration has motivated a trend to move towards untied aid.

To the extent, however, that the donor is under a budget constraint and wishes to achieve specific policy aims with the assistance, this desire can be addressed in other ways than tax exemption. For example, suppose that the donor is interested in combating malaria in the recipient country. The donor could negotiate with the recipient government, insisting that this government also provide public funds directed to achieving the goals of malaria eradication (not necessarily as part of the same project). Such a flexible approach could satisfy donor concerns without needing to use tax exemption as a policy tool.

17. In addition to the weakened rationale for exemption in many instances, account should be taken of the costs imposed on recipient countries by a tax exemption policy. The principal problem is one of fraud. Tax administration capacity in most developing and transition countries is weak. 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. The volume of goods involved might be several times the amount of the actual assistance. Given the significant size of foreign aid, this potential for tax fraud can have a significant adverse effect on the domestic tax system. In addition to fraud, tax exemption imposes costs on tax administrations of recipient countries in terms of keeping track of the various exemptions provided and administering them. The administrative burden and the risk of fraud can vary depending on the way that exemptions are structured. For example, in the case of VAT imposed on domestic supplies, the supplies can be exempted or, alternatively, a refund could be provided upon application by the purchaser. The latter mechanism would involve a better control on use of the exemption. Finally, instead of providing an exemption, the recipient government might provide vouchers to contractors working under aid-financed projects, in the amount of estimated indirect taxes. The contractors could then use these vouchers to pay the taxes. The advantage of the voucher approach is that it allows up-front identification of the budgetary cost to the recipient government. On the other hand, administration of the voucher system (or exemption systems) involves administrative costs. Reduction of the transaction costs of aid for recipient countries is one of the factors motivating some donors to review their policies.

18. An additional negative effect of tax exemption lies in the distortions it creates. If tax exemption, as is typical, is granted for imports but not for domestic procurement, a distortion is created to the detriment of domestic producers.

III. Options

19. Tax exemption for aid projects requires considering a number of factors and policies. As mentioned above, in some cases donors will wish to continue to insist on exemption. In other cases, donors may drop such demands, as long as the recipient country meets specified conditions. It is unlikely that all donors will agree to unlimited taxation of all aid, but it is quite possible that many aid-financed projects will become subject to the normal tax regimes over time.

20. One option for donors is to deal with each recipient country on a case-by-case basis. This provides maximum flexibility to balance the competing policy concerns. This option suffers from some drawbacks, however. Case-by-case negotiations are time consuming and can place a strain on the limited capacity of recipient countries. Absence of coordination can also lead to anomalies: donor countries will find it cheaper to operate in some countries (those offering generous tax treatment) than others, and projects financed by different donors will be subject to different regimes, not only involving administrative complexity but seemingly implying that one donor can accomplish more with a given amount of expenditure than another.

21. An alternative would be for donors and recipients to enter into discussions setting out a framework under which some exemptions for international assistance might be lifted. Such a framework could include assurances of sound public expenditure management practices in the recipient country. It could also include a review of the level of taxation and the jurisdictional rules, so as to provide assurance of reasonableness to donors.

22. The two alternatives are not mutually exclusive. Different donors may want to move at different paces (for example, the World Bank already took a decision in 2004 to largely abandon the policy of not financing taxes, but other donors have not come this far). The approach of coordinated donor discussion might also be tried in a few countries on a pilot basis.

23. In conclusion, it seems that developments on a number of fronts have rendered the policy of tax exemption for aid-financed projects obsolete at least in part. Because many different situations, types of transactions, and types of taxes are involved, there is not a simple yes-or-no answer as to whether aid-financed projects should be taxed. This seems to be a fruitful area for discussion among the concerned countries and international organisations.

Questions for discussion

24. There are a number of questions that would benefit from further discussion among donor agencies and countries that are aid recipients, including the following.

25. Would assurances of sound public expenditure management practices in a given recipient country facilitate the lifting of at least some tax exemptions required by donors? If so, could a uniform process be set in place to provide such assurances? To what extent could donors rely for this purpose on public expenditure management initiatives which recipient countries have undertaken in cooperation with international financial institutions?

26. Are there situations in which donors would accept taxation by the recipient country on the condition that such taxation is considered reasonable? If so, could uniform criteria of reasonableness be established?

27. In cases where donors insist on maintaining exemptions, specifically what kinds of transactions and taxes are sought to be exempted? With respect to each one of these, can mechanisms be found so as to minimise administrative costs and to minimise the possibility of abuse? For example, in the case of VAT what are the pros and cons of using a refund mechanism as opposed to an exemption mechanism?

Is the use of vouchers – under which the recipient government grants no exemptions, but provides contractors with vouchers that can be used to pay the associated taxes – a desirable alternative to exemption?

28. Can the complexity of administering tax exemptions associated with aid projects be reduced by using standardised legal instruments? Can best practices be identified in terms of drafting legal instruments providing tax exemptions, under which the transactions benefiting from tax exemption and the taxes concerned would be identified with specificity?