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Tax treatment of donor-financed projects

Draft Guidelines Prepared by the Staff of the International Tax Dialogue Steering Group*

Summary

At its second session held from 30 October to 3 November 2006, the United Nations Committee of Experts on International Cooperation in Tax Matters discussed note E/C.18/2006/5 on the Tax Treatment of International Assistance Projects and, at the end of that discussion, invited the International Tax Dialogue to do further work on this issue through a process that would allow donor agencies to participate. The staff of the International Tax Dialogue Steering Group has concluded that the best way forward would be to prepare a set of draft guidelines to be discussed by the Committee and to consult with all stakeholders, including primarily donor agencies, on these guidelines.

The draft guidelines prepared by the staff of the ITD Steering group are included in this note. If the Committee agrees, the next step would be a joint meeting of donors and tax experts to discuss these guidelines. That meeting could take place in the first part of 2008. The purpose of that meeting would be to discuss the principles underlying the draft guidelines as well as their wording with a view to present to the Committee a revised set of guidelines that could subsequently be forwarded to the ECOSOC with a recommendation that these guidelines be used by donors and recipient countries when dealing with the tax treatment of donor-financed projects.

*The member organizations of the International Tax Dialogue (ITD) Steering Group are the International Monetary Fund, Inter-American Development Bank, OECD and World Bank. This note has been prepared by staff of these organizations, and represents their views alone: it should not be taken to represent the views of any of these member organizations, or of their member countries.

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I. Introduction

1. At its second meeting held on 30 October – 3 November 2006, the United Nations Committee of Experts on International Cooperation in Tax Matters discussed note E/C.18/2006/5 on the Tax Treatment of International Assistance Projects. That note had been prepared by staff of the members of the International Tax Dialogue Steering Group pursuant to the decision, at the first meeting of the Committee, that "further consideration should be given to the tax regime applied to donor-sponsored development projects with a view to making recommendations to the Economic and Social Council."

2. The note first summarized current practice in the taxation of foreign project assistance. It then presented the reasons why donors might seek tax exemption in the recipient countries for the projects that they finance. It argued for a reconsideration of the presumption that such projects should be tax exempt, and put forward some options for change. The main option put forward in the note was to "develop guidelines towards a more coordinated approach that countries would be free to adopt."

3. During the discussion at the second meeting of the Committee, it was noted that the issue of whether or not tax exemptions should be provided arose differently in different situations: it was suggested, for example, that some exemptions might be appropriate for emergency relief, whereas similar exemptions might be inappropriate in cases of infrastructure development or entry into the financial markets, because of distortions that might arise and the possible impact on domestic enterprises and workers in those sectors. It was generally accepted that the Committee of Experts was the appropriate forum to deal with such an issue and that some further work was needed both on the substance, notably to provide the Committee with case studies, and on the procedures. The Committee therefore "invited the International Tax Dialogue to do further work, through a process that would allow donor agencies to participate."

4. This note has been prepared pursuant to that invitation. The staff of the International Tax Dialogue Steering Group, which has prepared this note, has concluded that the best way forward would be to prepare a set of draft guidelines to be discussed by the Committee and to consult with all stakeholders, including primarily donor agencies, on these guidelines.

5. If the Committee agrees, the next step would be a joint meeting of donors and tax experts to discuss these guidelines. That meeting could take place in the first part of 2008. The purpose of that meeting would be to discuss the principles underlying the draft guidelines as well as their wording with a view to present to the Committee a revised set of guidelines that could subsequently be forwarded to the ECOSOC with a recommendation that these guidelines be used by donors and recipient countries when dealing with the tax treatment of donor-financed projects.

6. The Draft Guidelines appear below. A general introduction provides the background for the Guidelines as well as how they are intended to be used. The Guidelines themselves appear after the introduction and are followed by detailed explanations.

7. At its third meeting on 29 October-2 November, the Committee is invited to discuss these Draft Guidelines and to decide whether they provide an

appropriate basis for further consultation and, ultimately, a possible recommendation to the ECOSOC.

II. Draft Guidelines on the tax treatment of donor-financed projects

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. In many cases, the general tax rules would provide for an exemption without the need for a specific exemption for donor-financed projects. For example, a non-resident importing goods which will be taken out of the country after being used for a project might qualify under the terms of a general customs regime for temporary imports. A non-resident 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 non-resident providing services without constituting a permanent establishment, again without specific reference to the project being aid-financed.

11. Each donor is of course free to establish the conditions under which it is willing to provide international assistance. Some donors may be concerned the imposition of taxes would decrease resources available for development activities and that it would be difficult to rally domestic support for payment of taxes. Donors should recognize, however, that tax exemptions create significant difficulties for recipient countries. Also, the Paris Declaration on Aid Effectiveness[1] reaffirmed the commitment, by various donor and recipient countries, to accelerate progress in "increasing alignment of aid with partner countries' priorities, systems and procedures and helping to strengthen their capacities". 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 guidelines. This is in line with the fundamental principle that underlies these Guidelines. The Guidelines are not,

1 Signed in Paris on 2 March 2005 by Ministers of developed and developing countries responsible for promoting development and the Heads of multilateral and bilateral development institutions.

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.

Scope and purposes of the Guidelines

12. These Guidelines deal exclusively with the tax treatment of assistance provided by, or on behalf of, governments and international organisations. While many of the recommendations formulated in the Guidelines could possibly apply to assistance provided by NGOs, private assistance raises a distinctive set of issues and is therefore not addressed here.

13. The Guidelines incorporate a number of existing international tax standards that are reflected in multilateral instruments as well as in the network of bilateral tax treaties based on the OECD and UN Model Tax Conventions. The Guidelines recommend that the tax treatment of transactions related to donor-financed projects comply with these standards.

14. The Guidelines have been prepared for purposes of assisting donor and recipient countries in determining the appropriate tax treatment of donor-financed projects. The Guidelines should provide greater uniformity and facilitate the discussion of tax issues between donors and recipients. 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.

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 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.

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.

5. 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.

B. Income taxation - employment remuneration

6. The remuneration, including employment-related benefits, for employment services related to an assistance project that an individual derives from that individual's employment 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.

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.

C. Income taxation - 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.

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 does not result in an unintended exemption of a foreign enterprise in its State of residence.

D. Indirect taxation - 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 referred to as "the Revised Kyoto Convention"), and

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

11. Domestically supplied goods, and services closely connected with such supplies, that would – if imported - qualify as "relief consignments" or "goods for humanitarian purposes" 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.

E. Indirect taxation – personal property 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 workers' stay is merely temporary and is related to that project.

F. Indirect taxation – temporary admission

13. 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 of a country, international governmental organization or agency thereof. For that purpose, countries should implement the rules of, or become parties to,

   a) Chapter 1 on Temporary Admission, Specific Annex G to the International Convention on the simplification and harmonization of Customs procedures, as amended (commonly referred to as "the Revised Kyoto Convention"), and

   b) the parts of the Istanbul Convention that relate to temporary admission.

14. 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.

G. Indirect Taxes – specific exemptions related to donor-financed projects

15. Where it is considered that tax relief from indirect taxes, including custom duties, must be granted with respect to goods used or supplied in relation to an assistance project of a country, international governmental organization or agency thereof in cases other than those described in the above Guidelines,

    a) the relief should be

        i) restricted to clearly identified goods that are strictly necessary for the purposes of the project, and

        ii) in the case of goods to be acquired specifically for that project, restricted to goods that are not available in the recipient country; and

    b) the taxes covered by the relief should be clearly identified, using where possible the tax terminology of the recipient country.

16. Where such relief from indirect taxes, including custom duties, is granted with respect to goods and services used in relation to an assistance project of a country, international 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.

17. Any agreement concerning such relief from indirect taxes, including custom duties, with respect to goods used in relation to an assistance project of a country, international governmental organization or agency thereof 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.

EXPLANATIONS OF THE 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.

1. Donors have traditionally been reluctant to agree to the recipient country's imposition of taxes in connection with the international assistance that they provide. This might be because they consider that the effectiveness of the funds that they allocate to foreign aid will be greater if no part of these funds is diverted towards general budgetary support of the recipient country. It might also be, in some cases, that donors may actively oppose providing any aid to the government that can be used directly for general budgetary purposes as they do not support certain expenditures financed by the regular budget. 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 might relate, for example, to a judgment by the donor that the recipient's public expenditure management framework is so flawed (e.g., involving substantial corruption) that direct budgetary support runs the risk of being largely wasted or diverted. Another possible reason for a reluctance to finance taxes in the recipient country is a concern that the recipient's tax policy is unreasonable in some way, e.g. as regards rates of taxation, which may be unusually high; as regards the determination of the tax base, which could be different from usual standards applicable to such taxes; or as regards some discriminatory feature of the tax.

2. These reasons, however, must be evaluated against the needs and the particular circumstances of recipient countries.

3. Concerns that a donor may have about public expenditure management in the recipient country may be warranted in some countries. However, a number of recipient countries have made substantial progress in this area. This suggests that, to the extent that the main concern of a donor is weak public expenditure management (e.g. a donor may feel that any direct budgetary support through the payment of taxes would be vulnerable to corruption and mismanagement), 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.

4. 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 percent in 2005. 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. This increased willingness to provide budgetary support points to a potential incoherence in simultaneously insisting on tax exemptions. It is hard to find a convincing rationale for a single donor who is simultaneously providing both targeted and general budgetary support to insist on tax exemption, since the same mix of support can be provided without any exemptions by reducing the level of general budgetary support. More generally fungibility means that even the provision of targeted support may be difficult to distinguish from general budgetary support. Because targeted support may allow the recipient to reduce its general public expenditures in the area which is receiving targeted support, the targeted support may, at least in part, have the same effect as general budgetary support.

5. The substantial changes that have been made to the tax systems of recipient countries in recent years must also be taken into account. 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 bilateral tax treaties. To the extent that a concern may remain about the tax system of a recipient country, 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 under international tax standards.

6. Moreover, the problems that tax exemptions for assistance projects create for recipient countries should be taken into account.

7. First, 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 customs, all kinds of goods might be allowed to enter without paying VAT or customs duty, even though these goods should not actually qualify for exemption. The volume of goods involved might be several times the amount of the actual assistance. Depending on how the exemption is administered, fraud may well also arise 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 legal basis for exemptions, i.e. they might be based on agreements that do not have the force of law. Even where a duly ratified treaty or law establishes exemptions, there are often difficulties of interpretation arising from vague drafting, particularly where the exemptions are provided in laws separate from, and not properly integrated with, the tax laws. These difficulties are compounded where the Ministry of Finance and the tax authorities are not consulted prior to the granting of the tax exemption and have not been involved in the drafting of the relevant legal provisions.

10. Fourth, tax exemptions can cause economic distortions detrimental to domestic production in recipient countries. If, for example, imported goods to be used for a donor-financed project are exempt, but no exemption is available for domestic purchases, then there will be a distortion in favor of imports.

11. Fifth, depending on how they are structured, tax exemptions can result in substantial transaction costs. Because policies on seeking tax exemptions may differ from donor to donor, officials in recipient countries need to familiarise themselves with the various requirements, which can be confusing and complex, particularly if tax administration is weak. Since these policies are superimposed on an existing legal framework, new legal issues may be presented (for example, whether a particular charge constitutes a "tax" which is eligible for exemption, or is instead a fee or user charge which is not eligible for exemption). In the case of VAT, exemptions tend not to work well, since they require the complex allocation of input credits (this would not be required if the exemption took the form of zero rating, but then the problem would be the creation of VAT refund claims on the part of 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 donor (the donor's budget rules may prohibit financing of taxes, which will require 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.

12. Finally, granting tax exemptions to any market participants always runs the risk of creating pressures for further exemptions, whether directly as a means of alleviating competitive distortions that the initial exemption created or indirectly by creating a precedent that others can call on. Many recipient countries already find it hard to resist the pressure to grant specific tax exemptions when 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 recipient countries have led to a growing acceptance of the principle that the general rules of taxation should apply to aid-financed projects. For instance, in April 2004, the World Bank changed its policy to allow financing of reasonable, non-discriminatory tax costs.2 Going forward, therefore, recipient countries will not have to face the choice of providing exemptions for Bank-financed projects, where

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2 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"). Previously, the policy of the World Bank had been that it would not use its loans to finance taxes. 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.

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-country basis as part of the Bank's overall 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 as 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 Asian Development Bank (ADB) have recently adopted similar policies.[3] Similarly, the French Development Agency (Agence Française de Développement (AFD)) has in recent years included in certain aid agreements (Contrat de Désendettement Développement (C2D)) the financing of taxes.

15. Guidelines 1 and 2 endorse that approach. They recognize, however, that in some cases, there may be valid reasons for insisting on tax exemptions despite the various developments and considerations described above. This will the case where serious deficiencies in the governance structure, tax system or tax administration of the recipient country justify such exemptions. One example would be where the governance structure of the recipient country is such that there is a serious risk that taxes paid with respect to the donor-financed project would be diverted to uses that the donor would clearly disapprove. Another example would be where the tax system of the recipient country seeks to levy taxes that are discriminatory or are clearly excessive (as regards their 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.

16. Where such considerations justify a request for tax exemptions, donors should adopt a targeted approach and, where possible, restrict the exemptions to situations where these considerations are relevant. There is no reason why exemption needs to be extended on a blanket basis. It can be tailored to minimize the difficulties for the recipient country.

17. It is recognized that circumstances may change to the point where a donor country's assessment of the governance structure, tax system or tax administration of a recipient country may no longer justify paying taxes to that country. In that case, the donor country will of course be entitled to require tax exemptions as a condition for continuing its assistance project.

18. In the case of donors that operate in many countries, it would be cumbersome to look at the details of the governance structure and the tax regime in each country. It would, however, be a duplication of effort for each donor to carry out such a review on its own, raising the question as to whether internationally agreed standards could be applied. Unfortunately, it would be quite difficult to agree internationally on such standards and cumbersome to establish procedures for their application to each recipient country. Necessarily, judgment is involved and accordingly the best approach may simply be to leave this determination to the

[3] See, in the case of the ADB, http://www.adb.org/Documents/Policies/Cost-Sharing-Eligibility-Expenditures/default.asp.

judgment of each donor concerned. Duplication of effort can, however, be minimized if both donors and recipients share information. For example, the analysis carried out by World Bank staff is reflected in "country financing parameters" which are supported by "country notes".[4] If these (together with similar exercises, if any, carried out by other donors) are shared among donors, together with any responses that the authorities wished to make in the case of taxes considered unreasonable, then all could benefit from the analysis carried out. The intention would not be to pass a judgement on the wider quality of a country's tax system but simply to make it easier for donors to conclude that taxes in a particular country are (or are not) broadly in line with normal international practice, and hence create some presumption that they should be allowed to apply to aid projects. In practice, therefore — and as is to some degree already the case in relation to public expenditure management systems — donors could rely on reviews carried out by others, to the extent that those reviews are supported by credible documentation and analysis.

19. If, despite the above considerations, the donor simply is unwilling to provide general budgetary support through the payment of taxes, the recipient country may have little choice than to accept the granting of tax exemptions. In such a case, however, it will still be important to take account of the procedural and administrative concerns reflected in these Guidelines.

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

[4] See Operations Policy and Country Services, World Bank, Eligibility of Expenditures in World Bank Financing: FY05 Report on Implementation Experience (Oct. 3, 2005) available at http://www1.worldbank.org/operations/eligibility/.

country. There is no guarantee, however, that officials representing the tax authorities of that country will be consulted.

23. Given the technicality of tax legislation, the special rules that might apply to the adoption of such legislation and the need to take account of administrative tax concerns, it is important that officials representing the tax authorities of a recipient country be involved in the negotiation and drafting of any specific tax provision dealing with donor-financed projects even if another ministry or government agency is taking the lead in the negotiations.

24. Whether these officials should come from the Ministry of Finance, from the tax administration of the recipient country or from both is a matter that should be decided by that country taking into account the various responsibilities that have been granted to its tax administration. The officials that should be involved are those that would normally be responsible for designing tax rules applicable to foreign taxpayers. In many cases, these would be officials of the Ministry of Finance. In some jurisdictions, however, tax administrations constitute separate agencies that have the responsibility of designing and implementing tax legislation; in such a case, it would seem appropriate to have representatives from such agencies involved in the negotiation and drafting of provisions dealing with the tax treatment of donor-financed projects. Since the tax exemptions might cover different types of taxes that may be administered by separate parts of the tax administration, it would be necessary for the recipient country to ensure that all relevant parts of its tax administration are consulted.

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 of different transactions in the context of each country's general tax rules. 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, 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 the agreements are authorized by law;

– Identifying with specificity the transactions benefiting from exemption, the applicable taxes, and the conditions for benefiting from exemption.

28. Participation of the appropriate officials from the Ministry of Finance or tax administration in the negotiation of these exemptions will often be the best way of ensuring that this is done.

29. Finally, to provide the transparency and information needed for policy making and public discussion, recipient countries should consider preparing and publishing tax expenditure analyses indicating the tax foregone as a consequence of exemptions granted with respect to foreign assistance.

5. 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.

30. Where it has been agreed to exempt from tax transactions related to donor-financed projects, it is important to do so in a way that minimize the burden, for the recipient country, of administering that exemption while, at the same time, minimizing the scope for tax fraud.. Guidelines 15 to 17 provide guidance as to how this may de done in the area of indirect taxes, including customs duties.

Income taxation - employment remuneration

6. The remuneration, including employment-related benefits, for employment services related to an assistance project that an individual derives from that individual's employment 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 Commentary on these models "[s]imilar provisions in old bilateral conventions were framed in order to conform with the rules of international courtesy and mutual respect between sovereign States". 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 interpreted in the same way. The reference to “resident” should therefore be given the meaning that 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 interpretation of the concepts of "permanent establishment" and "fixed base", as well as the need to 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 "enterprise" applies to all forms of business organizations and would therefore apply to a large 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. As is the case for other Guidelines, the reference to "resident" should be given the meaning that it generally has for the purposes of tax treaties.

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 does not result in an unintended exemption of a foreign enterprise in its State of residence.

43. If a donor country, international governmental organization or agency thereof insists on a tax exemption for enterprises that will carry on activities in connection with an assistance project, this Guideline first recommends that such exemption, at a minimum, should not apply to local enterprises and to sub-contractors so that only foreign enterprises that are paid directly by the country, organization or agency are entitled to claim that exemption. This recognizes that the recipient country should have the final say in deciding whether or not local enterprises should be taxed; it also avoids the difficult issues involved in trying to determine which enterprises should be entitled to a general exemption granted with respect to a donor-financed project.

44. This Guideline also recommends that the exemption should be designed in a way that avoids unintended exemption in the country of residence of a foreign enterprise. The tax legislation of many countries, and a number of tax treaties, exempt profits of local enterprises that are attributable to permanent establishments located in other countries on the assumption that such profits will be taxable in these other countries. The combination of these provisions with a tax exemption granted in a bilateral agreement with respect to activities related to donor-financed projects could result in a total exemption from taxes without the tax authorities of both countries being aware of that situation. Clearly, the involvement of tax authorities in the negotiation of tax provisions applicable to donor-financed projects (as is recommended in Guideline 3) will reduce the risk of this happening.

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 referred to as "the Revised Kyoto Convention"), and

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

45. Supplies by donor countries, international governmental organizations and agencies thereof to respond to acute humanitarian crises constitute a subcategory 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 emergency aid that would already be in place before a crisis occurred is paramount for swift and efficient donor intervention.

47. Many countries have adopted domestic tax provisions regarding "relief consignments", but 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 donor or aid agencies. While these agreements may cover many of the issues discussed below, they may 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 activities covered. 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 others. 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 and adding to the complexity of applying them. In many countries, tax and customs officials may not have ready access to them or be familiar with their terms.

49. A number of international instruments currently exist in this area. These mainly concern clearance procedures and relief from import and export duties and taxes, but do not cover taxes on domestic transactions. Also, these instruments have not been universally adopted. The main international instruments in this area are managed by the World Customs Organization (WCO).[5] 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 Istanbul Convention.[7]

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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 amended), done at Kyoto on 18 May 1973, and amended on 26 June 1999, commonly referred to as "the Revised Kyoto Convention".

[7] *Convention on Temporary Admission*, done at Istanbul on 26 June 1990, commonly referred to as "the Istanbul Convention".

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.

52. The following principles should be followed when designing rules and administrative practices to implement this Guideline for exempting relief consignments from import duties and taxes:[10]

– A definition of "relief consignments" should be included along the following lines:

> *goods, including vehicles and other means of transport, foodstuffs, medicaments, clothing, blankets, tents, prefabricated houses, water purifying and water storage items, or other goods of prime necessity, forwarded as aid to those affected by disaster; and*
>
> *all equipment, vehicles and other means of transport, specially trained animals, provisions, supplies, personal effects and other goods for disaster relief personnel in order to perform their duties and to support them in living and working in the territory of the disaster throughout the duration of their mission.*[11]

– Countries may find it useful to refer to the following definition of "disaster" in Article 1 of the UN Model Agreement on Customs Facilitation in International Emergency Humanitarian Assistance:

> *A serious disruption of the functioning of the society, causing widespread human, material, or environmental losses which exceed the ability of affected society to cope using only its own resources.*
>
> *The term covers all disasters irrespective of their cause (i.e. both natural and manmade).*

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8 The Revised Kyoto Convention is comprised of the Body of the Convention, of a General Annex, and of ten Specific Annexes, most of which are further divided into two or more Chapters. Countries may accede to the Convention without accepting any or all of the Specific Annexes and/or Chapters (Article 8(3) of the Convention). See http://www.wcoomd.org/ie/En/Conventions/PG0137E1.pdf for the latest status of acceptance regarding the Specific Annexes and/or Chapters.

9 Similar to the Revised Kyoto Convention, the Istanbul Convention comprises a body and 13 Annexes. Countries may accede to the Convention without accepting all Annexes, although they have to accept at least Annex A on Temporary Admission Papers and one other Annex (Article 24(4) of the Convention). See http://www.wcoomd.org/ie/En/Conventions/PG0139E1.pdf for the latest status of acceptance regarding the Annexes.

10 See Chapter 5 on Relief Consignments, Specific Annex J to the Revised Kyoto Convention.

11 Ibid.

- Accelerated and simplified clearance procedures for relief consignments should be provided[12] so that customs clearance of relief consignments is carried out as a matter of priority and simplified and expedited clearance procedures can be used, such as the lodging of a simplified, provisional or incomplete declaration, pre-arrival declarations, clearance outside normal hours and without normal charges as well as examination/sampling in exceptional circumstances only. Such clearance procedures should be provided for in the customs legislation and the necessary procedures should be planned for in advance and documented so that they can be implemented in short order.
- The exemption from duties, taxes and restrictions applicable provided for relief consignments should include[13] a waiver from economic export prohibitions or restrictions, and export duties and taxes otherwise payable; as well as a waiver from import prohibitions and restrictions, and import duties and taxes, for relief consignments received as gifts by approved organizations for use by or under the control of such organizations, or for distribution free of charge by them or under their control.
- Goods imported for humanitarian purposes, i.e. medical, surgical and laboratory equipment and other relief consignments that do not qualify for the exemption for relief consignments, should be granted temporary admission with total relief from import duties and taxes, and without the application of economic import restrictions or prohibitions;
- Temporary admission of such goods should not be subject to stricter conditions than the following:
  - 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.
  - 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
  - Relief consignments should be dispatched to persons approved by the competent authorities in the territory of temporary admission.
- In addition to the general recommendations regarding accelerated and simplified clearance, whenever possible, an inventory of the goods together with a written undertaking to re-export should be accepted for medical, surgical and laboratory equipment in lieu of a customs document and security.
- Temporary admission of relief consignments should be granted without a Customs document or security being required. However, the Customs authorities may require an inventory of the goods, together with a written undertaking to re-export.

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[12] See Standards 2 and 3 of Chapter 5, Specific Annex J to the Revised Kyoto Convention.

[13] Recommended Practices 5 and 6 of Chapter 5, Specific Annex J to the Revised Kyoto Convention.

– 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, that would – if imported - qualify as "relief consignments" or "goods for humanitarian purposes" 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 treatment to relief consignments that are sourced or supplied domestically under the same conditions and circumstances as imported relief consignments would enjoy pursuant to the instruments discussed above.

54. The above guideline therefore recommends that a similar exemption be granted with respect to domestically supplied goods, and services closely connected with such supplies, that would – if imported – qualify as "relief consignments" or "goods for humanitarian purposes" for import duty and tax exemption on temporary admission. Such exemption from domestic transfer taxes could be achieved either on the side of the supplier (by zero-rating qualifying domestic supplies) or on the side of the purchaser (by granting refund of domestic taxes paid). From an administrative point of view, the latter method is preferred as it allows for tighter controls. Also, the beneficiaries of such an exemption from domestic transfer taxes should be identified beforehand in the same manner as beneficiaries of import duty and tax exemption for such relief consignments.

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 workers' stay is merely temporary and is related to that project.

55. 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

[14] Chapter 1 on Travellers of Specific Annex J to the Revised Kyoto Convention; specific Annex B.6 of the Istanbul Convention also concerns travellers' personal effects, and Chapter 3 on Relief from Import Duties and Taxes of Specific Annex B to the Revised Kyoto Convention. So far only 7 countries have accepted Chapter 1 on Travellers of Specific Annex J (3 of which made reservations), while Chapter 3 on Relief from Import Duties and Taxes of Specific Annex B was accepted by 8 countries (5 of which made reservations). Furthermore, with respect to household goods, the Guidelines to Chapter 3 of Specific Annex J state that there "is presently no standard set of conditions among WCO Members for granting relief", this being an area for further harmonization.

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 their residence to the recipient country.

57. Bilateral assistance agreements typically provide relief from import duties and taxes for personal property of workers dispatched to the recipient country in the context of projects funded under that agreement. The following is a typical example:

> The personal property of experts charged with the execution of projects and programs in the context of this agreement and who are not citizens of [the recipient country] and do not permanently reside there, is exempt from duties, taxes and other charges when imported into [the recipient country]. When such goods are transferred in [the recipient country], the excises due must be paid in accordance with the provisions in force in [the recipient country].

58. Exempting the personal property of such workers from indirect taxes, including import duties, is justified as long as their stay is merely temporary and is related to the donor-financed project. Since there is currently no established international practice that specifically deals with import duty and tax exemption for personal effects and household goods of persons who are not travellers but at the same time do not necessarily intend to relocate their place of residence, this Guideline therefore recommended that such exemption be generally provided. This should be done subject to the following conditions:

- the scope of the exemption be defined by recourse to the internationally established notions of ‘personal effects’ and ‘removable articles’ that exist for travellers and persons relocating their place of residence;
- the type of taxes covered by the exemption be clearly defined by: using the terminology of the country which grants the exemption, and, ideally, by individually listing the country’s duties and taxes for which exemption is granted;[16]
- the beneficiaries of the exemption be clearly defined, and residents of the recipient country be denied the exemption;

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[15] While virtually all countries provide for import duty and tax exemption for personal effects of non-resident travellers, only some countries grant relief in general for household goods of persons who move their residence to their territory. Often this type of exemption is limited to “returning residents”, i.e. residents of the country that return to their former residence after having spent a prolonged period of time abroad.

[16] See e.g., Article 2 para. 3 (‘Taxes Covered’) of the OECD and UN Model Tax Conventions.

– the application of temporary admission rules (notably the obligation to re-export within a predetermined time-period) be limited to specified high-value or high-risk goods (e.g., vehicles); and

– the other procedures and conditions be those of similar exemptions that are well-established in the domestic legislation of the recipient country.

59. Recipient countries may opt to incorporate this exemption along the lines of these recommendations into their domestic legislation, either indiscriminately for all personnel working under an assistance agreement or only for those who work under an assistance agreement that provides for this benefit "in accordance with the recipient country's domestic law provisions in force". Alternatively, such an exemption may be agreed to bilaterally.

Indirect taxes - Temporary Admission

13. 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 of a country, international governmental organization or agency thereof. For that purpose, countries should implement the rules of, or become parties to,

a) Chapter 1 on Temporary Admission, Specific Annex G to the International Convention on the simplification and harmonization of Customs procedures, as amended (commonly referred to as "the Revised Kyoto Convention"), and

b) the parts of the Istanbul Convention that relate to temporary admission.

14. 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.

60. The benefits of not imposing import duties and taxes on goods which are intended to stay only temporarily and for a particular purpose in a given country are widely recognized both by traders and by customs authorities. There are strong economic, social and cultural reasons for not imposing the import duties and taxes that would otherwise be due, for instance to allow traders to test foreign goods before they decide to import them, or to stimulate exchanges in the cultural, educational and scientific area. The customs procedure that provides for relief from import duties and taxes on goods imported for a specific purpose and on the condition that they be re-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 to 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 aid 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 and adding 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 customs documents and guaranteeing associations. It is also more liberal than the Revised Kyoto Convention 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.

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-financed projects to deviate from the general domestic rules on temporary admission, special

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[17] The Istanbul Convention combines into a single instrument all the existing provisions on temporary admission in a multitude of earlier conventions and agreements on the ATA ("ATA" is a combination of the French "admission temporaire" and the English "temporary admission") carnet with respect to specific types of goods. The ATA carnet system is one of 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] The Kyoto Convention only encourages parties to adopt "a less restrictive practice" regarding economic prohibitions or restrictions with respect to temporary admission goods.

rules may be agreed upon bilaterally to deal with specific issues relating to the carrying out of the project (e.g., usage or special categories of goods not normally allowed for temporary importation, longer time-limits during which goods are allowed to stay in the country, etc.). Alternatively, domestic law may grant customs a margin of discretion, circumscribed by the existence of an assistance agreement, to deviate on certain points from the general rules on temporary admission and subject to prior application to that effect by a qualifying importer.

Indirect Taxes – specific exemptions related to donor-financed projects

15. Where it is considered that tax relief from indirect taxes, including custom duties, must be granted with respect to goods used or supplied in relation to an assistance project of a country, international governmental organization or agency thereof in cases other than those described in the above Guidelines,

a) the relief should be

i) restricted to clearly identified goods that are strictly necessary for the purposes of the project, and

ii) in the case of goods to be acquired specifically for that project, restricted to goods that are not available in the recipient country; and

b) the taxes covered by the relief should be clearly identified, using where possible the tax terminology of the recipient country.

66. Guidelines 15 to 17 deal with the drafting and implementation of specific provisions for the relief from indirect taxes, including import duties, with respect to goods and services related to donor-financed projects. These Guidelines should apply when it is decided that the recipient country should grant relief beyond the situations dealt with through the previous Guidelines on indirect taxes.

67. Tax exemptions from indirect taxes and import duties that are currently found in bilateral agreements are often worded too broadly. Many of these agreements fail to clearly identify the type of goods that qualify for the exemption otherwise than by reference to general terms such as ‘equipment’, ‘instruments’, ‘machinery’, or even broader terms such as ‘supplies’, ‘assets’ or ‘resources’, albeit limited to what is ‘necessary’ to carry out the project, or is ‘financed by’ the donor country. In some agreements, the latter reference is in fact the only limitation to the scope of the exemption.

68. If it is considered that a tax exemption from indirect taxes, including custom duties, must be granted with respect to goods used or supplied in the context of donor-financed projects, it is paramount that from the outset there be as little doubt as possible as to which goods qualify for exemption. Indeed, whereas initially both parties may have a clear idea of, and agree to what qualifies for exemption that understanding may, and often does change over time. A clearly and unambiguously defined scope of application is also a prerequisite for efficient administration by the recipient country’s authorities. The goods for which an exemption is made available should therefore be clearly identified by the agreement; preferably the agreement, or an annex thereto, should list the goods or categories of goods concerned, ideally by reference to their HS classification code.

69. Especially for materials that can easily be diverted to the local market, such as raw materials (e.g., construction materials) and other commodities (e.g., petrol), the agreement, or an annex thereto, should determine maximum quantities; at the very least, the agreement should provide for a mechanism to determine such maximum levels in common accord and prior to the introduction of the goods into the recipient country.

70. Also, from a tax policy perspective, donors should not insist on, and recipient countries should not grant tax exemptions for goods that are identical or essentially similar to those readily available on the local market of the recipient country.

71. Moreover, the terminology used to identify the taxes for which exemption is granted is often unclear and sometimes inconsistent. The terms range from just "customs duties" over "all customs duties and taxes" and "import duties, customs duties and other taxes" to "all taxes or charges", and sometimes specifically refer to "value added taxes". Some agreements even provide exemption from import restrictions or prohibitions, whether or not limited to what would be "otherwise required for reasons of public health or safety". Certain agreements include a reference to export taxes, restrictions or prohibitions. None of the agreements surveyed defined the terms used, or contained a list of the taxes covered by the exemption. This wide variation also appeared between agreements concluded by the same donor country. In some instances, there was even inconsistency within the same agreement.

72. This lack of precision may raise questions of interpretation. When the exemption is for "customs duties" only, it may be argued that other taxes due on importation (e.g., GST/VAT, excise tax/other consumption taxes) are not exempt, whereas under a clause referring to "import duties, customs duties and other taxes" they clearly are. In the latter case, however, the question may arise whether service charges such as harbor dues, warehouse or handling charges or fees and the like are also waived, whereas there may be less doubt under a clause referring to "all taxes and charges".

73. Such issues of interpretation are compounded by the inconsistencies between the various agreements a country may have entered into, whether as a donor country or as a recipient country. Minor variations between the various agreements require constant and careful attention, in particular by the competent authorities of the recipient country, who often lack sufficient administrative capacity to do so effectively and efficiently.

74. It is therefore important that taxes covered by the exemption be clearly identified, using the tax terminology of the recipient country. Ideally, a list of the recipient country's taxes and levies for which exemption is granted will be included in the agreement itself,[20] or in an annex, with a general provision allowing the agreement to continue to apply if these taxes are modified or replaced by broadly similar taxes.

16. Where such relief from indirect taxes, including custom duties, is granted with respect to goods and services used in relation to an assistance project of a country, international governmental organization

[20] See e.g., Article 2 para. 3 ('Taxes Covered') of the OECD and UN Model Tax Conventions.

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 assigned, treasury vouchers are issued to the contractor up to the contractor's forecasted amount of duties and taxes.[23] Any excess tax burden falls on the contractor. The system thus has a built-in control mechanism: bidders will be careful not to overstate their tax forecast to obtain the contract, while an understatement leaves the contractor to bear the excess tax burden when the contractor wins the bid. In addition, it allows the government of the recipient country to keep track of foregone amounts of duties and taxes.

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[21] E.g., Mali, cited in *Customs Modernization Handbook*, World Bank 2005, p. 238, box 10.9

[22] See e.g. for Guinea: Instruction No 196/414/PM/MBRSP of 13 December 1996 on the tax treatment of government procurement: http://www.droit-afrique.com/images/textes/Guinee/Guinee%20-%20Regime%20fiscal%20marches%20publics.pdf

[23] The system identifies which duties and taxes may be financed by the government through treasury vouchers, and which taxes must always be borne by the contractor. For instance, under the Guinea rules (See previous footnote) only (1) import duties and taxes on goods the ownership of which is transferred to the recipient country in the course of the project or which are incorporated into the constructions that are transferred to the recipient country, and (2) VAT on the domestic supplies under the contract are payable with "*chèques sur le Trésor Série Spéciale*" or "CTSS". For contracts which are only partly donor-financed, vouchers are issued only in proportion to the foreign aid provided.

78. While this system is straightforward for import duties and taxes and for single-stage domestic sales taxes, it is more complicated for 'domestic VAT' (i.e. VAT on domestic supplies, other than import VAT). Indeed, the amount of domestic VAT for which exemption and thus treasury vouchers may be claimed is not necessarily equal to the amount of output VAT (i.e. the total consideration for the supply multiplied by the VAT rate) but is the net amount of VAT due (i.e. the output VAT minus the input VAT on domestically sourced supplies or taxed imports), the forecasting of which may prove to be more difficult.

79. Contractors under foreign-funded projects for which duty and tax exemptions are available thus have an incentive to insist on outright VAT exemption for their domestically sourced supplies, which 'break' the VAT chain and thus undermine the VAT system of input tax credits. Indeed, domestic suppliers further down the supply chain will also claim exemption, thus leading to 'exemption creep' in the VAT system.[24] Another potential weakness of the voucher system may be the risk of forgery of vouchers, although with proper controls in place this risk should not be too difficult to manage.

80. The above guideline also recognizes that whatever system is used, the tax administration of the recipient country should ensure that proper administrative procedures are applied to ensure that goods and services on which indirect tax will be relieved are used for the purpose of the relevant project. In the case of imported goods, such procedures would typically include

- Establishing a clear and strict authorization procedure to identify the importer, the type and quantity of the goods and the exempt use for which they will be imported;
- Verification upon importation, to reconcile the goods, the import declaration and supporting documents presented to customs with the prior authorization; and
- Post-clearance controls to verify whether the imported goods are put to, and are not diverted from their exempt use.

17. Any agreement concerning such relief from indirect taxes, including custom duties, with respect to goods used in relation to an assistance project of a country, international governmental organization or agency thereof 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.

81. Most agreements providing for relief from indirect taxes with respect to goods used or provided in the context of donor-financed projects do not stipulate what happens when these goods are subsequently disposed of or diverted from their intended purpose. In most cases duties and taxes should become payable and this should be clarified in order to avoid any uncertainty.

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[24] See L. Ebril, M. Keen, J.-P. Bodin and V. Summers, *The Modern VAT*, IMF 2001, p. 89