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Item 5(c)(x)

Taxation of development projects

TAX TREATMENT OF DEVELOPMENT PROJECTS

Introduction

The issue of the tax treatment of development projects, also often referred to as donor-financed projects, has been on the Committee agenda for many years. In recent years there has been little action on the item however, mostly because the next steps involve finding a forum where donors and representatives of those receiving assistance (including from tax administrations) can come together to discuss this issue further.

2. During the last (the fourteenth) session of the UN Committee of Experts on International Cooperation in Tax Matters, the Committee recommended the matter be put on the list of items the next Committee Membership (this current Membership) might look at and decide whether and how to carry them forward. It was therefore included in the provisional agenda for this, the fifteenth, session. This note is intended as a “for information” note on this issue to help the Committee debate whether, and if so how, it should play a part in practical responses to the key questions and challenges posed by the tax treatment of development projects.

3. In 2007, under the auspices of the International Tax Dialogue, a paper written by Mr. Jacques Sasseville and Mr. Victor Thoronyi, then respectively of the OECD and the IMF secretariats, drafted a set of guidelines to assist the relationship between development organizations and donor countries on one hand and recipients of such development assistance on the other. The guidelines received the Committee’s support.

* E/C.18/2017/1

Key issues and background

4. The central issue is that development projects are a major source of investment in many developing countries, particularly the least developed ones where such support can account for up to 60% of the budget. This can be a substantial source of tax revenue in those countries and consequently spread the positive externalities of such projects. Many developing countries however also face many challenges in their tax administrations that may lead to inefficiencies in tax collection or even to mismanagement of the collected funds. This possibility seems to be the main argument for donor countries and a number of organizations in requiring that development projects they fund be tax exempt. Even if there are not any integrity issues, some donors prefer to be able to say to their own taxpayers that contributions are fully utilized on the project itself, without “overheads” due to the need to pay tax. The alternative view is that supporting the tax system is a key aspect of supporting tax systems, especially as exemptions are often the subject of abuse.

5. During past discussions in Committee sessions, it was recognized that depending on situations, some exemptions may be more justified than others. For instance, exemption of emergency relief imports can be readily justified whereas an exemption on a major infrastructure project may not be as compelling because of the resulting economic distortions that might arise and a possible negative impact on competing domestic businesses.

6. It is in this context that the above mentioned guidelines were drafted to serve as basis for discussion in a larger meeting of all stakeholders (countries and non-traditional donors and countries recipient of assistance for development projects). Given the time elapsed, the Committee may need to revisit the issue and if necessary set up modalities on an update of the guidelines, though major seems would not seem required by any change in relevant practice.

7. Tax exemption for development projects takes different forms, including exemption for VAT or import duties. Goods or other items exempted can be put in different categories, including goods for emergency relief, temporary imports, imported goods for infrastructure, and non-resident workers’ income driven by the financed project.

8. The variety of types of donors – countries, NGOs and international organizations - makes it harder to have harmonized rules on tax exemption at a country level. Each donor sets its rules on how they provide assistance for a recipient county. Some of the donors’ concerns on imposition of taxes may be related to decreased resources available for development activities. At the same time, it is important to note the difficulties created by differing tax exemptions for tax administration in recipient countries. The Paris Declaration on Aid Effectiveness also reaffirmed the commitment, by donors and recipient countries, to accelerate progress in “increasing alignment of aid with partner countries’ priorities, systems and procedures and helping to strengthen their capacities”.

The guidelines:

9. The guidelines as initially drafted dealt with assistance provided by foreign governments and international organizations. They did not seek to address assistance provided by NGOs and private donors. Given the substantial increase in private funding for large projects, in social sectors in particular, it may be necessary to consider the pros and cons of including such sources of funding in any future guidance.
10. The current guidelines as extracted below incorporate existing standards reflective of multilateral standards and bilateral tax treaties *in some instances*. The guidelines recommended a harmonization of tax treatment of donor funded projects based on those guidelines. It is also recommended to avoid proliferation of different rules for the sake of transparency and ease of tax administration in the recipient countries.
11. The guidelines are not meant to be binding but rather to serve as a framework to facilitate discussion between donor countries and recipient countries in determining rules on tax treatment for a given project with the intended outcome of limiting proliferation of varying rules per donor.
12. Some international organizations and a few donor countries have already made a decision not to seek tax exemptions for the development projects they finance. It is important however to seek a common understanding and guidelines for all donor funded projects so as to alleviate the burden of applying several different rules and legislations for different projects by tax officials in the recipient countries. This will limit misinterpretation and in some cases abuse of those rules and guidelines.
13. At the time of the drafting of the guidelines, a large number of countries were not yet parties to the multilateral instruments in the fields of indirect taxes that are referred to in the guidelines. It was suggested that in such cases countries receiving aid may benefit from unilaterally conforming their tax laws to those guidelines.
14. The guidelines are as follows.
- A. *General consideration:*
- Donor countries, international governmental organizations 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.

In practical terms and in order to follow the spirit of this guideline, the official of the Ministry of Finance and/or Tax Administration officials of the recipient country should be part of the negotiations of tax treatment of a donor-funded project.

B. Income taxation - employment remuneration:

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.

This is a principle that lends itself to some debates. It is a long standing tradition in the donor funded projects not to tax individual income or remuneration derived from working in that project. However one may question the justification of not paying taxes by a foreigner residing in country more than half a year and in some cases for several years as a consultant on particular project.

C. Income taxation – profits and payments to foreign enterprises:

Payments made to an enterprise that is not a resident of the recipient country should not be taxable unless that enterprise carries activities related to the donor-financed project for more than 183 days in the recipient country.

D. Indirect taxation - humanitarian crises:

No indirect taxes, including custom duties, should be imposed on the import of goods to be used to respond to humanitarian crises such as natural disasters, famine, or health emergencies. 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.

E. Indirect taxation – personal property and household goods of workers:

Personal property and household goods of workers coming to a recipient country for the purpose of an assistance project of a country, international governmental organization or agency thereof should be exempt from indirect taxes, including import duties.

F. Indirect taxation – temporary admission:

No indirect taxes, including custom duties, should be imposed on the temporary admission of goods to be used for the purposes of an assistance project 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.

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

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.

Conclusion:

15. The purpose of this paper, is to put before the Committee the issue of the tax treatment of donor-financed projects and to highlight some of the key issues that arise for most developing countries when dealing with development projects. In case the Committee finds it justified to study the topic further, whether in a subcommittee or otherwise, these existing proposed guidelines could serve as an initial working document to start with and to update as the work goes forward. A subcommittee on this topic is one option, although a smaller group of Committee Members could, as an alternative, investigate further whether this work could benefit from further Committee attention. A meeting with donors and recipients remains important if the guidelines are to have a practical impact in support of development.