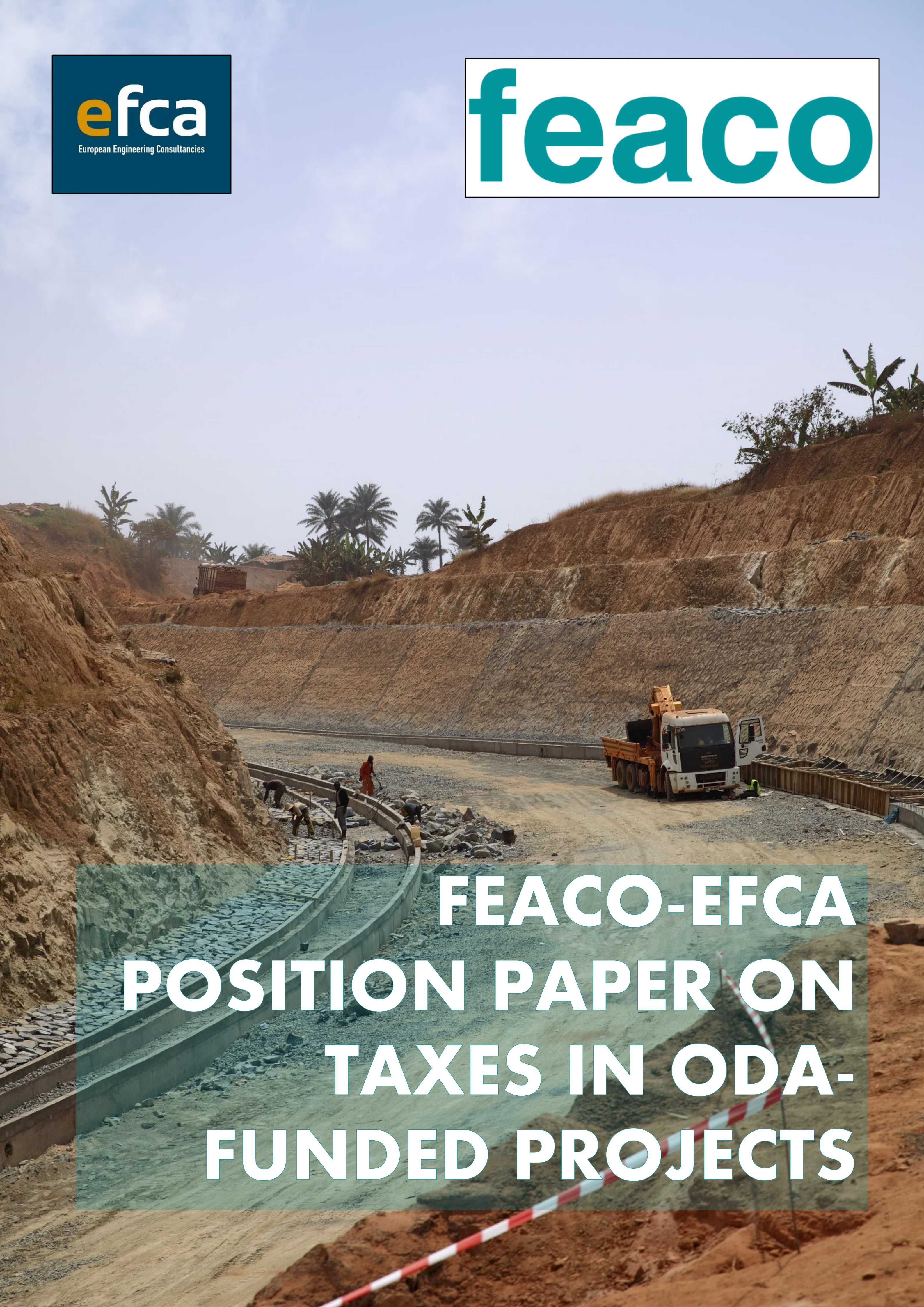
FEACO-EFCA POSITION PAPER ON TAXES IN ODA-FUNDED PROJECTS



In today's dynamic global landscape, the Consulting and Engineering industry plays a pivotal role in Official Development Assistance (ODA) projects. However, complex and unclear taxes treatment and regulations in recipient countries pose significant challenges, often impeding project efficiency and effectiveness. This position paper by FEACO and EFCA addresses these critical taxes-related issues, underscoring the need for transparent, standardized taxes guidelines and international cooperation. Our goal is to facilitate a more predictable and equitable taxes environment, ultimately enhancing the impact and sustainability of ODA-funded projects.

Lack of Clarity in Taxes Obligations

Companies operating in recipient countries often struggle to determine the exact taxes they are required to pay. This lack of clarity poses a significant financial risk, particularly for small and medium-sized enterprises (SMEs). SMEs may lack the necessary resources or expertise to navigate complex taxes systems, leading to unexpected taxes bills and penalties.

A practical example of the challenges faced due to unclear taxes regulations is seen in the case of a mid-sized European engineering firm which undertook a water management project in a developing country in Southeast Asia. Despite initial clarity on taxes exemptions as part of the ODA agreement, the firm faced unexpected corporate taxes demands from local authorities midway through the project. The ambiguity stemmed from a lack of alignment between the ODA framework agreement and the host country's evolving taxes legislation. As a result, the project faced significant delays and increased costs, affecting not only the firm's financial standing but also the timely completion of a critical infrastructure project that aimed to enhance the local community's access to clean water.

To address this issue, it is crucial in the context of ODA-funded projects to establish clear guidelines on taxes obligations, especially for SMEs, and simplify taxes procedures to ensure compliance and minimize financial risks.

Challenge of Establishing and Closing a Permanent Establishment

A significant challenge faced by the Industry in ODA-funded projects is the requirement to establish a permanent establishment in the recipient country. A "permanent establishment" refers to a fixed registered place of business through which a company carries out its business activities in a country, either wholly or partially. This requirement can be burdensome and impractical for Companies, impeding their participation in ODA-funded projects. It is essential to explore alternative arrangements that allow Companies to effectively contribute to projects without the need for a full-fledged permanent establishment. By adopting flexible approaches, we can encourage broader participation and foster inclusive development in ODA-funded projects.

Closing a permanent establishment when the project is closed can also be challenging. It involves navigating bureaucratic procedures, regulatory requirements, taxes obligations, and potential legal implications. Additionally, the risk of taxes racket and corruption in some countries can complicate the process further. Companies may encounter difficulties in obtaining approvals, complying with local regulations, settling taxes liabilities, terminating contracts, and addressing employment-related matters. Cultural and language barriers, unfamiliarity with local laws, the absence of a well-defined taxes system and the need for professional assistance can add complexity and cost to the closure.

Role of MDBs (Multilateral Development Banks) and Donors

MDBs and donors play a crucial role in addressing the taxes challenges. With their significant influence and resources, they have the potential to promote best practices and advocate for transparent taxes frameworks in recipient countries. By providing or requesting clear and precise taxes guidelines from recipient states at the earliest stage of the procurement process, they can mitigate the risks and enhance the project's integrity.

It is equally essential that during projects' implementation MDBs and donors are actively engaged in ensuring transparency, due process in the application of taxes frameworks and adherence of recipient countries to agreements.

MDBs and donors are uniquely positioned to influence the adoption of clear and transparent taxes guidelines in ODA projects. They can leverage their funding power and policy influence to encourage recipient countries to adopt standardized taxes practices. Specifically, MDBs can:

- *Incorporate taxes Clarity in Funding Agreements*: Condition funding on the recipient country's commitment to clear taxes guidelines for ODA projects.
- *Provide Technical Assistance*: Offer expertise to help recipient countries develop and implement transparent taxes systems for ODA projects.
- *Promote Best Practices*: Share successful taxes regulation models from various countries to guide recipient countries in reforming their taxes systems.

Donors, on the other hand, can:

- *Advocate for Transparency*: Use diplomatic channels to encourage host countries to adopt transparent taxes practices.
- *Align ODA with taxes Reform*: Tie ODA disbursements to milestones in taxes reform, ensuring that aid is effectively contributing to sustainable fiscal policies.
- *Facilitate Knowledge Exchange*: Create platforms for sharing experiences and strategies between countries to foster a common understanding of effective taxes governance.

Addressing Unintended Taxes Avoidance and Budgetary Oversights in ODA Projects

In OECD and UN reports, it has been noted several times that the current ambiguity in ODA taxes exemptions may inadvertently facilitate taxes avoidance by Companies and Individuals. This is not typically a deliberate effort to evade taxes but rather a consequence of unclear taxes regulations.

Additionally, there is often an observed pattern where MDBs and donors adopt an approach of passive oversight regarding the taxes aspects in ODA projects, essentially following a policy of non-engagement or avoidance in addressing taxes-related issues. This lack of engagement leads to taxes considerations being overlooked in the economic analysis and budget planning of ODA projects.

In scenarios where direct taxes, beyond customs and VAT, are applied, project budgets often prove inadequate to cover these taxes. This underscores the critical need for clearer taxes guidelines and comprehensive budget planning that includes potential direct taxation, ensuring that ODA-funded projects are financially viable and sustainable, even when confronted with taxes obligations that might emerge during the project lifecycle.

Additionally, existing Double Taxation Agreements (DTAs) can create competitive disparities in ODA-funded projects. Companies from countries with favourable DTA terms may have an advantage over those from countries without such agreements. To prevent such distortions, a holistic financial evaluation of ODA-funded projects at procurement stage should consider the implications of both direct and indirect taxes, ensuring fair competition and equitable treatment for all participating entities.

International Cooperation and Common Understanding

International collaboration plays a pivotal role in addressing the taxation challenges encountered in ODA-funded projects. Recognizing the importance of a shared understanding of taxation implications, the OECD has emphasized the need for coordinated efforts by developing a Hub for *taxes Treatment of Official Development Assistance* (ODA)[1], launched in 2022, what emphasizes the growing need for transparency in taxes policies related to ODA. This hub acts as an accountability mechanism, aligning with the commitments of the Addis Ababa Action Agenda and providing clarity on taxes policies and practices carried out by Development Assistance Committee (DAC) members.

International cooperation can be fostered through:

- *Global Forums and Conferences* to encourage the participation of various stakeholders in international discussions on taxes policies, promoting a shared understanding and coordinated efforts.

[1] https://www.oecd.org/taxes/taxes-treatment-official-development-assistance/

- *Standardized Reporting and Transparency* to advocate for the adoption of standardized reporting mechanisms for taxes practices in ODA-funded projects, ensuring accountability and comparability across nations.

This collaborative approach not only enhances transparency but also facilitates the equitable and efficient execution of development initiatives.

<u>Standardized Taxes Guidelines</u>

To ensure consistency and clarity, it is beneficial to develop standardized taxes guidelines for ODA-funded projects. These guidelines should encompass the key taxes obligations, exemptions, and incentives applicable to such projects. By having a standardized framework, companies can have a better understanding of their taxes liabilities, reducing confusion and enabling them to plan and allocate resources effectively.

Moreover, standardized guidelines promote transparency and enhance accountability. They provide a reference point for companies, MDBs, donors, and recipient countries, fostering a common understanding and facilitating smoother implementation of taxes obligations. These guidelines can assist recipient countries in comprehending the expectations of companies and MDBs/donors, thereby enhancing the effectiveness of project execution.

Although they are not binding, our industry values and encourages the application of the *United Nations Guidelines on the taxes Treatment of Government-to-Government Aid Projects*[2].

<u>Enhancing Legal Transparency and Policy Coherence in ODA Taxes Practices</u>

We advocate for greater transparency in ODA taxes practices. This includes publishing ODA framework treaties and agreements to provide clarity to all stakeholders. Transparency is key in ensuring that taxes practices are consistent with international norms and national laws of recipient countries.

A critical evaluation of the current ODA taxes exemptions is necessary. We suggest a review that examines the legal basis and implications of these exemptions, their uniformity across taxes categories, and their alignment with the goals of sustainable development.

Furthermore, a balanced approach should be adopted in ODA taxes practices. This involves considering the effectiveness of Aid alongside the importance of supporting fair taxes systems in recipient countries. The aim is to harmonize the efficiency of foreign aid with the principles of equitable taxation.

[2] https://financing.desa.un.org/document/un-guidelines-taxes-treatment-government-government-aid-projects

Information Sharing and Best Practices

Facilitating the sharing of information and best practices among Companies, MDBs, and donors can significantly improve taxes compliance in ODA-funded projects. Establishing platforms or networks where stakeholders can exchange experiences, challenges, and successful strategies encourages collaboration and learning. This exchange of knowledge can lead to the adoption of effective taxes management approaches, innovative solutions, and the identification of potential pitfalls to avoid. Additionally, sharing best practices can enhance the overall efficiency and effectiveness of taxes compliance efforts.

CONCLUSION

It is imperative for all stakeholders, including MDBs, donors, recipient countries, and industry representatives, to acknowledge the challenges outlined in this position paper and to work collaboratively to find effective solutions.

By establishing and requesting clear taxes guidelines, promoting transparency, ensuring fair competition, and fostering international cooperation, we can enhance the implementation of ODA-funded projects and contribute to sustainable development. This requires standardized frameworks, information sharing, and the exchange of best practices to improve taxes compliance and minimize risks.

Our Federations, the *European Federation of Engineering Consultancy Associations (EFCA)* and the *European Federation of Management Consultancies Associations (FEACO)*, are committed to actively engaging with MDBs, donors, and other stakeholders to drive the necessary changes.

Together, we can create a more inclusive, transparent, and equitable environment for ODA-funded projects, ensuring their effectiveness and leaving a positive impact on recipient countries.

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*The **European Federation of Engineering Consultancy Associations (EFCA)** has member associations in 29 countries and is the sole European Federation representing the engineering and related services industry. EFCA also represents FIDIC (The International Federation of Consulting Engineers) in Europe. The EFCA's European External Aid Committee monitors developments within the European institutions involved in external aid such as the EC, EIB, KfW, AfD, and the EBRD.*

*The **European Federation of Management Consultancies Associations (FEACO)** has the purpose to assist in the promotion and development of the profession of Management Consultancy in Europe. The FEACO Procurement Committee (FPC) has been running for more than 20 years and is dedicated to follow all activities that the International Financing Institutions (IFI's) drive around Development Aid financing, policies and more particularly their related procurement procedures.*