MENA-OECD INVESTMENT PROGRAMME

RECOMMENDATIONS ON FRAMEWORKS TO SUPPORT DEVELOPMENT OF NATIONAL TAX POLICY REFORM AGENDAS

- Working Group 3 -

This document presents preliminary recommendations to support development of national reform agendas on tax policy analysis and design to encourage direct investment in MENA countries, for consideration, revision and agreement by Working Group 3. The text incorporates a number of changes suggested at the 6-7 September 2005 meeting of Working Group 3 of the MENA-OECD Investment Programme.

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1. Many MENA countries are currently engaged in reforming and restructuring their tax systems to improve efficiency, spur investment and stabilize revenue yield. In general, there are two approaches to tax policy design. The first is to tax investments differently in order to achieve specific economic goals such as increased employment, regional development or introduction of new industries and technology by relying heavily on tax incentives for specific activities. The second approach is to apply generally the same tax rate and base to all activities. Table 1 provides the current top personal and corporate tax rates in each MENA country.

2. In recent years, MENA countries have migrated from the first approach to the second one, by adopting tax policies that lower the overall corporate statutory rate while phasing out generous tax incentives. The results of these reforms should be beneficial to both investors and the governments. Investors benefit from lower tax rates and less complicated tax administration, while the government benefits from lower incidence of tax evasion and avoidance. Current examples of major tax reform initiatives in MENA countries are described in Annex I.

3. Despite the significant tax policy reform undertaken in individual MENA countries, there has been little or no regional dialogue on key domestic and international tax issues confronting tax policy makers charged with designing tax systems that are supportive of investment or widespread assistance from international organizations on supporting the reforms. One of the main goals of the MENA-OECD Investment Programme, therefore, is to bring MENA countries into the global debate on tax and incentive policy strategies, to share experiences on the implementation of tax measures to enhance a country's ability to attract investment, and to consider how the project can be developed to assist MENA counties meet their tax reform goals.

4. Although tax policies are not the most important determinant of investment, they can have a major impact on investment decisions through affects on the cost of capital and on the expected profitability from a given investment. In a globalised world characterised by increased capital mobility, a well-designed and administered tax system can have a strong impact on attracting investment.

5. The following broad recommendations for tax policy analysis, design and evaluation should help guide the development of national tax policy challenges and reform strategies in the region, with OECD support. They are based on analysis of MENA country tax systems and current reforms as well as reform experience in other developing regions.

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GENERAL RECOMMENDATIONS FOR CONSIDERATION

Tax Analysis and Policy Coherence

1. **Ministries of Finance should be encouraged to establish an 'incentive and tax analysis' unit.** MENA countries are encouraged to develop the analytical capacity, organizational arrangements and institutional procedures necessary within the Ministry of Finance to conduct a professional review of tax policies, including international comparisons of the net burden placed on investors when locating in one jurisdiction, versus another. Strengthening systems for policy analysis will ensure that policy decisions are based on full information about their likely impact.

2. Each 'incentive and tax analysis' unit should develop a standardized set of analytical skills. By working together the tax analysis units of each MENA country, with the support of the OECD, should initiate plans to develop databases, methods and measures to analyse the links between investment and current and proposed tax policy design, including

- Working knowledge of micro-simulation principles and techniques in modelling the revenue impact of policy changes, in particular corporate income tax. When taxpayer-level information becomes available, a sample of corporations should be chosen and relevant micro-data examined in order to obtain measures of the tax burden on firms.

- Capacities for evaluating the corporate marginal effective tax rates (METRs) and corporate average effective tax rates (AETRs) by type of asset and investor type. The effective marginal tax rate will show the extent to which the tax system reduces the rate of return on investment, taking into account not only the basic tax rates but also many technical features of the tax system, such as capital allowances, loss carry-forward provisions and capital gains tax on disposal of capital assets.

- Tax expenditure budgeting procedures and guidelines to measure revenue foregone by targeted tax incentives and other significant departures from a benchmark tax system, where information is available. Tax expenditure amounts should be considered alongside direct expenditure amounts targeted at similar activities to inform the budget process about the advantages and disadvantages of employing tax incentives versus direct spending.

- Data management and systems to provide the basis for revenue estimates of proposed changes to the tax law, analysis of corporate METRs and AETRs, and tax expenditure budgeting.

3. In accordance with the national constitution, t**he Ministry of Finance should have ultimate responsibility for drafting tax policy legislation**. In MENA countries, as in OECD countries, many Ministries, agencies, and interest groups are normally involved in the development of tax policies affecting investment. At the same time, centralising the drafting of tax policy legislation within the Ministry of Finance will go a long way to solving one of the chief complaints of the MENA business community; namely that the plethora of Ministries introducing tax incentive and tax policy legislation results in significant uncertainty as to future after tax returns from proposed investments. To further improve the

transparency and policy coherence of the tax system, all income tax laws and regulations should be contained in a single act of legislation and administration carried out by one government body.

Design Issues in Support of Direct Investment

4. MENA countries with tax systems should offer a well-balanced tax structure that is reasonably competitive with structures prevailing elsewhere in the region and in the major trading partner countries. Efficiency, equity and simplicity all favour taxing investments at the same rate, with a broad tax base and a moderately low tax rate. A low rate/broad base tax system with limited reliance on incentives has the following advantages:

- A low corporate rate is an incentive to invest in that it allows investors to keep a larger portion of profits.
- A low corporate rate, with limited and targeted incentives, signals to investors that the government is interested in letting the market determine the most profitable investment without interference from the government.
- Revenue yield may be higher because investors would have few tax planning opportunities and compliance and administration costs would be lower.

5. Rules for the determination of corporate taxable income should be comprehensive and generally consistent with international norms. Investors expect basic tax provisions that take into account legitimate business costs. To ensure the main design features of the corporate tax system adequately reflect expectations of investors, policymakers are encouraged to address the following issues:

- Overly complex depreciation rules have been one of the chief complaints of investors in the MENA region. Rates and methods for tax depreciation should adequately reflect true economic rates of depreciation of broad classes of depreciable property, account for inflation and be reasonably easy to apply.
- To take into account business cycles, businesses should be allowed to carry forward (and possibly back) business losses, to offset taxable income in future (prior) years. The argument in favour of generous carry forward rules is particularly strong where depreciation claims are mandatory, rather than discretionary.
- The effects of double taxation of corporate profits – first at the corporate level, and then at the shareholder level – should be analyzed and the revenue and behavioural effects of integration measures should be considered. Inter-corporate dividends paid from one resident company to another should be excluded from corporate taxable income to avoid double or multiple taxation of the same income.
- Where capital gains are subject to tax, taxpayers should be allowed a deduction for capital losses to offset the gains. Recapture rules should apply to tax excess tax depreciation claims.

- Efforts should be made to minimise tax arbitrage possibilities by treating interest, dividends and capital gains in a similar manner to discourage taxpayers from characterising one form of income as another or to choose one organisational form over another for purely tax reasons.

6. **Countries should consider the adoption of residence-based tax rules rather than the current source base system**. Most MENA countries levy tax only on income generated within their borders; a system known as source taxation, rather than on the worldwide income of residents, a system known as resident taxation. While source taxation is an easier system to administer, it **can** provide investors with an incentive to invest in foreign countries, particularly in home countries with high tax rates.. By removing the incentive to invest abroad, resident based taxation coupled with credits for foreign source tax paid could assist MENA countries retain investment.

7. **Tax administration agencies should be streamlined and made more transparent.** MENA investor surveys show clearly that investors' chief complaint about taxes is not necessarily the overall burden as much as the complicated and opaque tax administration system. Efforts should be made to modernise tax administration through computerisation, rapid and transparent dispute resolution, elimination of bonuses based solely on amount of tax collected and introduction of modern taxpayer assistance services. At the same time, effective penalty regimes should be in place to deter widespread tax avoidance and evasion and level the playing field between those investors that comply with the tax rules and those who do not. Tax returns, information bulletins and taxpayer service offices should be readily available to taxpayers.

Evaluation and Monitoring of Tax Systems and Revenue Performance

8. **Revenue performance should be annually evaluated**. Sustainable revenue performance is a paramount consideration of any analysis of tax policy and tax policy reform. As institutional capacity for modelling likely revenue effects deepens, MENA countries should monitor the annual revenue yield of the tax system, by developing and implementing simple models, suitable to local conditions. This annual evaluation should include the systems for monitoring marginal and average effective tax rates by sector and size of firm. The results from the models should be publicly available and subject to third party scrutiny.

International Tax Policy Considerations

9. **Expand tax treaty networks.** Multi-national enterprises will prefer to invest in countries that have concluded tax treaties with their home country in order to avoid potential double taxation. At the same time, tax treaties provide a framework for exchange of information among tax authorities.

10. **Develop and implement tax base protection rules.** To guard against aggressive tax planning, particularly by multinational enterprises, and enable collection of a fair and reasonable share of tax on host

country profits from such enterprises, MENA countries should consider developing and implementing tax base protection rules. These rules include:

- Thin capitalisation rules
- Anti-treaty shopping rules
- Transfer pricing rules; and
- Controlled foreign corporation rules.

Table 1. Corporate and Personal Tax Rates in the MENA Countries and Recent Reform Efforts

	Statutory Rates:			Recent Reform Efforts
	Corporate	Personal	Comments on Rates	
Algeria			Exemption from corporate and personal income tax, and from property tax. Temporarily reduced customs duty and VAT on items related to the investment.	
Bahrain	0 percent	0 percent	Bahrain's only direct tax is imposed at a rate of 46% on the profits of companies involved in the production and refining of hydrocarbons and their derivatives.	
Egypt	20 percent	20 percent	Before recent reforms, top tax rates were 42 percent for corporate and personal income.	Egypt enacted significant tax reform legislation in the summer of 2005, by halving the top corporate and personal tax rates.
Jordan	15% on mining, industry, hotels and hospitals 35% on insurance and financial institutions 0% on agriculture 25% on all other companies	5- 30% 50% exclusion for private sector workers Full exemption for foreigners working for foreign firms		The Ministry of Finance is examining ways to eliminate the differentiated corporate income taxes in favor of one rate for all activities.
Kuwait	0% for wholly owned Kuwaiti	0% for all individuals	Generous fiscal incentives are	

	businesses 0-55% for foreigners operating a business		available to reduce corporate income tax on foreign investors.	
Lebanon	15% for all business; 10% for capital gains	Up to 20%	In addition to the low statutory rate, Lebanon offers several tax incentive schemes	MOF is considering a major tax reform overhaul
Morocco	39.6% for financial and insurance companies. 35% for all other companies.	13-44%	Morocco offers several very generous tax incentives for investments, key sectors, disadvantaged regions and free trade zones.	Morocco is the first MENA country to develop a tax expenditure budget
Oman	Up to 12% Foreign branches up to 30%	6-7% on foreign workers		
Qatar	Up to 35%	0%	Corporate tax holiday for 5 years, renewable for another 5 years. Exemptions from customs duties on machinery and equipment Exemption from export duties.	
Saudi Arabia	2.5% flat tax for Saudi and GCC residents (zakat) 20% for foreign companies for non-oil and gas income.	GCC and foreign employees exempt Self-employed foreigners 0-35%		In 2004, Saudi Arabia replaced multiple corporate tax rates on non-GCC companies with flat 20% rate. Law also include several modern tax practices, including reliance on internationally accepted tax principles, accelerate depreciation, and transfer pricing provisions.
Syria	10-45%	Wage income 5-12.5%	Corporate tax holiday up to 5 years, extendable to	

		Other income taxed as business income	7 years in the case of exporters and companies with a government stake. Duty free imports of machinery and equipment.	
Tunisia	20 –35 %	0-35%	Corporate tax holiday for 10 years. Reduced tax rates thereafter for export companies. Tax exemption on reinvested earnings. Tax and duty exemption on imported capital and input goods.	
United Arab Emirates	0% for UAE businesses 0-55% for foreign businesses	0%	Generous tax holidays for foreign investors largely eliminates all taxation with FEZs.	
Yemen	Up to 35%	Up to 20%	Corporate tax holiday for 7 years, extendable to 16 years. Exemption from real estate taxes, and from tax and customs fees on project fixed assets.	

ANNEX I: RECENT MAJOR TAX REFORM EFFORTS IN MENA COUNTRIES

Egypt. The Egyptian Parliament in the summer of 2005 enacted comprehensive tax reform, reducing the personal and corporate tax rates from 42 percent to 20 percent. To maintain the revenue base and modernize their tax system, the law contains a number of significant international tax provisions and anti-abuse rules, including residence-based taxation with foreign tax credits, introduction of transfer pricing and thin capitalization rules and definitions of permanent establishment and royalties. The aim of the new law is to attract additional investment and reduce the scope for tax evasion by the gray economy.

Jordan. The new Minister of Finance is currently examining approaches to comprehensive tax reform on a revenue neutral basis that would eliminate tax distortions caused by the multileveled income tax rates. The tax reform options will be examined in tandem with an overhaul of the current and generous tax incentive schemes.

Morocco. Major tax reform legislation based on recommendations from the IMF, WB and EU will be presented to the Parliament in October 2005. Some reforms have already been enacted in the 2005 budget, e.g. imposing taxes for the first time from co-operatives. Overall, the new reform legislation is intended to simplify the tax laws by reducing the number of taxes from 42 to 17 and to expand the tax base by gradually phasing out the number of exemptions. In addition, the tax administration department is currently developing a tax expenditure budget that will measure the amount of revenue lost from current tax incentive schemes. This will be the first tax expenditure budget developed in the MENA region.

Saudi Arabia. In 2004, Saudi Arabia enacted new income tax legislation that replaced the multiple corporate income tax rates on non-Gulf Co-operation Council (GCC) companies with a single rate of 20 percent for all non-oil and gas income. A progressive rate of tax continues to apply to the oil and gas sector. The new law contains a number of modern tax practices and policies, including reliance on internationally accepted tax principles for the first time, introduction of accelerated depreciation and transfer pricing laws. The tax holidays that were available under the Foreign Capital Investment Regulations have been repealed. Under those regulations, foreign companies with at least 25 percent Saudi ownership received a five or ten year tax holiday for investments in agricultural, industrial or other similar sectors. Investors that received tax holidays under the repealed regulations were grandfathered i.e., they continue to receive the exemption for the approved period.