



Special Series on Tax Law Design Issues to Respond to COVID-19

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Tax Law Design Considerations When Implementing Taxing Instruments to Support the Recovery From COVID-19

This note¹ focuses on the tax law design considerations that should be taken into account by countries—with a particular focus on low-income countries—when designing domestic tax instruments to support measures taken in response to the COVID-19 outbreak and its aftermath.² It first sets out the key legal design principles to consider when developing domestic tax measures to increase revenue mobilization, each of which should be designed to mitigate against regressivity, distortions and the risk of double taxation and ultimately result in the adoption of a rules-based instrument with prospective (and—where appropriate—temporary) effect in order to achieve greater tax certainty. The note then applies these legal design principles to selected domestic tax measures that have recently been considered or adopted by various countries, or which otherwise represent expected tax law trends, including COVID-19 recovery contributions (for instance, income tax surcharges or surtaxes and/or higher-end property/wealth taxes), rent taxes (for instance, excess profits taxes that capture location specific rents)³ and minimum taxes (for instance, on the corporate profits of multinational enterprises (MNEs)).

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² See also *COVID-19 Recovery Contributions* by IMF Fiscal Affairs Department (IMF FAD, February 2021).

³ IMF FAD, February 2021 argues for rent taxes, which raise important tax law design questions to manage implementation risks (for instance, from profit shifting). This also makes the effective taxation of location specific rents (LSRs) especially important, and when seeking to introduce a rent tax it would be important to ensure that LSRs are covered.

1. GENERAL TAX LAW DESIGN PRINCIPLES FOR IMPLEMENTING TAXING MEASURES

When designing domestic tax instruments (whether in the form of a COVID-19 recovery contribution⁴ or otherwise) to support measures taken in response to the COVID-19 outbreak and its aftermath, countries should:

- **Focus on their domestic tax law framework to strengthen and increase domestic revenue mobilization**, by considering opportunities to target measures through existing regimes (for instance, through general base broadening by reducing exemptions or carve-outs from existing taxes, or, where a broad tax base already exists, by increasing top rates of tax on income, property or wealth) or designing new tax instruments (for instance, extending or introducing high-end property/wealth taxes) that conform to good tax law design practices.
- **Good tax law design practices mean designing measures that are rules-based** to achieve greater tax certainty, and that have regard to the need to mitigate against regressivity, distortions and the risk of double taxation, which might otherwise increase the risk of exposing a measure to a legal challenge.
- **New taxing instruments should only apply prospectively and not retroactively**, and their legal design should align with their stated objective and purpose (for instance, one-off or temporary surcharges or levies should have a legislated phase-out or sunset provision). Introducing a structural change to the system (for instance, wealth tax where one does not exist) is likely to be time-consuming, and worthwhile only if intended to be permanent (IMF FAD, February 2021).

2. SPECIFIC TAX LAW DESIGN PRINCIPLES FOR IMPLEMENTING COVID-19 RECOVERY CONTRIBUTIONS

When designing domestic tax instruments to support measures taken in response to the COVID-19 outbreak and its aftermath (whether in the form of temporary increases in top rates of tax or ones that could become more permanent such as an extension to, or adoption of, higher-end property/wealth taxes), the following more specific tax law design aspects should be considered:

- **To the extent that measures aim to increase substantive tax liabilities (for instance, increasing the tax rate, or broadening the tax base by extending or introducing a wealth tax) legislation is likely to be required** (with emergency omnibus legislation possible whenever multiple laws are affected).⁵
- **The legal design of any new taxing instrument should align with the objective and purpose of the measure being implemented.** Countries should be careful to manage the risk that an announced special or temporary levy becomes permanent and may become susceptible to constitutional challenge whether on the grounds of expropriation or otherwise. A legislated phase-out or sunset provision would support the temporary nature of such a new taxing instrument, which could be designed with the possibility of extending or renewing it (for instance, after parliament/congress has evaluated and concluded that the objective and purpose has not yet been met). A one-off or temporary tax surcharge⁶ (or levy) is relatively straightforward

⁴ COVID-19 recovery contributions can take many forms but would typically consist of domestic taxing instruments that are levied on high incomes or wealth to help meet extraordinary financing needs (for instance, following a pandemic) while also promoting social cohesion in difficult times (see also IMF FAD, February 2021). They are commonly referred to as solidarity taxes or levies.

⁵ See *Tax Law Design Considerations When Implementing Responses to the COVID-19 Crisis* (IMF LEG, April 2020).

⁶ See IMF FAD, February 2021 for a discussion of the differences between surcharges and surtaxes.

to implement from a legal design and drafting perspective. However, more structural tax reform measures need to be designed very carefully, especially when intended to become a more lasting feature of the tax system (for instance, see Box 1 below which discusses the key tax law design considerations to take into account if the implementation of a wealth tax was decided to be pursued where one does not exist).

- ***The new taxing instrument should be rules-based, as well as being of uniform principled application.*** This will minimize the risk of breaching legal principles of equality (for instance, if the new taxing instrument were to treat taxpayers in comparable circumstances differently). This will also minimize the need for selective taxpayer carve-outs, which can give rise to another range of legal issues relating to non-discrimination or selective advantages, in addition to increasing compliance and administration burdens. Other domestic constitutional limitations might also be more easily managed where a new measure is designed as a new tax or regime (rather than, for example, seeking to disproportionately increase existing social security contribution amounts). These design decisions will also inform whether the instrument gives rise to a tax that is within the scope of existing tax treaties.
- ***Implementation and administration efficiencies can be achieved by drawing on existing legislative features, powers and reporting requirements when designing the taxing instrument.*** For instance, a one-off or temporary surcharge (or levy) would ordinarily be imposed on top of, or in addition to, the existing tax on the established tax base (for instance, taxable income or turnover) such that the new one-off or temporary surcharge (or levy) is then levied as an additional percentage of that same tax base. Similarly, the legal enforcement of any extension to an existing taxing instrument or adoption of a new taxing instrument (for instance, wealth tax) can also be supported by the continued existence of: increased exchange of information (both domestically and internationally, acknowledging that some gaps still exist in terms of both the information exchanged and the effective use of that information to actively enforce compliance); effective penalty provisions and sanctions for non-compliance; and significant and targeted compliance activity by tax administrations, using their existing suite of enforcement and collection powers.
- ***Clear guidance and communication should be provided to assist all relevant stakeholders (for instance, taxpayers, tax officials and tax advisors) to comply with and administer the taxing instrument,*** including whether any separate registration and de-registration procedures are required for COVID-19 recovery contribution taxpayers. This would not need to be comprehensive if the charge was designed as a one-off or temporary surcharge (or levy) on the existing tax base, as tax returns would already be computed and filed under the existing system. However, some modifications to withholding tax rates would be necessary if the surcharge is to be collected via withholding (such as under a PAYE/PAYG system). Any extension to an existing taxing instrument or adoption of a new one (for instance, wealth tax) on the other hand will require new comprehensive guidance (published externally for taxpayers and tax advisors, and internally for tax officials to ensure understanding is thorough and uniform), and covering in particular the identification and valuation of assets (if imposed on stock, instead of flows or consumption), and any other procedural aspects that may need to be developed such as prescribed forms for filing (for instance, a dedicated tax return or schedule), reporting (for instance, by third parties) as well as payment procedures.

Box 1. Wealth Tax – Tax Law Design Considerations

- A wealth tax could be designed as ***an annual tax at a prescribed rate levied on all of net wealth*** (financial plus non-financial assets *minus debts*) ***above an exemption threshold***. Allowing debts to be deducted when determining the tax base may better align with any overarching legal

principle relating to the ability to pay.

- A **relatively high exemption threshold**, enhancing the progressivity of the tax, would also potentially minimize the rent seeking behavior of taxpayers or their lobbying for selective carve-outs/exemptions, which can give rise to legal issues relating to non-discrimination or selective advantages in addition to increasing compliance and administration burdens.
- **Legal enforcement and administrability can be supported** by increased exchange of information, effective penalties and sanctions for non-compliance, and targeted compliance and enforcement activity by tax administrations. Existing reporting requirements (for instance, on financial institutions, investment/asset custodians, etc.) could be bolstered to assist in determining annual wealth balances.
- **Concurrent adoption of an exit tax** (for instance, at possibly higher rates of tax) could alleviate capital flight or expatriation concerns, again supported by effective information exchange and reporting requirements and the effective use of these instruments.

3. SPECIFIC TAX LAW DESIGN PRINCIPLES FOR IMPLEMENTING TAXES ON LOCATION SPECIFIC RENTS

All countries could consider domestic tax law measures that seek to specifically and more comprehensively target the taxation of economic rents—being, the excess of returns over the minimum investors require—in their jurisdiction, including in response to the COVID-19 outbreak and its aftermath (IMF FAD, February 2021). This could include, for instance, excess profits that are location or sector specific with respect to their jurisdiction.⁷ While sector specific taxes are often discouraged given the legal design drawbacks and potential distortions associated with ring-fencing, the case for allocating the right to tax income from location-specific rents to the location country appears widely accepted.⁸ While international rent taxes can be crafted in line with recent reform proposals, including those under discussion in the G-20/OECD Inclusive Framework,⁹ multilateral implementation is necessary (and should be the primary objective) for the proper taxation of global residual profits (or excess consolidated profits) across jurisdictions.

However, domestic tax law instruments targeting location-specific rents arising from a single jurisdiction or geographic area could also be an attractive tax base because they can in principle be taxed without distorting investor behavior. Although more common in the extractives sector, countries could think about designing tax rules that specifically extend them more universally to other location-specific rents. However, putting this economic concept into legal language that can be implemented through a domestic law instrument has historically been challenging, and would need to be carefully integrated with the already adopted tax policy positions embodied within an existing tax system (for instance, tax treatment of immovable property). A domestic tax instrument of this kind:

⁷ The issue of taxing location-specific rents is also explored in the toolkit on the Taxation of Offshore Indirect Transfers which was published under the framework of the Platform for Collaboration on Tax (PCT 2020).

⁸ See IMF Board Paper “Corporate Taxation in the Global Economy” (IMF 2019).

⁹ Cover Statement by the Inclusive Framework on the Reports on the Blueprints of Pillar One and Pillar Two – October 2020, OECD/G20 Inclusive Framework on BEPS, OECD, Paris (OECD 2020).

- is already commonly adopted to capture **location-specific rents clearly linked to natural resources and rights** (such as those embodied in licenses) to explore for, develop, and exploit those natural resources; but
- could be extended further to also cover excess profits derived during and post-crisis from **rents linked to other national or public assets, such as from licenses to exploit public goods** (for instance, electricity, gas, or other utilities given global lockdowns; telecommunications, broadcast spectrum and wireless networks and so on), and other **public authorizations or support giving rise to economic rents**, including authorizations to conduct business or produce products which generate large residual profits attributable to market concentration or crisis profiteering.

A basic skeleton (with the strongest possible caveats given its simplified form) of such a tax on location-specific rents (without detailed calculation rules) is set out at Box 2 below for illustrative purposes.

Box 2. Location-Specific Rent (LSR) Tax¹⁰

1. (1) LSR Tax (LSRT) is charged and payable by an entity for any year of income in which the entity has a positive accumulated net cash position from the conduct of an enterprise under an LSR right.
- (2) The amount of LSRT payable under subsection (1) by an entity for a year of income is the aggregate of LSRT payable for the year with respect to each separate enterprise conducted by the entity under an LSR right.
- (3) LSRT payable by an entity with respect to an enterprise conducted by the entity under an LSR right is calculated as [x percent] of the accumulated net cash position [representing cash flow, but this could be designed and drafted in alternative ways] of the entity for the year.
- (4) LSRT is imposed separate from, and in addition to, any other tax or charge, including income tax.
- (5) Payments made and received in respect of an LSR right have a source in [Jurisdiction].
- (6) In this section, “LSR right” means
 - (a) an exploration, prospecting, development, or similar right relating to land or buildings, including a right to explore for mineral, oil or gas deposits, or other natural resources, and a right to mine, develop, or exploit those deposits or resources, from land in, or from the territorial waters of, [Jurisdiction];
 - (b) information relating to a right referred to in paragraph (b); or
 - (c) a right, authorization or other approved benefit granted by or on behalf of a public authority (whether or not embodied in a license) to be an exclusive or semi-exclusive supplier or provider of:
 - (i) goods (such as pharmaceuticals or radioactive material);
 - (ii) utilities (such as electricity or gas); or
 - (iii) other services (such as those relating to telecommunications and broadcast spectrum, and digital networks and platforms),
 countrywide or within a geographic area of [Jurisdiction].

Source: Authors' formulation.

¹⁰ These basic provisions are very general in nature and do not take into account the individual circumstances of any particular tax system. They are merely intended to provide a first insight into what sort of rights could give rise to income from location-specific rents when expressed in legal language. An instrument that taxes economic rents could be designed in several alternative ways. The ultimate form of any such provisions to be adopted by a given jurisdiction would also need to take into account its specific legal tradition and system—including any constitutional and international law limitations, including double tax treaties—as well as its political and administrative structure and fiscal policies.

4. SPECIFIC TAX LAW DESIGN PRINCIPLES FOR IMPLEMENTING MINIMUM TAXES

The current trend toward domestic tax law measures in the form of minimum taxes on the corporate profits of MNEs, particularly in respect of inbound investment, should remain especially appealing to low-income countries when responding to the COVID-19 outbreak and its aftermath. However, care needs to be taken when designing these minimum taxes so that they achieve their policy objective without jeopardizing trade and foreign investment,¹¹ and their adoption should not undermine the ongoing consensus building process in the G-20/OECD Inclusive Framework (which is considering both an inbound and outbound minimum tax measure).¹²

An inbound minimum tax measure is more relevant and crucial for low-income countries. In contrast, an outbound minimum tax measure will typically be of limited relevance for them since low-income countries typically host no major multinational enterprises. Low-income countries have a generally accepted sovereign right to implement a well-designed inbound minimum tax measure and should be cautious about agreeing—whether bilaterally or multilaterally—to constrain their ability to impose or enforce that right, including by agreeing to allow another country’s outbound measure to apply in priority to their own inbound measure. Such inbound measures are also capable of being designed to ensure consistency with double tax treaties. In this regard, minimum taxes on inbound investment into low-income countries should seek to conform to the following tax law design principles:

- ***They should be residence-based*** so as to maintain consistency with existing double tax treaties, which do not typically affect a contracting state’s right to tax its own residents, such that:
 - a. the measure operates to tax a resident entity or local permanent establishment;
 - b. the measure operates by denying tax benefits (for instance, deductions), and/or as a separate minimum tax assessment to essentially reverse those tax benefits,¹³ and
 - c. in each case, with the denial of tax benefits or separate minimum tax assessment being calculated on a tax base comprising base-eroding amounts/payments, including high-risk profit shifting payments giving rise to deductions in the low-income country, which could cover payments for both goods¹⁴ and services.¹⁵

¹¹ See also IMF 2019.

¹² See OECD 2020

¹³ This leaves open the possibility of adopting a separate minimum tax assessment mechanism. While much of the current G-20/OECD led debate revolves around the denial or scaling back of base-eroding deductions under a country’s regular corporate tax, a key difference with this mechanism is that it would produce a minimum tax by applying a different rate (e.g. 20 percent) to a narrowed base and imposing a separate minimum tax liability. It has been suggested by various commentators that this difference in assessment mechanism (while somewhat more complex) could be legally significant. For example, it could arguably overcome the non-discrimination article depending on terms of individual double tax treaties because this mechanism would not actually formally limit deductions (which still apply under the regular system at the ordinary corporate tax rate), but instead operates to impose a separate minimum tax liability on resident entities or PEs with the effect of eroding some of the tax benefit of the relevant deductions (e.g. at the different 20 percent minimum tax rate) without ever formally denying them. This legal assessment is untested, but see, for example, the arguments advanced in Avi-Yonah and Wells (2018) in relation to the Base Erosion and Anti-Abuse Tax (BEAT) in the United States.

¹⁴ Measures affecting trade in goods (such as those affecting the cost of goods sold) also need to be carefully designed with regard to applicable WTO rules.

¹⁵ The rule should cover a broad range of payments (for example, any payment giving rise to a deduction or tax base reduction in the hands of the payer) to avoid planning around the rule by taxpayers and should also combat “conduit” or “imported” arrangements. Further, other forms of domestic minimum taxes (for instance, based on gross or net assets, or turnover) could also be considered (see also IMF 2019).

- **The denial of tax benefits or the assessment of a minimum tax relating to base-eroding payments should depend on those payments not being subject to minimum effective taxation in the hands of the recipient** (not minimum level of substance in *recipient* jurisdiction),¹⁶ with the onus to be placed on taxpayers claiming the tax benefit to prove that adequate tax has been paid. This design feature will better mitigate against the risk of double taxation and more specifically target asymmetric related-party arrangements (that is, deduction for payment in the source country from which the payment is made, without corresponding taxation of the payment in the hands of the related recipient); and
- **They should be nondiscriminatory** (meaning provisions should apply equally to like domestic transactions).

5. CONCLUSION

This note outlined the key tax law design considerations that should be taken into account when designing domestic tax instruments to increase revenue mobilization (whether in the form of a COVID-19 recovery contribution or otherwise) to support measures taken in response to the COVID-19 outbreak and its aftermath. Any such tax measures should be implemented through a rules-based instrument with prospective (and—where appropriate—temporary) effect in order to achieve greater tax certainty. The relevant instrument should be specifically designed in a manner that mitigates against:

- regressivity (for instance, to better align with any overarching legal principle relating to the ability to pay, and more general notions of equity);
- distortions (for instance, by avoiding ring-fencing or selective carve-outs which can give rise to legal issues relating to non-discrimination or selective advantages in addition to increasing compliance and administration burdens); and
- the risk of double taxation (for instance, to better conform with existing international tax law norms).

The note applied these legal design considerations to the following selected domestic tax measures that have recently been considered or adopted by various countries, or which otherwise represent expected tax law trends:

- Tax instruments that seek to specifically and more comprehensively target the taxation of economic rents (for instance, excess profits that are location or sector specific) in their jurisdiction, as well as other possible instruments ranging from those temporarily increasing top rates of tax (for instance, via an income tax surcharge or surtax) to ones implementing an extension to, or adoption of, more permanent higher-end property/wealth taxes, all perhaps on ‘crisis recovery contribution’ grounds; and
- Minimum taxes (for instance, on the corporate profits of MNEs), which will remain especially appealing for low-income countries to complement existing traditional measures.

¹⁶ Given that substance is now required for the purposes of both the OECD’s Forum on Harmful Tax Practices and the EU listing of noncooperative tax jurisdictions, a carve-out simply based on substance would significantly erode the policy intent, impact, and effectiveness of the minimum tax rule on outbound payments for low-income countries.

Any of the above measures could be adopted on a standalone basis (for instance, a temporary income tax surcharge) or combined with other measures (for instance, a more permanent rent tax or wealth tax could be introduced at the same time as adopting a domestic minimum tax to combat continued base erosion and profiting shifting from MNEs).

6. REFERENCES

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