

# Republic of Armenia: Technical Assistance Report-Growth-Friendly Rebalancing of Taxes



# REPUBLIC OF ARMENIA

## TECHNICAL ASSISTANCE REPORT— GROWTH-FRIENDLY REBALANCING OF TAXES

January 2019

This Technical Assistance report on the Republic of Armenia was prepared by a staff team of the International Monetary Fund. It is based on the information available at the time it was completed on October 2018.

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# **Republic of Armenia**

## **Growth-Friendly Rebalancing of Taxes**

Martin Grote, Nariné Nersesyan, and Riël Franzsen



**Technical Assistance Report**

**October 2018**

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## PREFACE

In response to a request from the Minister of Finance, Mr. Atom Janjughazyan (request letter, 11 June 2018), a technical assistance mission from the IMF Fiscal Affairs Department (FAD) visited Yerevan, Armenia, during the period July 3 – 16 to evaluate pro-growth tax reform initiatives currently under discussion in Parliament and review efforts of modernizing the recurrent property tax. The mission was led by Martin Grote and comprise Nariné Nersesyan (both from FAD) and Professor Riël Franzsen (external expert). This aide-mémoire contains the mission's conclusions and recommendations.

The mission had insightful meetings with the Minister of Finance, Mr. Atom Janjughazyan, Mr. Arman Poghosyan, Deputy Ministers of Finance, Mrs. Nairuhi Avetisyan (Head: International Tax and Customs Relations), Mr. Ori Alaverdyan (Head of Revenue Policy and Administration Methodology Department: Ministry of Finance) and other senior staff in the Ministry. The Mission held discussions in the State Revenue Committee (SRC) with Mr. Davit Ananyan (Head of the SRC), and Mr. Mikayel Pashayan (Deputy Chairman: SRC). At the Ministry of Economic Development and Investment, the mission had discussions with the Minister, Mr. Artsvik Minasyan, Messrs. Avag Avanesyan and Albert Babayan (Deputy Ministers in the Ministry of Economic Development) and senior staff. At the Ministry of Territorial Administration and Development the mission met with the Deputy Minister, Mr. Vache Terteryan; and Mr. Hmayak Hakobyan (Head of the Real Estate Cadaster Evaluation and Monitoring Department in the State Committee on the Real Property Cadaster (SCRPC), discussing the state of the cadaster. The mission exchanged views with the Deputy Governor, Mr. Nerses Yeritsyan (Central Bank of Armenia). Local communities' capacity to administer the property tax was discussed with Mr. Robert Petrosyan (Irvezh Community), officials from Abovyan, and Mr. Vahan Movsisyan of the Community Finance Officers Association.

The mission discussed tax restructuring priorities with Mr. A. Hovsepyan (President of AmCham); Mrs. I. Dumanyan (CEO of Mentor Graphics of Siemens); Mr. K. Garaseferyan (Corp. Affairs and Communication Manager of JTI Armenia); Mr. G. Gyulbudaghyan (Managing Partner: Grant Thornton CJSC); Mr. D. Sargsyan (Head: Legal Services of the Ameria Group of Companies); Mr. A. Hovakimyan (US Embassy); Mr. A. Ghazaryan (Managing Partner of the American University of Armenia); and Mrs. V. Ararktsyan (Executive Director of AmCham). At PricewaterhouseCoopers (PWC) the mission discussed tax policy stability and revenue administration challenges with Mr. V. Nalbandyan (Managing Director); Mr. M. Ahern (Partner: Tax and Legal Services); Mrs. A. Mesropyan (Manager), and Mrs. H. Harutyunyan (Manager).

The mission is grateful for the full and effective cooperation received from the authorities. The excellent logistical and analytical support by the IMF Resident Representative in Armenia, Ms. Yulia Ustyugova and her staff, in particular, Vahram Janvelyan, and Marina Aleksanyan is gratefully acknowledged. Finally, the mission wishes to recognize the heavy workload absorbed by the mission interpreters Ms. Lilit Simonyan and Ms. Marietta Sahakyan.

## ABBREVIATIONS AND ACRONYMS

AMD	Unit of Currency in Armenia, the Dram
AEOI	Automatic Exchange of Information
AETR	Average Effective Tax Rate
BEPS	Base Erosion and Profit Shifting
CBA	Cost-Benefit Analysis
CbC	Country-by-Country Reporting
CFOA	Community Finance Officers Association
CGT	Capital Gains Tax
CIS	Commonwealth of Independent States (formerly the USSR)
CIT	Corporate Income Tax
CTT	Capital Transfer Tax
DIT	Dual Income Tax
ETR	Effective Tax Rate
EOIR	Exchange of Information on Request
EU	European Union
FAD	Fiscal Affairs Department
FDI	Foreign Direct Investment
FEZ	Free Economic Zone
GDP	Gross Domestic Product
ID	Identification Number
ICT	Information Communication Technology
IMF	International Monetary Fund
LOB	Limitation of Benefits
MAP	Mutual Agreement Procedure
MCAA	Convention on Mutual Administrative Assistance in Tax Matters
MCF	Marginal Cost of Public Funds
METR	Marginal Effective Tax Rate
MMIS	Municipal Management Information System
MNE	Multinational Enterprise
MOF	Ministry of Finance
MTAD	Ministry of Territorial Administration and Development
OECD	Organization for Economic Co-operation and Development
PIN	Personal Identification Number
PIT	Personal Income Tax
PPT	Principal Purpose Test
SCRPC	State Committee of the Real Property Cadaster
SSC	Social Security Contribution
SRC	State Revenue Committee
TA	Technical Assistance
TAR	Technical Assistance Report
TC	Tax Code
VAT	Value-Added Tax

## EXECUTIVE SUMMARY

With the appointment of a new government, a lively debate has ensued about redirecting fiscal policies in support of a balanced revenue-raising strategy that is conducive to investment and growth. Currently, Armenia needs to raise more revenues in support of fiscal consolidation and to generate additional funding for developing and maintaining the physical infrastructure with special reference to the need of improving the urban built-up environment. Since the Authorities requested the mission to consider tax measures that are supportive of growth and/or tradeable sector, the proposed restructuring of taxes recognizes that real estate taxes, resource rent taxes, and broad-based consumption taxes (VAT and excises) are least distortive for growth. The 2016 Technical Assistance Mission in its report reviewed already unutilized tax bases as far as excises are concerned (taxation of gambling, mobile air time, waste packaging taxes, alcohol and tobacco taxation). As requested by the authorities, this mission focused on improving personal and business income taxes, presumptive taxation, and the recurrent real estate tax as base-broadening of the latter could support the fiscal program of the new government.

The mission's proposals are cognizant of the growth and equity trade-offs. Also, the government in its tax review is advised to internalize the following key institutional lessons from successful comprehensive tax reforms across the world: the tax reform needs a positive rallying cry such as *"raising revenues for service delivery"* that should continue for the reform period of say five years. It would be helpful to implement gradual, incremental changes that are aligned to the overall reform theme and to get reform-backing from a high-profile Champion in the Executive. The Minister of Finance should prominently lead the tax reforms to stabilize expectations and provide for certainty amongst investors. It would be prudent to coordinate complex tax policy changes with capacity readiness of the State Revenue Committee. Finally, consider synchronizing tax increases with the roll-out of high-visibility public service delivery to gain buy-in from the public.

Personal income taxation (PIT) can and should perform its main function of generating revenues in line with the distributional fairness maxim. Given that about 30 percent of the population is poor with a gradually widening inequality, the authorities should ensure that the skewed income distribution is not worsened through the joint impact of the tax system. In adjusting the PIT system, it is therefore important to maintain the progressive rate structure to ensure adherence to equity and preserving taxation according to an individual's ability to pay. With progressivity in mind, PIT reforms should lighten the tax burden of the low-income cohorts, while minimizing the revenue impact of the reform. Hence, a personal allowance or tax-free threshold equal to the global poverty line of AMD 30,000 is recommended. This is costly to the budget but if taxes were to be adjusted within a holistic framework, other indirect tax instruments such as excises (discussed in the 2016 TA Report) could be utilized to compensate adequately for suffered revenue declines that arise from taking a large cohort of low-income taxpayers out of the PIT net. Importantly, the flat tax (PIT) should be avoided as it exacerbates income inequality by unduly benefiting high-income taxpayers at the expense of low- and middle-income households.



The Flat Tax' negative distributional consequences are compounded by the sizable erosive impact on tax revenues if top PIT tax rates are lowered to a lower proportional flat rate. Less tax revenues would be available, possibly resulting in cutbacks on pro-poor expenditure programs. Revenue administration is important too. If the revenue administration continues successfully to close loopholes and enhance compliance (e.g., by requiring that all wage earners and sole proprietors file simplified and pre-filled tax returns that can still be audited), these additional revenues should be allocated to advance tax burden relief of low-/middle-income households.

The basic choice facing Armenian's policy makers is whether to continue with a corporate tax (CIT) system that imposes, compared to the region, a relatively high statutory rate with several differentiated tax rates of the incentive regimes. Alternatively, one could revamp the system through base broadening measures that would afford a lower and more uniform rate structure. To make the CIT system simpler, fairer and less distorting in its impact on investment choices, the mission recommends a reform path that rationalizes CIT preferences, repeals tax allowances, and removes tax rate differentials within and across sectors of the economy. Adopting a uniform rate would be much more neutral in its impact on investment decisions, which would largely restore a level playing field for investors. Further, a tax system with a uniformly applied tax rate is less susceptible to aggressive tax-planning opportunities such as domestic transfer pricing.

With regard to the *special or presumptive tax system*—encompassing the revised patent fee, the turnover tax, and the family company regimes—the pertinent design weakness is that this special tax system can stunt the growth potential of small businesses. It imposes attractive relief through a turnover tax or flat charge which results in a bunching of firms under the turnover threshold. But for start-ups with accounting losses, it still taxes the first dram of turnover in that it disallows loss carry-forwards and tax deferrals. Income splitting is widespread in order not to migrate into the general tax system with a higher tax and compliance burden. A growth-oriented presumptive tax system should, however, reduce the compliance burden for start-up firms and should impose an equal, if not higher, tax burden as encountered in the general regime. This would encourage firms' growth beyond the turnover threshold as the regime should not be a refuge for high-income taxpayers, splitting their income to benefit from a presumptive regime's low tax burden.

Unfortunately, the recently revised presumptive regime does not address this fundamental shortcoming. Furthermore, the mission advises that VAT payers, legal persons, and certified professional service providers should never qualify for being taxed under the special tax system. Also, taxpayers should no longer be able to annually elect whether they want to operate in the presumptive or standard regime as this invites aggressive tax planning.

The taxation of real estate in Armenia has the potential to generate more revenue. Communities require additional revenue to provide services, maintain infrastructure, and upgrade and maintain poorly-maintained multi-apartment buildings. Currently, collections from the land tax and property tax on buildings generate inadequate revenue because the tax is assessed on cadastral values that are well below market values, a high country-wide value threshold, and a too low, centrally determined tax rate structure. Attempts to move cadastral values closer to market

values as a step towards the implementation of a market value-based system are supported. In the interim, agricultural land values must be reviewed and commercial farms as well as vacant urban land should be more heavily taxed.

**This Technical Assistance Report (TAR) comprises an executive summary and four chapters.**

Chapter 1 presents background to the current technical assistance input and an introductory overview of the authorities' tax rebalancing strategy. Chapter 2 discusses government's proposed adjustments to personal income taxation. Chapter 3 reviews the corporate income tax and the role of presumptive taxes. Chapter 4 presents options for increasing revenues from the taxation of real estate. The Report's numerous appendices inform about the justifications for the previous TA Reports' key recommendations, such as: the future of a market-value based property taxes; tax expenditures and cost-benefit analysis models; and a high-level scoping of Armenia's involvement in the Inclusive Framework to begin the implementation of the four BEPS minimum standards and Armenia's commitments in terms of the Automatic Exchange of Information framework.

The Report's recommendations are recorded in Table 1.

**Table 1. Armenia: Summary of Recommendations**

<b>Recommendations or tax reform principles</b>	<b>Revenue Impact as % of Projected 2018 GDP Increase (+) Decrease (-)</b>
<b>Chapter I: Comparative Tax Structure and Pro-Growth Tax Reforms</b>	
<i>Key Tax Reform Steps and Advice:</i>	
A comprehensive package of tax reform measures should be announced upfront, where after incremental implementation of individual tax instrument adjustments can ensue.	neutral
For the sequencing of tax reforms, develop a communication theme that includes "revenues for service" and target fairness-enhancing rebalancing of taxes.	neutral
Seek Cabinet support and approval for the rationalization of tax incentives.	neutral
For purposes of the income tax reform, and with revenue neutrality in mind, design compensatory tax measures under the excise and VAT regimes.	neutral
Consolidate one incremental tax reform, before embarking on the next adjustment.	neutral
Synchronize carefully tax increases with the roll-out of visible public service programs.	neutral
Pay sufficient attention to proper planning for implementation, timely legal drafting, release of guideline notes, and preparation of new IT systems and training of administrative staff.	neutral
<b>Chapter II: Taxation of Employment Income</b>	
<i>Taxation of Employment Income:</i>	
Maintain the progressive rate structure of the PIT to ensure distributional fairness.	neutral
Avoid the introduction of the flat PIT system.	(+)

Recommendations or tax reform principles	Revenue Impact as % of Projected 2018 GDP Increase (+) Decrease (-)
To improve progressivity of the income tax system while minimizing the revenue impact of the reform, consider introduction of a personal allowance at the level equivalent to the global poverty line—currently around AMD 30,000—to be phased out at incomes higher than AMD 100,000 per month.	(-)
Consider harmonizing the requirements for payment of pension contributions for self-employed individuals with those for employees.	neutral
Ensure horizontal fairness by aligning effective tax burdens on identical income earned by taxpayers in different sectors (regardless of their organization as natural or legal persons).	(+)
Communicate to taxpayers the benefit of better compliance—as additional revenue from the expanded tax base will be used for a gradual decrease in tax burdens for low/middle-income groups.	neutral
<b>Chapter III: Corporate Income Tax and the Role of Presumptive Taxes</b>	
<i>Investment Incentive Regimes:</i>	
Rationalize the current tax incentive regimes and privileges, thereby ensuring equal treatment of all sectors.	+0.02
Adopt a uniform profit tax rate to remove the source of investment distortions, promote greater efficiency, and reduce profit-shifting opportunities.	+0.2
Gradually reduce the statutory tax rate to 17.5 percent; communicate the intended reduction of the statutory tax rate upfront to increase predictability and transparency of tax policies.	neutral
Use the revenue “surplus” generated by the CIT restructuring to finance PIT reforms that aim to improve its progressivity and equity.	neutral
<i>Cost-benefit Analysis for Tax Expenditures:</i>	
Conduct regular and thorough cost-benefit analyses of tax privileges to support government decision-making.	neutral
<i>Presumptive Tax Systems for Small and Medium Enterprises:</i>	
Consider introducing a comprehensive presumptive regime: i.e., a simple lump sum tax for microbusiness taxpayers (i.e. uniform patent fee) and a single turnover-based tax for SMEs below the VAT registration threshold without any sectoral differentiation for both categories.	(+)
Impose only one rate/amount for the patent tax regime as well as the turnover tax; exclude as a high priority all certified professionals (e.g., engineers, medical service providers, lawyers, accountants) and any legal person from presumptive taxation.	(+)
Restaurants and medical practitioners with turnovers above the newly proposed VAT registration threshold of AMD 58.35 million must be in the standard VAT, PIT and CIT regimes.	(+)
Once having migrated into the standard regime, a taxpayer cannot elect to return to the presumptive regime at the beginning of the next fiscal year.	(+)
Assure proper segmentation of taxpayers—align presumptive taxation thresholds with those of the VAT system and its newly reduced VAT registration threshold.	neutral

Recommendations or tax reform principles	Revenue Impact as % of Projected 2018 GDP Increase (+) Decrease (-)
Provide for simplified accounting and quarterly filing for medium-sized taxpayers as they migrate from the SME turnover regime into the standard CIT system.	neutral
<b>Chapter IV: Increasing Revenues from the Taxation of Real Estate</b>	
<i>Real Estate Environment:</i>	
The impact on higher compulsory contributions to maintain the common property of apartment buildings on poorer taxpayers need to be addressed through hardship relief.	neutral
<i>Real Estate Tax as Proposed by the 2016 Tax Code:</i>	
Consider lower regional tax-free thresholds for residential properties.	(+)
If a national value threshold for residential property is retained, it should be lower than the current AMD 3 million.	(+)
Simplify the tax rate structure by differentiating only with reference to use of the real estate.	(+)
Implement annual local rate setting as part of the decentralization initiative in the medium term—but within a centrally-determined range of rates.	neutral
Simplify the determination of cadastral values as proposed in the Draft Law even further by deleting characteristics in formulae that only have a minimal impact on value.	neutral
<i>Tax on Agricultural Land:</i>	
When market values are introduced, commercial farm land should also be assessed to market value and an appropriate tax rate specified.	(+)
In the interim, the 1999 cadastral values of agricultural land must be reassessed, or indexed to better approximate market values, and the land tax should be levied accordingly.	(+)
Small, subsistence farms should be taxed using a simplified area-based approach.	(+)
<i>Revenue Potential of an Enhanced Property Tax System:</i>	
Define and include “vacant urban land” in Section 11 of the Tax Code and introduce a higher tax rate for this category than the rate(s) for residential properties.	(+0.2)

# I. COMPARATIVE TAX STRUCTURE AND INTRODUCING PRO-GROWTH TAX REFORMS

## A. Background to the Technical Assistance Request and Advice

**1. The authorities wished to be advised on the promotion of growth-friendly tax policy reforms and a review of the immovable property tax.** In particular, this entailed the following analyses: (1) the design of the profit tax (rates, tax base, tax expenditures, and development of standardized cost-benefit analyses for tax incentives); (2) personal income tax (PIT) with a review of the tax rate structure and tax-free thresholds; (3) an assessment of presumptive tax regimes (patents and turnover taxes) and reform attempts since the 2015 tax policy (TP) Technical Assistance (TA) mission suggested major structural reforms in this regard; and (4) fuller utilization of the recurrent property and land taxes. Finally, the authorities expanded the TA Mission's terms of reference to include TA advice on BEPS-related implementation of minimum standards and required capacity in international standards of exchange of information.

**2. Armenia is at a historic crossroad.** The peaceful change of government three months ago created opportunities for much-needed structural and governance reforms. The new government aims at dismantling oligarchic structures, removing barriers to domestic competition, restoring a level playing field in the economy, improving the business and investment environment, ultimately targeting a market-led economic growth strategy.

**3. Currently, Armenia needs to raise more revenues in support of fiscal consolidation and to provide more funding for capital (physical infrastructure) and social spending.**

Armenia's General Government Revenue—especially its tax revenue—records significant growth since 2004 (Table 2). This was predominantly driven by persistent annual increases of collections from taxes on income, profits and capital gains. Yet, the level of government revenue collection is relatively low compared to Armenia's immediate peers as well as other comparator groups<sup>1</sup> (Figure 1). Efforts are needed to bring down public debt that exceeded 55 percent of GDP in 2017 and the budget deficit, ambitiously targeting 2.7 percent of GDP in the 2018 budget (down from 4.8 percent in 2017). Poverty and inequality are socially pressing issues that require concerted policy efforts on all fronts. As such, the tax system needs to effectively balance the country's broad range of social and development objectives against the need to create an investment-friendly business climate. Tax policies should, therefore, be sufficiently nuanced to promote economic growth, pursue distributional fairness, but also remain regionally competitive—all being difficult tradeoffs. Table 3 compares Armenia's tax structure against her immediate peers, being mostly the member states of the former Soviet Union.

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<sup>1</sup> For the purposes of this report, the following countries are selected as Armenia's comparator group: Albania, Azerbaijan, Belarus, Bosnia and Herzegovina, Bulgaria, Croatia, Cyprus, Czech Republic, Estonia, Georgia, Hungary, Iran, Kazakhstan, Kosovo, Kyrgyz Republic, Latvia, Lithuania, FYR Macedonia, Moldova, Montenegro, Poland, Romania, Russia, Serbia, Slovak Republic, Slovenia, Tajikistan, Turkey, Turkmenistan, Ukraine, Uzbekistan.

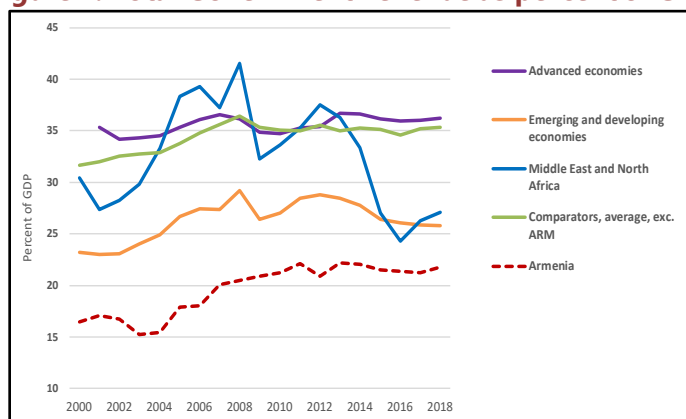
**Table 2. Armenia: General Government Revenue (percent of GDP), 2004 – 2016**

Year	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Total Revenue (A + B + C + D + E)	19.6	20.5	21.0	22.8	23.8	23.7	24.2	25.6	24.2	22.2	25.9	25.1	24.9
A. Taxes, excl. SSC (a + b + c + d + e + f)	14.5	14.8	14.8	16.4	17.7	17.1	17.6	17.7	18.0	21.0	22.1	21.6	21.7
a. Taxes on income, profits, and capital gains	2.7	3.3	3.8	3.9	3.9	4.5	4.4	4.7	4.9	8.6	8.1	8.2	9.1
a.1. Income Taxes Payable by Individuals	1.1	1.2	1.3	1.5	1.5	1.9	2.1	2.1	2.1	5.6	6.0	6.2	6.5
a.2. Income Taxes Payable by Corporations and Other Enterprises	1.7	2.1	2.5	2.4	2.4	2.6	2.2	2.6	2.8	3.0	2.1	2.1	2.5
a.3. Income Taxes - Other	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
b. Taxes on payroll	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
c. Taxes on property	0.4	0.3	0.2	0.2	0.2	0.5	0.5	0.4	0.2	0.3	0.4	0.5	0.5
d. Taxes on goods and services	5.9	6.4	6.1	9.1	10.1	9.3	10.0	9.6	9.7	9.6	10.2	9.4	8.9
d.1. Sales/GST	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.4	0.0	0.0	0.0
d.2. VAT	5.4	5.9	5.6	7.8	8.8	8.0	8.6	8.6	8.6	8.2	9.1	8.4	7.7
d.3. Excises	0.5	0.5	0.5	1.3	1.3	1.4	1.4	1.0	1.2	1.1	1.0	1.0	1.2
d.4. Turnover	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
d.5. Permission to use vehicles	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
e. Taxes on international trade and transactions	0.6	0.7	0.6	0.8	1.0	0.8	0.8	1.0	1.0	1.0	1.0	1.2	1.1
e.1. Exports	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
e.2. Imports	0.6	0.7	0.6	0.8	1.0	0.8	0.8	1.0	1.0	1.0	1.0	1.2	1.1
f. Other taxes	4.8	4.1	4.0	2.4	2.4	1.9	1.9	2.0	2.1	1.5	2.4	2.3	2.2
B. Grants	0.7	0.7	0.6	0.8	0.4	0.7	0.9	1.7	0.5	0.2	0.5	0.6	0.6
C. Social contributions	2.7	2.8	3.0	2.8	2.9	3.3	3.0	3.3	3.0	0.4	0.4	0.0	0.0
D. Other Revenue	1.7	2.2	2.5	2.8	2.7	2.6	2.7	2.9	2.7	0.6	3.0	2.9	2.5
E. Residual*	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0

Source: GFS General Government and/or Fiscal File.

Note: "..." fields represent missing values.

**Figure 1. Total Government Revenue as percent of GDP**



Source: IMF, World Economic Outlook

**4. This TA mission's review and outputs are preceded by the 2015 FAD Technical Mission that analyzed the Authorities' tax policy proposals underlying the 2015 Draft Tax Code with its subsequent 2016-promulgation.** That TA mission's recommendations covered approaches to tax reform, taxation of employment and capital income, taxation of business income and protecting its base against tax avoidance schemes, the VAT and the turnover-based presumptive business tax regimes, the recurrent property tax, excise taxation and VAT base broadening. Finally, the 2016 TA Report made suggestions on how to embrace the revenue potential of environmental taxes. Consequently, the current mission's advice and proposals should be read together with the analysis and proposals contained in the 2016 TA Report.<sup>2</sup> For

<sup>2</sup> Grote et al., 2016.

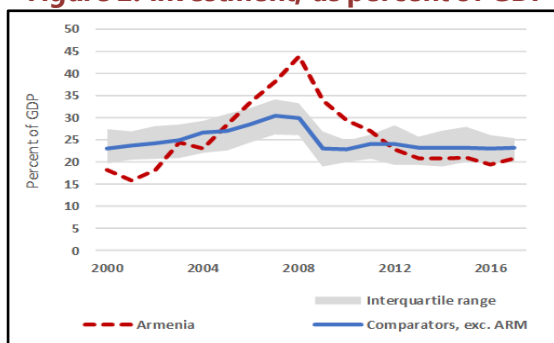
ease of reference, Appendix 1 provides a summary of the 2016 TA advice but key policy discussions of the 2016 Report will not be repeated.

## B. Comparative Tax Structure, Investments and Growth Behavior

**5. Pursuing greater simplicity of the tax system is advised (especially with regard to the presumptive regimes).** The Armenian system distorts the level-playing field for investors by imposing non-uniform effective tax rates on different businesses, depending on their size, residency, business activity, or location of their investment. Preferential tax treatment on the level of individual companies and products is widespread, while compliant businesses within the tax net face significant compliance burdens. Informality thrives for a number of reasons, with complexity in the tax provisions being leading causes. Large variances in effective tax rates and the remaining loopholes in the tax system aid opportunities for tax arbitrage. Overall, the fundamental requirement of a business- and growth-friendly tax system—i.e., neutrality with respect to investment decision-making—is compromised.

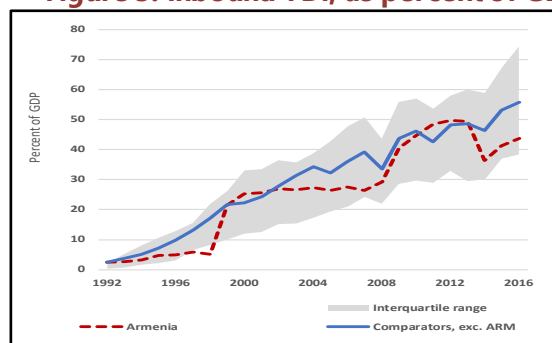
**6. Armenia's tax system may have a significant impact on capital investment decisions.** While non-tax factors, including geopolitical ones, had a role in constraining private sector development, the complexity of some tax instruments, the lack of predictability, and discretionary tax-related decision-making, may have contributed to discouraging investments given these investor uncertainties. Indeed, after the steep plunge following the world financial crises, gross capital formation as a percent of GDP has stagnated over the last several years (Figure 2). Equally, the inbound foreign direct investment (FDI) stock declined significantly in the aftermath of the Russia crisis (post 2014) and has been slow in recovery thereafter (Figure 3). This trend is far more pronounced relative to the performance of the FDI stock in the comparator countries.

**Figure 2. Investment, as percent of GDP**



Source: IMF, World Economic Outlook

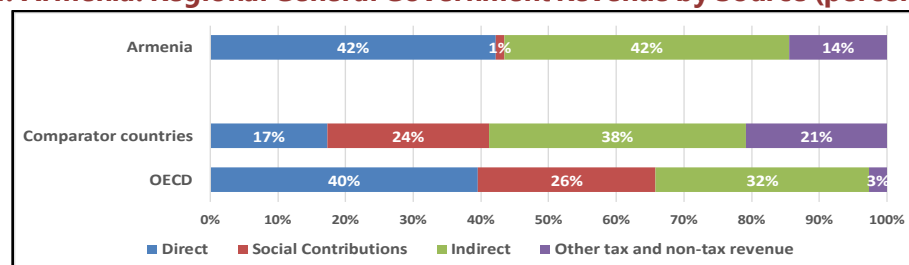
**Figure 3. Inbound FDI, as percent of GDP**



Source: UNCTAD

**7. Given these pressures of attracting FDI, support for economic growth without ignoring the distributional fairness imperative, requires a comprehensive view on the tax system.** Since Armenia's tax structure (2016) reveals some unique features compared to the peer group (see Table 3 and Figure 4); most of the tax instruments should be included in the review to afford a revenue-neutral rebalancing.

**Figure 4. Armenia: Regional General Government Revenue by Source (percent of GDP)**



Source: IMF, World Economic Outlook, and OECD

**Table 3. Armenia: Regional General Government Revenue by Source (percent of GDP), 2016**

Country	Year	Total Revenue	Tax Revenue (excl. SSC)	Income, Profits, and Capital Gains					Payroll	Property	Goods and Services					International Trade			Other Taxes	Social Contributions	Grants	Other Revenue
				Personal Income	Corporate Income	Other	Total Income				Sales	VAT	Excises	Turnover	Vehicles	Total	Imports	Exports	Total			
Armenia	2016	24.9	21.7	6.5	2.5	0.0	9.1	0.0	0.5	0.0	7.7	1.2	0.0	0.0	8.9	1.1	0.0	1.1	2.2	0.0	0.6	2.5
Albania	2016	26.4	18.3	1.9	1.0	0.0	2.9	0.0	0.4	0.3	8.9	2.8	0.0	1.1	13.1	0.4	0.0	0.4	1.4	5.2	1.0	1.9
Azerbaijan	2015	34.4	15.7	1.9	4.1	0.0	6.0	0.0	0.4	0.3	6.5	1.2	0.0	0.1	8.2	0.7	0.0	1.1	0.2	3.3	0.0	15.3
Belarus	2016	42.2	25.1	4.1	2.7	0.0	6.9	0.0	1.7	0.0	8.7	2.3	0.6	0.0	11.6	1.0	2.5	3.6	1.4	10.6	0.3	6.1
Bosnia and Herzegovina	2016	42.7	22.6	1.8	1.5	0.0	3.3	0.0	0.4	0.0	11.5	0.4	0.0	0.1	12.0	0.0	0.0	0.0	6.9	15.0	0.1	5.0
Bulgaria	2016	34.9	21.0	3.0	2.1	0.0	5.2	0.0	0.6	0.0	9.2	5.2	0.0	0.0	14.4	0.0	0.0	0.0	0.8	7.8	...	...
Croatia	2014	39.8	22.6	3.2	1.7	0.0	4.9	0.0	0.5	0.1	12.4	3.9	0.0	0.1	16.4	0.1	0.0	0.1	0.7	12.6	0.7	3.9
Cyprus	2014	39.5	25.0	2.7	6.3	0.0	9.0	0.9	1.2	0.0	8.6	3.6	0.0	0.0	12.2	0.0	0.0	0.0	1.8	8.2	...	...
Czech Republic	2016	39.4	19.9	3.8	3.5	0.0	7.3	0.0	0.2	0.0	7.4	3.8	0.0	0.0	11.2	0.0	0.0	0.0	1.1	14.7	0.7	4.1
Estonia	2016	39.5	22.8	6.0	1.7	0.0	7.7	0.0	0.3	0.0	9.4	4.7	0.0	0.0	14.1	0.0	0.0	0.0	0.6	11.8	1.5	3.5
Georgia	2016	28.5	25.9	7.1	3.1	0.0	10.2	0.0	1.1	0.0	9.7	3.2	0.0	0.0	12.8	0.2	0.0	0.2	1.6	0.0	0.9	1.7
Hungary	2016	44.8	25.6	4.9	2.3	0.0	7.2	0.6	0.6	0.1	9.3	3.2	2.3	0.2	15.0	0.0	0.0	0.0	2.1	13.6	0.9	4.7
Iran	2009	27.4	8.8	0.8	4.1	0.0	4.9	0.0	0.0	0.2	0.4	0.4	0.0	0.1	1.1	1.5	0.0	1.5	1.2	4.8	0.0	13.8
Kazakhstan	2016	17.9	14.0	1.5	4.2	0.0	5.7	1.2	0.5	0.0	3.3	0.4	0.0	0.1	3.8	0.6	1.8	2.3	0.4	0.6	0.0	3.3
Kosovo	2015	25.5	23.3	1.3	1.7	0.0	3.0	0.0	0.3	0.0	10.0	6.1	0.0	0.5	16.7	2.3	0.0	2.3	1.0	0.0	0.3	1.9
Kyrgyz Republic	2016	34.5	20.3	2.3	2.5	0.0	4.9	0.0	0.5	1.3	8.6	2.0	0.0	0.0	11.9	2.9	0.0	3.0	0.0	5.8	2.2	6.2
Latvia	2016	37.0	22.7	6.4	1.7	0.0	8.1	0.0	0.9	1.0	8.2	3.5	0.0	0.0	12.6	0.0	0.0	0.0	1.1	8.6	...	...
Lithuania	2016	34.2	17.4	4.0	1.6	0.0	5.6	0.0	0.3	0.1	7.8	3.2	0.0	0.0	11.1	0.0	0.0	0.0	0.3	12.5	1.1	3.1
Macedonia, FYR	2016	28.7	18.1	2.4	1.8	0.0	4.2	0.0	0.2	0.1	7.6	3.7	0.0	0.0	11.5	0.8	0.0	0.8	1.5	7.4	0.6	2.6
Moldova	2016	34.1	21.7	2.4	2.5	0.0	4.8	0.0	0.3	0.0	10.8	3.4	0.0	0.0	14.2	0.7	0.0	1.1	1.3	9.8	1.0	1.5
Montenegro, Rep. of	2016	42.4	25.6	4.0	1.1	0.0	5.2	0.0	0.3	...	12.7	4.6	...	...	17.3	...	...	0.6	2.2	11.7	0.4	4.7
Poland	2016	38.7	20.5	4.8	1.8	0.0	6.7	0.2	1.2	0.0	7.0	4.1	0.0	0.0	11.2	0.0	0.0	0.0	1.2	13.7	...	...
Romania	2016	30.9	17.7	3.8	2.2	0.0	6.0	0.0	0.7	0.2	6.5	3.5	0.0	0.1	10.3	0.0	0.0	0.0	0.7	8.1	0.1	4.9
Russia	2016	36.7	18.0	2.5	3.3	0.0	5.9	0.0	1.2	0.0	5.6	1.6	0.0	0.2	7.4	0.7	2.4	3.1	0.4	8.0	0.0	10.7
Serbia	2012	40.8	24.2	4.6	1.5	0.0	6.1	0.0	0.4	0.0	10.3	5.1	0.0	0.3	15.6	1.0	0.0	1.0	1.0	12.4	0.1	4.1
Slovak Republic	2016	39.3	18.0	3.3	3.5	0.0	6.8	0.0	0.4	0.0	6.7	2.7	0.0	0.0	9.4	0.0	0.0	0.0	1.4	14.3	...	...
Slovenia	2016	43.3	22.0	5.2	1.6	0.0	6.8	0.0	0.6	0.0	8.2	4.1	0.0	0.1	12.3	0.0	0.0	0.0	2.3	14.8	...	...
Tajikistan	2015	...	...	...	...	...	...	...	...	...	...	...	...	...	0.0	...	...	...	...	...	...	...
Turkey	2016	34.4	18.8	3.7	1.6	0.0	5.4	0.0	0.3	0.0	5.1	4.7	0.0	0.4	10.3	0.4	0.0	0.4	2.5	9.7	0.0	5.9
Turkmenistan	...	...	...	...	...	...	...	...	...	...	...	...	...	...	0.0	...	...	...	...	...	...	...
Ukraine	2016	38.5	25.2	5.8	2.5	0.0	8.4	0.0	0.4	0.0	9.9	4.3	0.0	0.0	14.2	0.8	0.0	0.9	1.4	5.7	0.2	7.4
Uzbekistan	2016	33.6	24.4	2.5	5.5	0.0	8.0	0.0	1.3	0.8	6.0	3.1	0.0	0.0	9.9	0.8	0.0	3.9	1.3	6.2	0.0	3.0
Avg. excl. Armenia		35.5	20.9	3.5	2.6	0.0	6.1	0.1	0.6	0.2	8.1	3.3	0.1	0.1	7.6	0.5	0.2	0.9	1.4	8.9	0.5	5.2
Avg. incl. Armenia		35.2	20.9	3.6	2.6	0.0	6.2	0.1	0.6	0.1	8.1	3.2	0.1	0.1	7.6	0.6	0.2	0.9	1.4	8.6	0.5	5.1

Revenue Source: GFS. GDP Source: WEO.

Note: Tax Revenue does not include Social Contributions. "..." fields represent missing values.

**8. A OECD study<sup>3</sup> reviewing the impact of different tax instruments on per capita growth found a relative strong relationship between taxes, investment and economic growth.** The study assessed the design of a tax structure and whether it would be conducive to economic growth. It provides a "tax and growth" ranking of taxes, confirming results from earlier literature but providing a more detailed disaggregation of taxes. Corporate taxes (CIT) are found to be most harmful for growth, followed by personal income taxes (PIT), and then consumption

<sup>3</sup> OECD Economics Department Working Papers, 2008, ECO/WKP (2008) 28, Paris.



taxes. Yet, no country can do without a CIT given the revenue needs and for the fact that generated economic rents by companies can be taxed heavily without affecting behavior. There are other good reasons for imposing CIT and PIT. Recurrent immovable property taxes appear to have the least negative impact on growth—but are costly to administer given the difficulties with registration of properties, their required periodic revaluation, and their general unpopularity with taxpayers. In addition, central government cannot simply substitute its income taxes with recurrent taxes on immovable property since in most countries property taxes are the exclusive tax domain and revenue source of sub-national governments. Also, only a small number of countries raise significant revenues from property taxes (Tables 3).

**9. Against this background, some pertinent features of Armenia’s tax structure, possibly informing future tax base and rate adjustments, need to be highlighted:**

- A heavy reliance on indirect taxation (i.e., broad-based consumption taxes) which is conducive for economic growth: in Armenia, 42 percent of tax revenues are generated from indirect taxes vis-à-vis the comparators’ 38 percent.
- PIT in Armenia raises 6.5 percent of GDP—significantly higher than the regional average of 3.5 percent. This is explained by Armenia’s discontinuation of the social security contribution system in 2013 and assuming these required payments into the PIT regime (see Chapter 2).
- Armenia’s CIT revenues of 2.5 percent vs. the comparators’ average of 2.6 percent of GDP.
- Property tax in Armenia raises revenues of 0.5 percent of GDP (mainly on vehicles and to a much lesser extent on immovable property), against the regional average of 0.6 percent.
- The revenue productivity of VAT is close to the world’s average (Figure 6) but Armenia’s VAT C-efficiency of 0.47 vs. the average 0.59 for comparators (Table 4), suggests that Armenia could still do further work on closing the VAT policy and compliance gaps.<sup>4</sup>

**10. With growing recognition of the tax system bottlenecks in Armenia, there is a need to thoroughly analyze the impact of tax policy options.** To be effective in evaluating the various tax policy proposals, it is essential that tax reform options are carefully assessed, quantitatively analyzed, and openly debated. This requires that decision-makers and all stakeholders in the debate have access to the best available data and independent, evidence-based analysis, including information about the impact of tax reforms on revenue, the income distribution, and the economy. There is a critical need for the MoF to play a leading role in explaining the economic rationale and intent behind changes in tax policy and tax legislation.

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<sup>4</sup> Changes in VAT revenue as a share of GDP can be attributed to three factors: changes in the VAT standard rate (Figure 5), in the share of consumption in GDP, and in the C-efficiency ratio. The C-efficiency ratio is the actual VAT revenue to the theoretical revenue derived from the product of aggregate final consumption and the VAT standard rate. This ratio is used as a broad indicator of the overall efficiency and effectiveness of the VAT system. Changes in the C-efficiency ratio have been more influential than the changes in the standard rate and final consumption ratio to GDP for the evolution of overall VAT revenues in many countries.

Global experience suggests that insufficient debate about tax reform options can lead to a tax system that fails the test of legitimacy in the eyes of the public.

**Figure 5. VAT Rates**

<b>VAT rate, unweighted averages</b>	
Emerging and Developing Europe	20%
<b>Armenia</b>	20%
CIS	17%
World	16%
Sub-Saharan Africa	16%
Latin America and the Caribbean	15%
Middle East and North Africa	14%
Emerging and Developing Asia	10%

Source: IMF, VAT rates database

**Figure 6. VAT Productivity**

<b>VAT productivity, unweighted averages</b>	
Emerging and Developing Europe	0.47
Latin America and the Caribbean	0.44
Comparators, excl. Armenia	0.42
World	0.39
<b>Armenia</b>	0.38
Emerging and Developing Asia	0.38
Sub-Saharan Africa	0.35
Middle East and North Africa	0.21

Source: IMF, World Economic Outlook and IMF Staff

**Table 4. Comparative CIT Productivity and VAT C-Efficiency, Latest Available Year**

Country	Latest Year	CIT Productivity	Latest Year	VAT C-Efficiency	Latest Year	VAT Productivity
Armenia	2016	0.13	2016	0.47	2016	0.38
Albania	2016	0.13	2016	0.53	2016	0.45
Azerbaijan	2015	0.20	2015	0.58	2015	0.36
Belarus	2016	0.14	2016	0.71	2016	0.43
Bosnia and Herzegovina	2016	0.15	2016	0.75	2016	0.68
Bulgaria	2016	0.22	2015	0.64	2015	0.45
Croatia	2016	0.10	2015	0.79	2015	0.51
Cyprus	2015	0.47	2015	0.59	2015	0.45
Czech Republic	2017	0.18	2015	0.59	2015	0.35
Estonia	2017	0.08	2015	0.73	2016	0.47
Georgia	2016	0.21	2016	0.73	2016	0.54
Hungary	2017	0.20	2015	0.60	2015	0.36
Iran	2016	0.10	2009	0.24	2009	0.13
Kazakhstan	2016	0.21	...	...	...	...
Kosovo	2015	0.17	2015	0.61	2015	0.56
Kyrgyz Republic	2016	0.20	2016	0.74	2016	0.71
Latvia	2015	0.11	2015	0.52	2015	0.37
Lithuania	2015	0.10	2015	0.51	2015	0.37
Macedonia, FYR	2016	0.18	2016	0.57	2016	0.42
Moldova	2016	0.21	2016	0.57	2016	0.54
Montenegro, Rep. of	2016	0.13	2016	0.80	2016	0.67
Poland	2017	0.10	2015	0.44	2015	0.30
Romania	2016	0.13	2015	0.50	2015	0.34
Serbia	2016	0.13	2015	0.63	2015	0.51
Slovak Republic	2017	0.15	2015	0.51	2015	0.34
Slovenia	2017	0.09	2015	0.59	2015	0.38
Tajikistan	2017	0.11	...	...	...	...
Turkey	2016	0.08	2016	0.40	2016	0.28
Turkmenistan	...	...	...	...	...	...
Ukraine	2017	0.14	2016	0.66	2016	0.49
Uzbekistan	2016	0.73	2016	0.42	2016	0.30
Avg, excl. Armenia		0.18		0.59		0.44
Avg, incl. Armenia		0.18		0.59		0.43

Sources:  
CIT Productivity: CIT Revenue from WEO/GFS (OECD and Eurostat, where data available), GDP from WEO; CIT Rates from FADTP Rates Database (Internal)  
VAT C-Efficiency: VAT Revenue data and C-Efficiency ratios from FADTP (Internal C-Efficiency Database) and GFS (OECD and Eurostat, where data available), Consumption Data from WEO, VAT Rates from FADTP Rates Database (Internal)  
VAT Productivity: VAT Revenue data from GFS (OECD and Eurostat, where data available), GDP Data from WEO, VAT Rates from FADTP Rates Database (Internal)  
Note: "..." fields represent missing values. Formulas:  
CIT Productivity = (CIT Revenue as % of GDP) / (CIT Rate)  
VAT C-Efficiency = VAT Revenue/(Total Final Consumption net of VAT Revenue \* VAT Rate)  
VAT Productivity = VAT Revenue % GDP/VAT Rate (%)

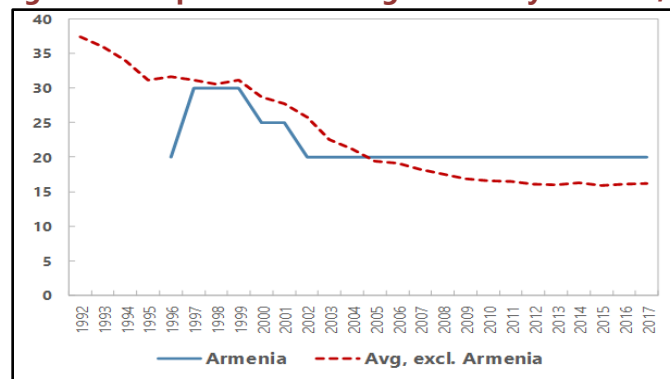
## C. Growth-Friendly Fiscal Measures

**11. Governments often regard taxes as a policy instrument for stimulating economic growth to the extent its distortionary effects are minimized on factors that generate growth such as utilization of capital and labor.** Before entertaining the roll-out of tax incentives, the mission wishes to caution that the relationship between taxes and economic growth needs more careful consideration. The above-mentioned tax structure analysis describes Armenia's relatively greater reliance on indirect taxes, but a higher reliance on trade taxes (1.1 percent of GDP vs. the comparator group's proportionally lower 0.8 percent of GDP, Table 3)). Correcting the tax structure before introducing new tax incentives is, therefore, advice

underpinned by the OECD's empirical evidence provided above.<sup>5</sup>

**12. A revenue neutral, growth-oriented tax reform could include a partial shift of the future tax burden from income taxes to less distortive taxes such as consumption or recurrent taxes on immovable property.** For this purpose, the Armenian tax policy design should guard the integrity of broad-based consumption taxes (VAT and excises) by *cutting back on exemptions* and seeking to raise more from these instruments. This could pay for a lowering of the basic CIT rate (which at 20 percent may be seen by investors as relatively high given the regions average statutory rate of 15.4 percent in 2017, see Figure 7).

**Figure 7. Regional Comparators: Average Statutory CIT Rate, 1992 - 2017**



Source: IMF, Fiscal Affairs Department, Tax Rates Database (Internal)

**13. Since 2006, Armenia's CIT rate became less attractive than the regional average rate.** Thus, broadening the CIT base—which could afford a gradually lower CIT rate in a revenue neutral fashion—could signal a more inviting investment environment. Also, it would provide less incentives to embark on tax avoidance as lower rates make this endeavor much less rewarding.

**14. The OECD paper suggests that a restructuring of taxes within each of the broad tax categories could secure significant efficiency gains.** Realistically, a greater revenue shift could probably be achieved into consumption taxes—but it has distributional consequences. Since consumption taxes are less progressive than PIT, or even regressive, transferring the tax burden from PIT to consumption taxes would reduce progressivity. Similarly, shifting revenue reliance from CIT to consumption taxation would increase share prices and wealth inequality as well as increase income inequality by lowering capital income taxation—and make income and wealth distributions more skew. These are not insignificant trade-offs in tax policy design but should be tackled soon as it is less costly than applying a plethora of blunt tax incentives. In the aftermath of the global financial crisis (2008 – 09), the IMF released key proposals on growth-friendly fiscal policies—see Appendix 2 for a detailed discussion.

<sup>5</sup> It is recognized that politicians are under pressure to introduce tax incentives, despite the policy concerns with them (i.e., redundancy, subject to abuse, revenue loss, and compromising equity and efficiency). Hence, policy makers should aim, when having to respond to competitiveness pressures and resort to tax incentives, to avoid those tax incentives (in particular, tax holidays) that are highly inefficient or subject to abuse.

## D. Designing a Comprehensive Tax Reform Strategy

### 15. Armenia announced an overhaul of the tax system—yet, caution should be exercised with respect to its timing and the process to ensure sustainability of collections.

The entire reform plan needs to be presented as a package of "give and take". The amendments should work towards a tax policy consolidation period whereby amendments are kept to a minimum with the view to stabilizing the tax system and maximizing certainty for taxpayers. All significant tax policy proposals should be conditioned on the readiness of the State Revenue Committee (SRC) and Customs to implement such changes. Rushed tax policy changes could backfire if taxpayers misunderstand these or they cannot be effectively administered. In this regard, it would be useful to pay attention to the lessons and experiences with successful tax reform approaches (Bird, 2004) in developed and developing countries (see Box 1). Success is defined as achieving the intended result of the tax restructuring: i.e., attaining the revenue target, attracting investments (often the reason for introducing tax expenditures), stimulating growth, or enhancing fairness and tax morale:

#### Box 1. Lessons from Successful Tax Reform Programs

- The essential requirement for success is *strong leadership and political backing for the Ministry of Finance* in reforming the tax system. Strong political leadership is exemplified by appointing a Champion who is prepared to put his/her reputation on the line for the entire period of the tax reform.
- The *champion should be backed by the chief executive*, i.e., the prime minister or the cabinet of ministers.
- A *holistic package of tax reform interventions*, if implemented properly, can be more successful than piecemeal adjustments which lose sight of the bigger picture. Taking such systemic view can help short-term political pressures and counter the proliferation of vested interests.
- A comprehensive tax reform program is to be preferred whereby *"the pluses of the reform are real and significantly enough so that taxpayers would accept the minuses"* that must go with it to make a reform program fiscally sustainable.
- The more *transparent tax consultations and discussions* are, the more successful reforms could be but it also means that the appointed champion (the executive or ministry responsible for taxation) maintains throughout the reform process its leadership position and drives it with passion and a sustained pace.
- The MoF should be supported in the tax reform program by a *strong tax policy team* (tax policy unit<sup>6</sup> or directorate), which integrates tax policy analysis with revenue estimation, and legal drafting. This team should also draw on private tax expertise.
- The *tax reform program should be communicated through all available media* and the taxpaying public should be continuously educated about the need for the reforms—and this is for the whole duration of the reform.
- In order to *create a positive message about the unfolding tax reform initiative*, the authorities should select a sequence of reforms, beginning with the generation of early revenue gains or a fairness-enhancing rebalancing. It would address the short-term nature of political goodwill by the electorate and could be part of so-called comprehensive gradualism in tax reform.
- *Consolidate one reform before attempting the next phase or tax intervention*—providing sufficient time for the SRC to prepare IT systems and train assessors adequately.

<sup>6</sup> Grote, 2017.

### Box 1. Lessons from Successful Tax Reform Programs (concluded)

- Crisis-driven or *hurried reforms due to poor preparation tend to fail*, even though they may contain a solid idea.
- Importantly, *tax reforms tend to be more successful when they involve simplification of tax systems* and legislation with accompanying lower compliance and administrative costs—again, the readiness of the tax administration is of central importance.
- Paying *sufficient attention to the implementation, proper legal drafting of tax amendments with guideline notes* (secondary legislation), IT system adjustments, the training of tax administration officials, and the printing of new tax return forms, will contribute to a successful reform.
- *Continuity among decision-makers* responsible for tax policy and implementation aids successful tax reforms.
- *Good reforms exclude quick fixes* such as premature tax amnesties before the tax administration has built sufficient competence; tax lotteries to force honest recording of turnovers, and the issuance of VAT invoices, or presumptive taxes that turn into tax relief measures.
- *Careful synchronization of incremental reform steps is ensuring a measure of success.*
- *Tax structure reform is best accompanied by modernization of the tax administration and expenditure policies.*
- *Tax reform should take account of unique conditions and limitations of a country.*
- During the reform, considerable thought and planning should go into *transitional provisions* to ensure sustainability and credibility of the reform.

## The Political Economy of Tax Reform

**16. The challenge for the new government is to deliver highly visible and substantive improvements to the quality of life of the population in the aftermath of the Velvet Revolution.** Modern democracies view paying taxes as a social contract between citizens and the state (i.e., state-building) by which the citizens pay their dues in return for public services. Tax reform initiatives should therefore enhance tax morale, which is the willingness to accept say a more revenue-productive property tax in exchange of improved public services under the banner of *Revenue for Service*.<sup>7</sup> If taxes are well designed, effectively collected, and prudently spent on reliable public services, taxes could indeed support economic growth. Similarly, proper tax design should advance distributional fairness—granting selective tax concessions achieves the opposite.

**17. Thus, the Armenian tax reform message should be linked to these social compact cornerstones.** But the message is only credible if budget outlays are indeed reducing extreme inequalities and if they would fund the post-revolution expenditure priorities. It could be the rallying cry for the tax reforms to get buy-in from skeptical taxpayers. The mission, in its discussion with stakeholders, received unanimous feedback that increases in taxes—such as a more revenue-productive property tax—would be rejected as taxpayers see no commensurate benefit returned in the form of municipal service provision. This suggests the attraction of *benefit taxes* for any future tax reform, such as road use taxes, environmental charges, and recurrent property taxes. To increase taxes in an environment of low tax morale is very difficult even

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<sup>7</sup> Fjeldstad, O-H, 2011. According to Fjeldstad, South Africans were more likely to pay local service charges if they felt that the government was providing services equitably and using the revenue to provide services.

though it has become a burning issue for providing sufficient resources to local communities for the refurbishing backlog of condominiums. However, taxpayer resistance could be managed down if local communities would commit to allocate a set percentage of property taxes towards improved maintenance of more than 55 percent of the condominium housing stock of Armenia. This would, for example, constitute a tax reform initiative with high visibility.

**18. The tax reform program should be cognizant of the effects of a currently corroded social contract and firm belief in the society that the state and service delivery have little credibility.** However, the political goodwill period of waiting for improvements in the tax system and the livelihood of especially the poor executed by the New Government may last only a few hundred days. Hence, given the urgency in changing perceptions about the effectiveness of the new government some overarching tax reform guidelines should be considered:

- Visible improvements in service delivery or alternatively, material changes to the tax burden of low and middle- income households through a rebalancing of taxes and tax rates.
- Some taxes would require restructuring to enhance their acceptability in terms of fairness, efficiency, predictability, and serving the interest of the majority rather than the select few.
- Consequently, consider introducing the concept of gradual, predictable, well-communicated decrease of the tax burden of low-income households which can be afforded by broadening of the tax base due to the rationalization of tax privileges and better tax compliance.

### **Roadmap for a Short- to Medium Term Tax Reform Program**

**19. A comprehensive review on the tax system is critical: all the tax instruments should be included in the reform to afford a revenue-neutral rebalancing.** The recommendation of preparing a package of tax measures is based on IMF FAD policy advice to many countries, emphasizing that policies must be designed and backstopped with realistic revenue estimates. Formulating a grand structural tax change and implementing it incrementally over say five years will more likely succeed. Given the constraints in revenue administrations, incremental tax changes within a thoroughly researched policy framework are about the only way to success. Overly ingenious ideas and a high reliance on discretionary administration should be avoided.<sup>8</sup>

**20. A medium-term tax reform strategy should stabilize tax collections and improve certainty for investors by reforming tax instruments in a synchronized manner.** Elements of consultative processes in relation to the introduction of a Comprehensive Tax System Reform Plan can be stylized as per Figure 8. As for the current tax reforms, the authorities have prioritized adjustments to PIT, CIT, and a modern property tax—with VAT and excises providing

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<sup>8</sup> Goode, 1984.

compensatory revenues if afore-going structural reforms may result in initial revenue losses. The mission addresses the following elements of such tax reform strategy:

**Figure 8. Circular Processes followed in a Comprehensive Tax Reform**



- *Extend the coverage of the PIT*—increase its progressivity by taxing high incomes at progressively higher rates—as addressed in Chapter 2.
- *Design a CIT that is broad-based* to allow for a uniform, statutory rate at regionally competitive levels. Having in the CIT regime 0 percent and positive tax rates invites domestic transfer pricing practices with elevated revenue leakage risks as the anti-transfer pricing capacity in the SRC is rudimentary but developing. This is exacerbated by the absence of binding regulations on how to prepare transfer pricing documentation<sup>9</sup> (see Chapter 3).
- *Avoid tax incentives that jeopardize revenue and good governance, are hard to reverse, or generate no offsetting social benefits* (see previous 2016 FAD TP advice). Instead, the mission wishes to re-emphasize the FAD TP advice in 2011 that attractive accelerated depreciation allowances encourages investments more cost-effectively.<sup>10</sup> Similarly, the full taxation of agriculture remains a high priority. Convincing taxpayers about the need for this intervention would, however, need synchronization with ramped-up support to farmers in the form of improved infrastructure as the political resistance against such adjustment is palpable. The cost of tax expenditures and pragmatic cost-benefit analyses of tax incentives is discussed in Chapter 3 and Appendix 4.
- As previously advised (2016 TA Report: 37-47), *the Special Tax Regimes for taxing business income—the Turnover Tax System, the Family Entrepreneurship System, and the Patent Tax System—require simplification, rationalization and reduction of tax benefits*. Globally, the purpose of such regimes is to reduce the regressivity of tax compliance burdens for small

<sup>9</sup> This was confirmed by the mission in discussion with the multinational accounting firms.

<sup>10</sup> Grote et al., 2011: 32.

and medium-sized businesses.<sup>11</sup> The intention is not to provide tax relief to these classes of taxpayers. The Special Tax Regimes should encourage businesses to grow and should not serve as a refuge for high income taxpayers to avoid tax—through say income splitting. Unfortunately, the current system falls short in all these areas. Legal entities and all registered professional service providers should not benefit from the Special Tax Regimes' privileges, nor should VAT payers—see Chapter 3.

- The authorities' indicated tax reform plan for the PIT system is a revenue loser which may require a VAT rate increase. *Given the already high VAT rate, reforms should focus on how to improve Armenia's VAT C-efficiency by addressing the policy gap (exemption creep) and compliance gaps* (it may require as a first step a VAT gap analysis by FAD).
- Given these same revenue risks, *enhance collections from imposing excises on untaxed activities such as gambling, betting, and mobile phone use*—see 2016 TA Report: 55-64.
- *Using a property assessment value that is closer aligned to the market value, consider various options for introducing an adjusted value-based or unit area-based immovable property tax to generate additional resources for the financing of local government*—Chapter 4.
- For the outlined tax reform strategy, the overarching imperative should be the pursuit of *simplification in tax legislation*—i.e., avoiding excessive rate differentiation in the patent regime or immovable property tax.
- The mission, on request by the authorities, suggests ways to *strengthen the capacity to deal with profit-shifting by developing guideline notes on transfer pricing documentation*—and accelerate compliance with the four minimum standards under BEPS—see Appendix 9.

### Key Tax Reform Steps and Advice

- A comprehensive package of tax reform measures should be announced upfront, where after incremental implementation of individual tax instrument adjustments can ensue.
- For the sequencing of reforms, develop a communication theme that includes “revenues for service” and target fairness-enhancing rebalancing of taxes.
- Seek Cabinet support and approval for the rationalization of tax incentives.
- For purposes of the PIT reform, and with revenue neutrality in mind, design compensatory tax measures under the excise and VAT regimes.
- Consolidate one incremental tax reform, before embarking on the next adjustment.

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<sup>11</sup> Small businesses such as sole proprietors spend a proportionally bigger share of their turnover on advice by tax accountants and practitioners to stay tax compliant than is the case for large corporate taxpayers.



- Synchronize carefully tax increases with the roll-out of visible public service programs.
- Pay sufficient attention to proper planning for implementation, timely legal drafting, release of guideline notes, preparation of new IT systems, and training of administrative staff.

## II. TAXATION OF EMPLOYMENT INCOME

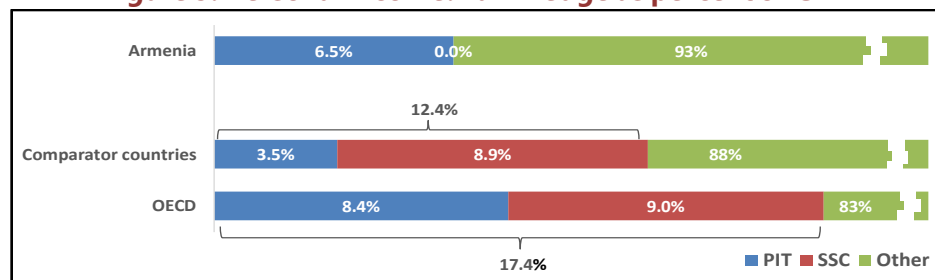
### A. Overview

**21. There are commendable elements in Armenia’s PIT system: it is generally simple, transparent, and relatively easy to administer.** The number of exemptions and deductions is minimal; and the system relies to a large degree on final withholding arrangements. With a three-brackets progressive rates structure, the current system attempts a high degree of progressivity. However, as shown further in the section the system is heavily skewed towards the lowest income distribution, with a largely flat effective tax rate structure that achieves only a minimal level of progressivity.

**22. In 2017, PIT generated AMD 314 billion—equivalent of 6.1 percent of GDP.** This performance is seemingly impressive if compared to PIT revenue figures of Armenia’s comparator group. Indeed, in 2016, the comparator countries collected a mere 3.5 percent of GDP in PIT (Table 3). However, when the revenue of the PIT is combined with social security taxes, Armenia’s PIT wedge appears very low when contrasted against the comparator group. In 2016, the comparator countries collected 12.4 percent of GDP—against Armenia’s 6.5 percent of GDP—in combined PIT and social security taxes (Figure 9). The bulk of PIT revenue—92 percent of total—is derived from the taxation of employment earnings, withheld at source. Investment income contributed a little over 3.2 percent of total PIT revenue in 2017.

**23. Resident taxpayers are taxed on worldwide income; nonresidents are taxed on income received from Armenia sources only.** A standard physical presence test is used to qualify for residence status, with physical presence of at least 183 days. It is not clear—at least in an unofficial English translation of the Tax Code provided to the Mission—whether the minimum period pertains to the calendar/tax year or any consecutive 12-month period.

**Figure 9. Personal Income: Tax Wedge as percent of GDP**



Source: IMF, World Economic Outlook, and OECD

**24. The PIT system is schedular, with a progressive tax on employment income, and a flat tax on capital income.** Wage income is taxed based on a three-rate progressive structure (Table 5). There is no personal allowance; the system is currently taxing those on or below the poverty line, and on the minimum wage. Capital income, such as dividend and interest, is taxed at a flat rate of 10 percent through final withholding. Rental income is taxed at a 10 percent, with additional 10 percent assessed if the rental income exceeds AMD 58,35 million.

**Table 5. Personal Income Taxation, July 2018**

Employment income	Brackets	Rate (in percent)
	Up to AMD 150,000 AMD 150,000—2,000,000 Over 2,000,000	23 28 36
<b>Dividends</b>	<i>Residents:</i> 5 percent (for dividends announced after 01.01.2018) <i>Non-residents:</i> 10 percent	
<b>Interest</b>	10 percent	
<b>Royalties</b>	10 percent	
<b>Rental income</b>	10 percent Additional 10 percent assessed when rental income exceeds AMD 58,35 million	
<b>Capital gains</b>	Regular income tax rates on realized capital gains. No capital gains on disposal of personal property.	
<b>Foreign interest, royalties and capital gains</b>	Included in the gross income and taxed as ordinary income.	
<b>Self-employment and business income</b>	As of 01.01.2018, subject to corporate income tax—20 percent (all necessary and documented expenses are deductible in determination of taxable income). <i>Activities subject to “patents” (e.g. dentistry):</i> fixed amounts per month depending on the type of business activity and location.	
<b>Pension income</b>	Not subject to income tax. Pensions from <i>voluntary pension plan</i> are taxed at regular individual tax rates.	

Sources: Country Surveys International Bureau of Fiscal Documentation (July 2018), and the Tax Code of the Republic of Armenia (unofficial English translation).

**25. There are two pillars in the Armenian pension system: a budget-financed defined benefit component and a “voluntary” pension fund component, in place since 2014.** From July 1, 2018, contributions to the “Voluntary Pension Fund”—Pillar II—are mandatory for all employees born after January 1, 1974, including employees of the private sector.<sup>12</sup> Originally, the employee contribution rate to their individual retirement accounts was set at 5 percent of income (up to monthly maximum of AMD 25,000) with government making a matching monthly contribution. In June 2018, as a temporary measure, the rates of contribution to the individual Pension Fund accounts were changed to 2.5 and 7.5 percent by employee and government respectively, to mitigate the impact on the disposal income of private sector employees<sup>13</sup> that were mandated to join the pension system, effective from July 1, 2018.<sup>14</sup> Linked to the current labor income, the Pension Fund plan is intended to provide the income replacement

<sup>12</sup> Before July 1, 2018, only public-sector employees were mandated to make contributions to the Pillar II of the Armenian pension system. Private sector employees could opt out of the system by requesting an exemption.

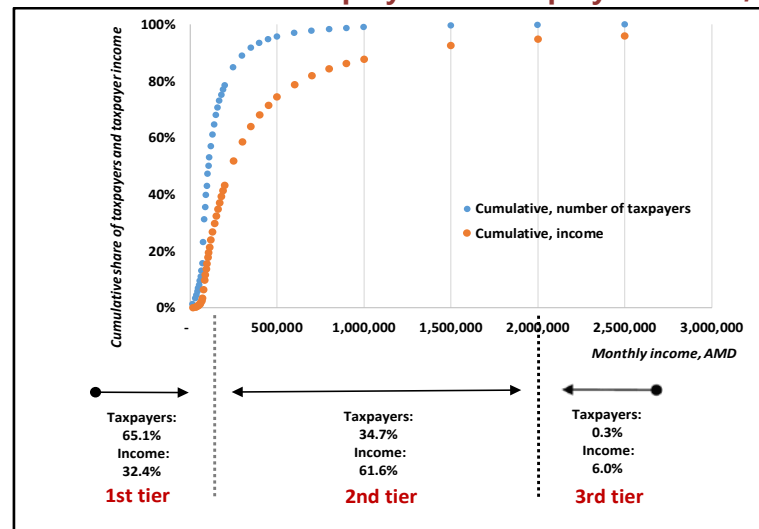
<sup>13</sup> Born after 01.01.1974.

<sup>14</sup> The rates of contributions are expected to be restored to their original levels: 5 and 5 percent for employees and employer respectively, in the context of the upcoming PIT reform.

(consumption smoothing) benefits to the Armenian working population. While pension contributions are a burden on labor incomes, they are distinct from taxes as they will eventually lead to future pension income, entitling individuals to future benefits.

**26. The distribution of employees and employment income is heavily skewed toward low- to middle-wage earners, with at least 79 percent of employed taxpayers earning less than the average monthly salary of AMD 194,000<sup>15</sup> in 2017 (Figure 10).** Cumulatively, over 65 percent of all employees are taxed under the first PIT bracket; they earn 32 percent of all employment income. The second bracket—between AMD 150,000 and AMD 2,000,000—contains about 35 percent of all employees and is responsible for the largest share of the taxable income—about 62 percent. Finally, a mere 0.3 percent of all employees fall into the top PIT bracket. Their income, 6 percent of all taxable employment income, attracts the highest tax rate—36 percent.

**Figure 10. Distribution of Employees and Employee Income, 2017**



Sources: State Revenue Committee, IMF staff estimates

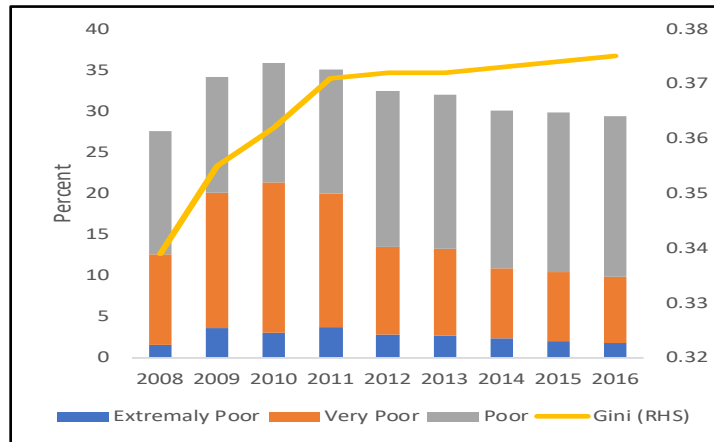
**27. The PIT system can and should perform its distributional function to alleviate the tax burden for the poor and vulnerable sections of society.** In Armenia, PIT is not performing this role as well as it could. In a context where about 30 percent of the population is poor (Figure 11), and the inequality is widening (evidenced by the rising levels of the Gini coefficient), authorities should be seeking to ensure that the already skewed income distribution (Figure 10 above) is not exacerbated by the tax system.

**28. The system of collection and assessment of PIT in Armenia is dependent on a withholding regime.** Under this arrangement, the obligation to withhold an amount of tax is imposed on independent third parties (withholding agents), e.g. employers and financial institutions. The tax withheld is final. Even when a taxpayer earns income from multiple sources,

<sup>15</sup> This value represents the average for the whole economy, according to the Ministry of Labor and Social Affairs.

as long as the earned income is subject to taxation at source by tax agents, the taxpayer has no obligation to recalculate the tax due and submit a final income tax declaration form. As a result, the government under-collects the tax due on earned personal income, as each income source is treated independently of others for taxation purposes,<sup>16</sup> creating unfairness along the way.

**Figure 11. Poverty Levels: Inequality**



Source: Statistical Committee, "Social Snapshot and Poverty in Armenia."

## B. Analysis of Revenue and Distributional Impact of PIT Reforms

**29. A major PIT system reform is envisioned in Armenia; several proposals for reform are currently evaluated.** As discussed in Chapter I, the most important consideration for the current Armenian reform agenda is a holistic view of the tax system that recognizes the importance of revenue sustainability, and considers the tax reform in its entirety, within a comprehensive package of "give and take" tradeoffs. Such "rebalancing" view is propagated by the key stakeholders, including the MoF and SRC. It is also shared by the private sector representatives this mission had a chance to interview. The analysis of PIT reform outcomes that follows were guided by such comprehensive approach to the tax system (discussed in Chapter I).

**30. Several objectives must guide the assessment of PIT reform options.** Among them, progressivity and distributional fairness of the tax system take center stage due to the uniqueness of PIT as a tax instrument for delivering vertical and horizontal equity. Indeed, the tax reform initiatives in Armenia provide an opportunity for alleviating the tax burden for the poor and vulnerable sections of society. Other important considerations include discouragement of the informal economy, as improved perception of equity could reap benefit of stronger taxpayer

<sup>16</sup> A simple numerical example will demonstrate the point. Suppose a taxpayer has two employers; he/she earns a monthly income of AMD 100,000 from each employer, for a combined income of AMD 200,000. Assuming a tax-deductible contribution to the Pension Fund of 5 percent, each employer withholds AMD 95,000 x 23 percent = AMD 21,850. A total AMD 43,700 is withheld by the two employers. Now suppose a year-end recalculation of tax liability is done. The tax due on the combined income of the taxpayer—AMD 200,000 is equal to AMD 45,700 (with the first AMD 150,000 taxed at 23 percent and the rest taxed at the higher rate—28 percent). As a result, AMD 2,000 of tax due is underpaid.

morale and improved compliance. A consideration of labor market competitiveness relative to other countries in the region is also important in the context of Armenia due to historically significant levels of emigration of high income earners; i.e., the so-called “brain drain”.

**31. Using employment income data for 2017, the mission built a simulation model to assess several employment taxation scenarios against revenue performance as well as the vertical equity and progressivity criteria.**<sup>17</sup> The key parameters defining five major simulated scenarios are summarized in Table 6. The current PIT regime, as of July 2018, with a progressive rate structure (23, 28 and 36 percent) was first compared with an alternative Scenario 1: a widely discussed option of taxing individual income under a two-rate progressive regime, with the income threshold at AMD 500,000 and rates of 20 and 25 percent applicable to incomes below and above the threshold (Table 6).

**32. Next, a threshold, either in the form of a general tax credit, a basic deduction, or a zero-tax bracket was simulated to support tax progressivity and equity objectives by reducing or eliminating the tax burden on people with the lowest incomes.** In Scenario 2, an alternative progressive structure that incorporates a tax credit equal to AMD 10,450<sup>18</sup> was tested with rates identical to the prevailing statutory rates (23-28-36). Further, Scenario 3 is simulated, with personal allowance set at the level equal to the global poverty line; AMD 30,000<sup>19</sup>; the personal allowance is phased out once incomes reach the level of AMD 100,000. Under Scenario 4, a personal allowance equal to the prevailing minimum monthly wage—AMD 55,000—was offered, to be phased out at the income levels higher than AMD 100,000. Finally, a 4-tier structure with a tax-free threshold equal to AMD 55,000 (prevailing minimum monthly wage) and the current tax rates (0-23-28-36) was assessed in Scenario 5.

**33. The revenue contraction under each of the five alternative scenarios was assessed, (Table 6), under static analysis, assuming no behavioral response by the taxpayers.** Both, a percentage change, as well as an absolute AMD amount of yearly revenue change was evaluated in comparison with the prevailing PIT regime. Based on the simulation results, Scenario 5 that offers a tax-free threshold for *all* PIT taxpayers is the costliest option under consideration, with a total yearly revenue loss of AMD 87 billion (equivalent to 1.4 percent of GDP). The option with the least revenue contraction is Scenario 3 under which is a monthly personal allowance of AMD 30,000 is offered that is subsequently phased out at the level equal to AMD 100,000.

**34. To allow for a possibility of an expanded tax base as a result of behavioral changes of the taxpayers, a potential base broadening element was incorporated into the model.** These behavioral changes could be a reflection of two main tendencies: (1) the taxpayers incentivized to exit out of shadow into the formal tax regime due to reduced effective tax rates;

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<sup>17</sup> At the request of the MoF, the simulation model in its entirety is delivered to the authorities to allow for alternative PIT scenario analysis, gauging their revenue and incidence impact.

<sup>18</sup> The estimated tax credit is an equivalent of a tax-free minimum wage income—AMD 55,000 as of July 2018.

<sup>19</sup> Based on the World Bank 2015 classification, the global poverty line is equal to USD 1.9/day, or roughly AMD 30,000/month.

and (2) better tax compliance due to improved tax administration efficiency. The last row of Table 6 shows by how much the current tax base must be expanded in order to neutralize revenue loss under each of the assessed scenarios. For example, under Scenario 1 (with two marginal rates: 20-25 percent), the current tax base must be broadened by 35.7 percent for a revenue-neutral outcome. Similarly, a base expansion of 62 percent is required to aim for revenue neutrality under Scenario 2.

**Table 6. Alternative PIT Scenarios**

	Scenario 1: 2-tier progressive structure		Scenario 2: Structure with Tax Credit		Scenario 3: Phased out personal allowance		Scenario 4: Phased out personal allowance		Scenario 5: A tax-free threshold	
	Income tiers (AMD/mo)	Tax rates	Income tiers (AMD/mo)	Tax rates	Income tiers (AMD/mo)	Tax rates	Income tiers (AMD/mo)	Tax rates	Income tiers (AMD/mo)	Tax rates
First threshold	Up to 500,000	20%	Up to 150,000	23%	Up to 150,000	23%	Up to 150,000	23%	Up to 55,000	0%
Second threshold	Over 500,000	25%	150,000— 2,000,000	28%	150,000— 2,000,000	28%	150,000— 2,000,000	28%	Up to 150,000	23%
Third threshold			Over 2,000,000	36%	Over 2,000,000	36%	Over 2,000,000	36%	150,000— 2,000,000	28%
Forth threshold									Over 2,000,000	36%
Tax credit/ Allowance AMD month			Tax Credit: AMD 10,450		Allowance: AMD 30,000 Phased at: AMD 100,000		Allowance: AMD 55,000 Phased at: AMD 100,000			
<b>Annual IMPACT:</b> comparison with current structure	<b>-17.5%</b> <b>[AMD 47 billion]</b>		<b>-27.2%</b> <b>[AMD 73 billion]</b>		<b>-9.9%</b> <b>[AMD 27 billion]</b>		<b>-16.8%</b> <b>[AMD 45 billion]</b>		<b>-32.3%</b> <b>[AMD 87 billion]</b>	
<b>Tax base broadening for revenue- neutrality</b>	<b>35.7%</b>		<b>62.0%</b>		<b>18.5%</b>		<b>33.7%</b>		<b>79.3%</b>	

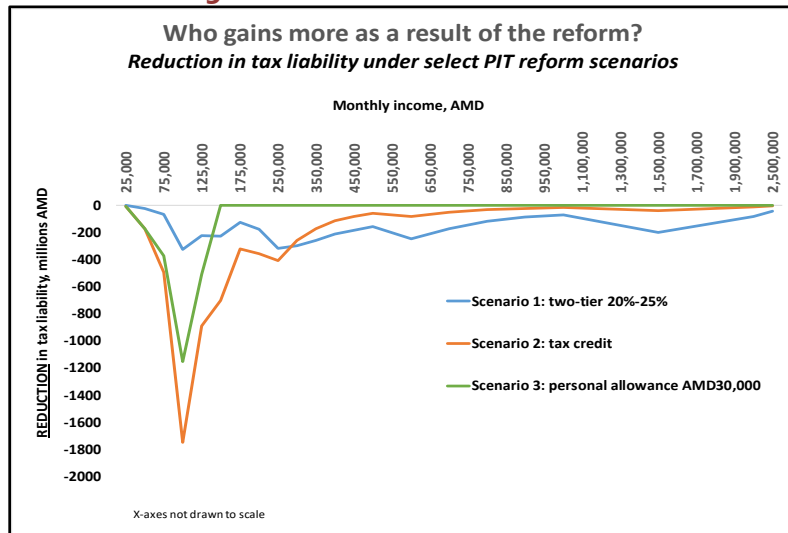
Source: IMF Staff estimates, based on data provided by SRC.

**35. More importantly, to support informed tax policy-making, the incidence analysis of the tax reform alternatives was conducted.** Two questions may be asked: “who is winning the most under each of the reform scenarios? Does the reform aim to relieve the tax burden on the most vulnerable; or will it serve the interest of a relatively well-off income group?

**36. Figure 12 and Table 7 show the reduction in tax liability for taxpayers at all income levels under Scenarios 1, 2 and 3 discussed above.** Figure 12 plots the absolute AMD value of the reduced tax liability relative to the prevailing tax system. The heat-map in Table 7 presents the reduction in tax liability as a percentage change of the current tax liability. For example, under Scenario 2, the 263,683 poorest taxpayers whose monthly income is less than AMD 100,000 will see a 76.2 percent reduction of their tax due (first row of Table 7). Similarly, under Scenario 3, the taxpayers with incomes exceeding AMD 300,000 will see no changes in their tax

liability; only the taxpayers at the lower end of the income distribution will see their tax dues to go down by more than half, with a significant positive impact on their disposable income.

**Figure 12. Winners of PIT Reform**



Source: IMF Staff estimates, based on data provided by SRC.

**Table 7. Incidence of the PIT Reform**

Impact of the Reform: reduction in tax liability (in percent of current liability)				
Income levels, AMD	Count of taxpayers	Scenario 1: two-tier 20%-25%	Scenario 2: tax credit	Scenario 3: personal allowance AMD30,000
100,000	263,683	-13.0%	-76.2%	-53.7%
200,000	217,458	-13.3%	-39.9%	-8.9%
300,000	63,746	-18.4%	-19.9%	0.0%
400,000	27,571	-21.8%	-13.2%	0.0%
500,000	13,870	-23.5%	-9.9%	0.0%
600,000	7,849	-24.2%	-8.0%	0.0%
700,000	4,871	-22.3%	-6.6%	0.0%
800,000	3,141	-20.6%	-5.6%	0.0%
900,000	2,155	-19.5%	-5.0%	0.0%
1,000,000	1,661	-18.5%	-4.4%	0.0%
1,500,000	3,921	-16.8%	-3.5%	0.0%
2,000,000	1,306	-15.0%	-2.4%	0.0%
2,500,000	560	-14.3%	-1.9%	0.0%

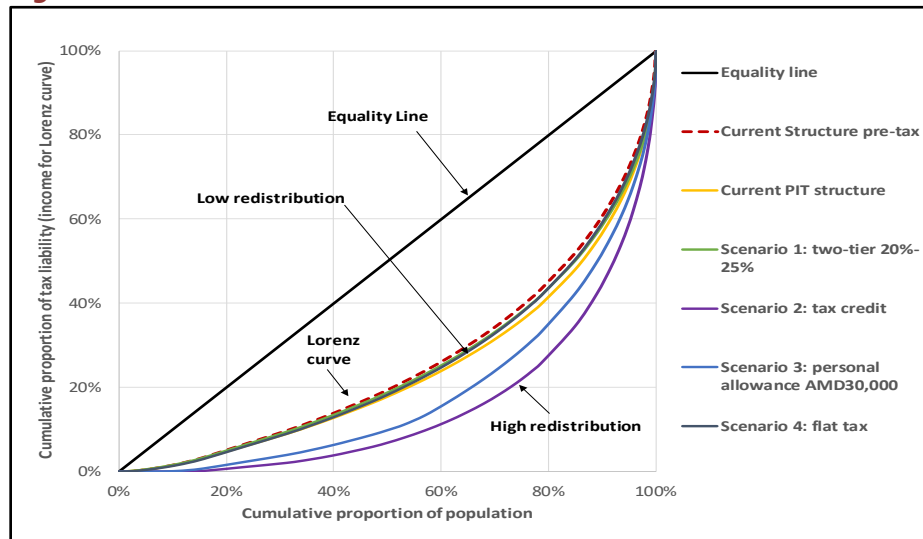
Source: IMF Staff estimates, based on data provided by SRC

**37. It is immediately clear that Scenario 2 is the most beneficial for taxpayers at the low end of the income distribution.** At the same time, as discussed above, it is the costlier option among the three under consideration. Scenario 1, which reflects a widely discussed, two-tier, 20-25 percent option involves a significant revenue downturn and is *the least favorable* for the poor, instead benefitting the relatively better-offs. The least costly option—the one preferred by this mission on the equity and distributional fairness grounds—is the option under Scenario 3. Under this scenario the entire revenue gain is distributed between the poorest income earners. The taxpayers with monthly income of up to AMD 100,000 benefit the most, followed by those with income below AMD 200,000.

## Vertical Equity and Tax Progressivity

**38. The concept of vertical equity refers to fairness across a group of people with different incomes (or levels of wealth).** While most people accept the premise that richer people should pay more tax than poorer people, how much more tax they should pay is often highly contentious. The term “progressivity” refers to the rate at which taxes increase (as a proportion of income or wealth) as income or wealth rises. A “progressive” tax is one in which the effective tax rate increases as income (or wealth) increases. A “regressive” tax is one in which the effective tax rate decreases as income (or wealth) increases. A “proportional” tax is one in which the effective tax rate remains the same as income (or wealth) increases.

**Figure 13. Distribution of Tax Burden under Alternative Tax Structures**



Source: IMF Staff estimates.

**39. Simulation results further show that the proposed two-tier structure (Scenario 1) affects distributional equity of the tax system.** Figure 13 displays tax concentration curves, showing the cumulative proportion of taxes against the cumulative proportion of income-receiving units (using pretax income as the classifier). According to this measure, a tax structure is judged to be progressive if the tax is more unequally distributed among taxpayers than is pretax income, thus resulting in a tax concentration curve which lies below the Lorenz curve. The redistribution is less favorable under the proposed two-tier rate structure (Scenario 1), as well as under a flat tax scenario (Scenario 4, the line closest to red-dotted line). The highest degree of progressivity is achieved when the tax credit is introduced (Scenario 2). Scenario 3, with tax-free income threshold of AMD 30,000 is less progressive than a tax credit option but, displays considerably higher degree of progressivity than the two-tier Scenario 1 or a flat tax Scenario 4.

## A Word of Caution on a Flat Tax

**40. During several stakeholder discussions, the mission received inquiries about possible introduction of a flat tax in Armenia as opposed to the progressive, multi-tier**



**structures.** Box 2 summarizes the key considerations in introducing a flat tax. To simulate impact of replacing the current progressive structure with a flat tax on labor income (while maintaining the existing structure for the taxation of capital income), the following two scenarios were simulated (Table 8). First, assuming no behavioral response to tax policy changes, a flat tax rate was simulated that would allow for revenue-neutrality of the tax reform. A flat rate of 25 percent was shown to ensure such outcome. Next, a scenario voiced during stakeholder discussions was tested—a flat tax of 20 percent. Revenue loss associated with this scenario is equal to AMD 53 billion under a static simulation. When a taxpayer behavioral response is simulated, to ensure revenue neutrality of the 20 percent flat tax regime, the personal income tax base must expand by 41.5 percent.

**Table 8. Flat Tax Scenarios**

	25 percent	20 percent
<b>IMPACT:</b> comparison with current structure	0.2% AMD 0.6 billion	-19.8% [AMD 53 billion]
Tax base broadening for revenue-neutrality	0%	41.5%

Source: IMF Staff estimates, based on data provided by SRC.

**41. Flat tax reforms are often associated with revenue losses.** Among the Central and Eastern European countries that adopted flat-rate tax systems after Russia, the reforms generally seem to have caused a fall in PIT revenues that has not been fully offset either by changes in taxpayers' behavior or by increases in other types of taxes. The introduction of a single personal income tax rate of 13 percent in the Russian Federation in 2001, was followed by an increase in real PIT revenues of about 26 percent in the first year after its introduction (Engelschalk and Loeprick, 2016). Yet, research suggests that the substantial increase in compliance was more the result of parallel efforts to strengthen tax administration (Ivanova, Keen, and Klemm, 2005). Similarly, tax revenue rose markedly in Georgia in the aftermath of the 2004 reform, which introduced a flat tax, but the revenue increase was most likely helped by draconian measures adopted by the government to reduce the inefficiency and corruption of tax administration.

**Box 2. Impacts of Introduction of a Flat Tax**

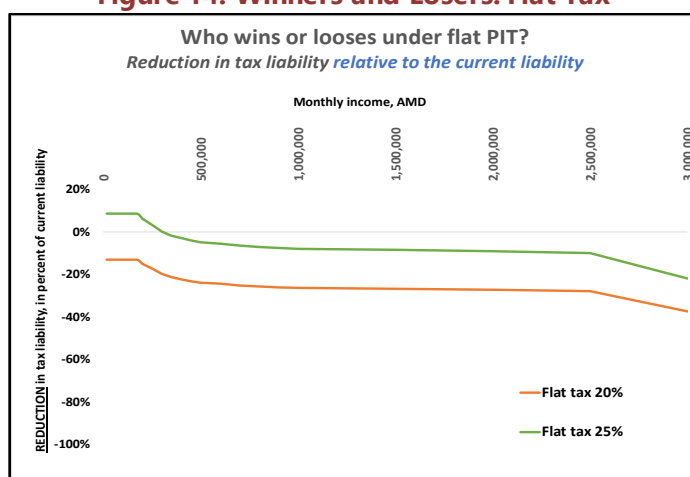
The original flat tax (Hall-Rabushka, 1983) was a combination of a cash-flow tax on business income and a tax on workers' income, both levied at the same, single rate (with a personal allowance available against the wage tax). However, most flat taxes that have been introduced use a looser definition as they refer only to personal income. The key impacts of the introduction of a flat tax system:

1. **Equity.** So long as a flat tax has some basic exemption, the tax is progressive since the average rate of tax increases with the level of income. The more relevant question is whether it is more or less progressive than the tax scheme it replaces. The distributional impact of the flat tax reforms is commonly quite complex, and by no means unambiguously adverse for some of the least well-off.
2. **Work incentives.** Marginal tax rates will fall for some and increase for other taxpayers, which might impact labor supply decisions. There is a vast empirical literature (Ivanova, Keen and Klemm, 2005) on the effects of tax reform on labor supply decisions. The broad consensus is that the effects of tax changes on the effort of primary workers are modest (reflecting offsetting, but perhaps large, income and substitution effects).

### Box 2. Impacts of Introduction of a Flat Tax (concluded)

3. **Compliance, administration, and simplicity.** There is indeed clearly an element of simplification in the flatness of a PIT, since this reduces the incentive to reallocate income across closely related individuals, makes withholding easier, and eases, for example, the need for income averaging for those with highly variable incomes. However, these effects could be nullified by the presence of the tax-free threshold, sometimes at quite high levels, resulting in two marginal tax rates. A recent study by the European Commission<sup>20</sup> looking at the prevalence of undeclared work in the European Union finds that *lower levels of undeclared work occur in Member States with higher per capita GDP, more modernized systems of government, higher levels of trust in authorities and lower levels of corruption, where social transfers are effective at reducing poverty*, there are higher levels of public expenditure on labor market interventions to protect vulnerable groups. Further, the study finds no significant relationship between undeclared work and the implicit tax rate on labor.
4. **Automatic stabilization.** The common argument that a flat tax weakens an automatic stabilization of the economy, upon which increasing reliance is generally placed in coping with shocks, might not be correct. The level of the threshold amount under the flat tax, below which incomes are not taxed, turns out to be crucial: if there is no threshold, then METR falls and the stabilizer weakens. However, with some taxpayers excluded from tax, the marginal tax rate applied under the flat tax will need to be higher than would otherwise be the case in order to raise the same revenue as the pre-reform tax. This tends to increase built-in stability.

Figure 14. Winners and Losers: Flat Tax



Source: IMF Staff estimates, based on data provided by SRC

42. **The general concern of a flat tax is that it raises income inequality since it does not take into account the ability-to-pay considerations.** Analysis of flat tax proposals suggests that they should be discouraged for Armenia as they clearly benefit the taxpayers at the higher end of the distribution at the expense of those at the lower end (Figure 14). In fact, a revenue-neutral 25 percent flat tax increases the tax burden on the poor, turning the better-offs into clear winners. The distributional fairness concern is compounded even further if there are attempts to substitute the revenue losses from the PIT reform with a one percentage point increase of the standard VAT rate (from the current 20 to 21 percent). Given the regressivity of VAT, this tax rebalancing has a more adverse impact on lower income cohorts vs. higher income households.

<sup>20</sup> European Commission (2017). "An evaluation of the scale of undeclared work in the European Union and its structural determinants".

The authorities are therefore invited to analyze the distributional impact of the VAT rate increase by utilizing household expenditure survey data as further explained in Appendix 3.

## Horizontal Equity and Tax Planning

**43. Horizontal equity means that different taxpayers with the same income or assets pay the same amount of tax.** The concept is simple and generally non-controversial in principle. But in practice, there can be significant dispute over what “same income” (or same consumption or same assets) means. A tax system that includes exemptions or special rules to treat economically similar taxpayers differently will not achieve horizontal equity. The multitude of tax regimes (see Chapter III), creates arbitrage opportunities across different types of income. The resulting tax burdens are widely divergent, possibly encouraging tax planning opportunities. Another important difference between the employee and self-employed regime rests in the requirements for payment of pension fund contributions. Currently, employed workers’ wages are subject to proportional payments of 2.5 and 7.5 percent<sup>21</sup> of gross wage value for pension fund contributions payable by employees and government respectively; while self-employed individuals are not part of the system. This differentiation creates distortions. Considerations could be given to harmonizing the requirements for payment of pension contributions for self-employed individuals with those for employed workers. Further analytical work is however required to show the divergence of tax burdens across different types of individual taxpayers.

## Final Reporting of Personal Income

**44. It is important for Armenia to implement the final reporting of tax.** It can be implemented through the provision of pre-filled tax returns to individuals. Such final tax reporting mechanisms have evolved to become a significant (and for some, transformational) element of revenue authorities’ e-services strategy worldwide. This is especially the case for the PIT, with almost half of revenue administrations using elements of this method. Pre-filing entails the use by revenue bodies of information held by them (e.g., taxpayer identity information, elements of taxpayer history, and third-party reports of income and deductions) to populate fields within tax returns which are then made available to taxpayers for verification. The completeness of the return sent to taxpayers is contingent on the range of third party reports that can be used by revenue bodies.

**45. A pre-filled return can be forwarded to taxpayers in paper form or in electronic form.** Electronically, taxpayers can access their pre-filled return via the Internet and, if required, advise of any necessary adjustments. Following the processing of confirmations and adjustments by the revenue body, final notices of assessment should be mailed to taxpayers, along with any refunds of tax owing to taxpayers. Under a ‘silent acceptance’ practice, taxpayers are not required to confirm that a return is correct in all aspects; instead, this is deemed to be the case if the

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<sup>21</sup> To revert to 5—5 percent employee—government contribution as part of the upcoming tax reform.

revenue body receives no advice from the taxpayer after a prescribed period of time. Taxpayers are subsequently issued with an official notice advising their final assessment details.<sup>22</sup>

**46. Very importantly in the context of Armenia, individuals must be subject to audit.**

Currently, the law allows audit of companies but not individuals (natural persons). Undeclared tax liabilities may result in high penalties and underreporting of a tax liability of at least AMD 2 million is treated as a criminal offence under the Criminal Code punishable by penalty or even imprisonment. However, taxpayers report their income through a self-assessment system and cannot be subjected to a tax audit, rendering such penalties ineffective. With sufficient information collection mechanisms in place, audits by tax authorities should act as an incentive for increased compliance and tax collection from individuals. The 2016 TA Report provided in the Supplementary Analysis and Legal Drafting Guide considerable background and draft legislative language as to how to broaden the audit to individuals, require self-declaration by all individuals, introduce measures against income splitting, and individuals avoiding wage taxation by incorporating themselves as independent contractors. The same concerns are still being raised by policy makers, suggesting that the 2016 TA Mission's recommendations have been forgotten.

**Recommendations**

- Maintain the current progressive structure of the PIT to ensure distributional fairness. Avoid introducing a flat PIT.
- To improve progressivity of the PIT system while minimizing the revenue impact of the reform, consider introduction of a personal allowance at the level equivalent to the global poverty line—around AMD 30,000—to be phased out at incomes higher than AMD100,000.
- Consider harmonizing the requirements for payment of pension contributions for self-employed individuals with those for employed workers.
- Ensure horizontal fairness by aligning effective tax burdens on identical income earned by taxpayers in different sectors (regardless of being organized as natural or legal persons).
- Communicate to taxpayers the benefit of better compliance, as additional revenue from the expanded tax base will be used for a gradual decrease in tax burden for all income groups.

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<sup>22</sup> Grote et al, 2016.

### III. CORPORATE INCOME TAX, INCENTIVES, AND PRESUMPTIVE TAXES

#### A. Corporate Income Tax (CIT)

47. **The Armenian authorities are looking for ways to reinvigorating investment in the country that would translate into more jobs and economic growth.** Achieving a broader corporate tax base and thereby being able to raise the same revenues at lower, more uniform rates through elimination of tax preferences is feasible. The mission reviewed alternative policy options that may be superior to tax incentives in terms of leveling the playing field for all investors, while offering greater transparency, administrative simplicity, and cost effectiveness. Based on a corporate tax micro-simulation analysis, alternative tax policy scenarios were simulated that could provide sounder and more sustainable attractiveness to investments. This could be indeed achieved in a revenue neutral fashion.

#### The Current Investment Incentive Regime Provides Attractive Options

- **Allowance for wages of disabled employees**—companies employing disabled can deduct 150 percent of the wages and other payments paid to such employees.
- **Incentives for free economic zones**—the annual income of a resident company or operator in a free economic zone, is exempt from tax—being an *unlimited tax holiday*.
- **Government-approved projects**—resident companies involved in business projects (excluding projects in the field of trade and finance) that are approved by governmental decree are granted a CIT exemption equal to 100 percent of the salary paid for newly established jobs. The exemption cannot, however, exceed 30 percent of the corporate tax payable for the current tax period. The exemption applies for a period of five full reporting years following governmental approval. Companies conducting governmental-approved construction and installation activities exclusively outside of Armenia are subject to a CIT rate of 5 percent. In addition, income paid to Armenian resident employees of such companies is taxed at a reduced rate of 13 percent. These rates apply from June 13, 2015.
- **Large exporters**—companies or groups of companies that (1) exclusively export goods and services; (2) do not carry out business activities in the field of metal mining and the processing and sale of precious minerals and excisable goods; (3) receive the sales proceeds in foreign currency on bank accounts held in Armenia; and (4) have their business plans approved by the government, are taxed at the following CIT rates: 5 percent if the annual exports of the company or the group of companies exceed AMD 40 billion; and 2 percent if the annual exports of the company or the group of companies exceed AMD 50 billion (on the whole amount exceeding the threshold). This incentive lapses next year.

- **Information technology (IT)**—resident companies involved in IT projects certified according to the Law of the Republic of Armenia "on IT sector state support" are granted a CIT exemption for revenues from IT activities. The exemption applies for a period of certificate validity. With effect from April 8, 2017, newly registered IT companies with up to 30 employees are exempt from CIT for a period of 5 years. The salaries paid to the employees of these companies are taxed at a flat rate of 10 percent.
- **Renewable energy production**—licensed resident companies involved in production of electric energy from renewable sources are granted a CIT exemption for revenues from electric energy sales. The exemption applies to sales to licensed energy distribution companies.

### Micro-simulation Modeling of Corporate Tax Returns

**48. A micro simulation analysis (Box 3) of Armenia's CIT returns was conducted based on the micro-, firm-level data provided by the SRC.** Alternative CIT policy choices and their impact in terms of revenue generation were analyzed. More specifically, one of the key questions was: Subject to tax revenue-neutrality, how far could the corporate tax rate be lowered if all tax incentives were to be repealed? In other words, what is the tax rate that could be applied uniformly to a broadened tax base, conditional on the revenue generated by the new system being at least equivalent to the one generated by the current system?

**49. The micro-analysis of the CIT system shows that it features a narrow tax base, non-uniform effective tax rates, and tax exemptions (Table 9).** The narrow base is the result of a generous set of tax allowances. To this narrow base, different nominal tax rates apply to different investments within the corporate sector depending on the economic activity, sector, and size. It results in effective rates significantly being different from the statutory tax rate (e.g., an effective rate of 12 percent in the construction sector, or an effective rate of 17.4 percent in the transportation and storage sector). The resulting CIT is further reduced by profit tax exemptions.

#### Box 3. CIT Micro-Simulation Model

- The "micro" in micro-simulation simply means that the data from individual tax returns, not aggregate statistics, are used in the analysis. The basic unit of micro-analysis is a single taxpayer. The "simulation" in micro-simulation means that the analysis essentially imitates (simulates) the filing of tax declarations by taxpayers under alternative tax law scenarios. It replicates the calculations made by each taxpayer to minimize tax liability or maximize after-tax income, consistent with the tax law being simulated. Subsequently, the results for all corporate taxpayers (or select groups of corporate taxpayers) are aggregated to determine the overall (or distributional) effect of a proposed policy choice. The utility of micro-simulation in evaluating alternative tax policy proposals is in its capacity to address simultaneous interactions among alternative tax bases and tax rate parameters.
- The database used for the micro-simulation analysis of CIT regime in Armenia is based on the entire population of the corporate tax returns filed with the SRC in 2017. In its final format, the data from the SRC is received in Excel format, in which each row is a taxpayer and each column is a variable describing the taxpayer's tax declaration variables (e.g. income from various sources, expenses, additions and adjustments, allowances, etc.), as well as data identifiers (e.g. for sector and location). For security and confidentiality

### Box 3. CIT Micro-Simulation Model (concluded)

- purposes all individual corporate taxpayer identifications were removed; each taxpayer is listed by a generic name: Taxpayer 1, 2, etc.
- The initial SRC file contained 14,384 taxpayers and 42 variables. From 14,384 database entries, 3,997 were empty, leaving a total of 10,387 non-empty fields. Further, each of the CIT taxpayers can represent more than one sectoral activity. For example, a single taxpayer can have activities in the Construction and Manufacturing sectors at the same time. The database received from the SRC represents a total of 18,142 sectoral activities.
- The dataset was tested for consistency to identify irregular entries, outliers and errors. The inconsistent entries have been edited, resulting in a new clean dataset.
- To compute corporate income taxes under alternative tax policy scenarios, the information contained within the dataset is processed consistent with what a taxpayer would do when filing his/her actual corporate tax declaration in real life.

### 50. The main “beneficiaries” of the CIT privileges are easily observable in Table 9.<sup>23</sup>

These are *agriculture, forestry and fishing, mining and quarrying, construction, wholesale and retail trade*, as well as the *financial and insurance activities*, and *education*. By far, the agricultural sector—including its multi-billion corporations—enjoys the lion share of all preferential treatment in Armenia. Indeed, agriculture attracts 61 percent of total tax-base narrowing tax incentives, an effective rate of 17.9 percent, as well as 73.9 percent of all profit tax exemptions.

**Table 9. Microsimulation of CIT Returns: Tax Expenditures**

		20 Tax privileges to reduce taxable profit (or net assets)	% of total	Effective profit tax rate of the sector	33 Profit tax exemptions/ benefits	% of total	Backwards-looking average effective tax rate
A	Agriculture, forestry and fishing	(2,425,738,032)	<b>61.0%</b>	<b>17.9%</b>	(204,761,448)	<b>73.9%</b>	<b>4.2%</b>
B	Mining and quarrying	-	0.0%	19.3%	-	0.0%	19.3%
C	Manufacturing	(165,650,755)	<b>4.2%</b>	20.0%	(48,314,739)	<b>17.4%</b>	<b>19.9%</b>
D	Electricity, gas, steam and air conditioning	(36,110,753)	0.9%	20.0%	-	0.0%	20.0%
E	Water supply; sewerage, waste managem	-	0.0%	20.0%	-	0.0%	20.0%
F	Construction	-	0.0%	<b>12.0%</b>	-	0.0%	<b>12.0%</b>
G	Wholesale and retail trade; repair of motor	(59,086,118)	1.5%	<b>17.4%</b>	(19,635,180)	<b>7.1%</b>	<b>17.3%</b>
H	Transportation and storage	(320,662)	0.0%	19.8%	-	0.0%	19.8%
I	Accommodation and food service activities	-	0.0%	20.0%	(582,864)	0.2%	20.0%
J	Information and communication	(79,416,160)	2.0%	19.6%	(900,657)	0.3%	<b>13.5%</b>
K	Financial and insurance activities	(500,096,703)	<b>12.6%</b>	<b>10.7%</b>	-	0.0%	<b>14.1%</b>
L	Real estate activities	(14,471,767)	0.4%	19.9%	(1,714,429)	0.6%	19.8%
M	Professional, scientific and technical activit	(4,375,000)	0.1%	18.9%	-	0.0%	18.7%
N	Administrative and support service activitie	-	0.0%	20.0%	(33,715)	0.0%	19.4%
O	Public administration and defense; compuls	-	0.0%	20.0%	-	0.0%	20.0%
P	Education	(686,651,305)	<b>17.3%</b>	<b>18.3%</b>	(10,200)	0.0%	<b>16.5%</b>
Q	Human health and social work activities	(1,916,116)	0.0%	19.9%	-	0.0%	19.8%
R	Arts, entertainment and recreation	(1,084,487)	0.0%	19.9%	(1,064,484)	0.4%	19.7%
S	Other service activities	(4,749,612)	0.1%	19.7%	(187)	0.0%	19.7%
U	Activities of extraterritorial organisations ar	-	0.0%	0.0%	-	0.0%	0.0%
	Total:	(3,979,667,470)		18.6%	(277,017,902)		

Source: IMF Staff, based on data provided by SRC.

<sup>23</sup> The table aggregates CIT taxpayers based on the economic sector classification and shows an aggregated value of lines 20 and 33 of the Armenian profit tax declaration form, downloadable from the SRC web-site <http://www.petekamutner.am/Content.aspx?itn=tsTICurrentTaxForms>. Effective tax rates are calculated based on the taxpayer declaration micro-data, as obtained from the SRC.

**51. Based on the microsimulation model, several alternative tax law scenarios were simulated (Table 10).** The first “what if” simulation—Scenario 1—*preserves* all preferential treatment where it has been granted, including base-eroding tax allowances, non-uniform tax rates, and profit tax exemptions. It simulates a single percentage point reduction of the statutory tax rate, applicable to standard taxpayers (those who apply the standard 20 percent prevailing under the current law). The simulation illustrates the cost of a rate reduction by one percentage point is equal to AMD 5.3 billion.

**Table 10. Microsimulation Scenarios**

	Current tax system	Simulated system 1	Simulated system 2	Simulated system 3
Tax privileges to reduce taxable profit (or net assets)	Yes	Yes	For select sectors only	For select sectors only
Non-uniform tax rates	Yes	Yes	For select sectors only	For select sectors only
Profit tax exemptions/benefits	Yes	Yes	For select sectors only	For select sectors only
Standard corporate tax rate	20%	19%	19%	17.5%
Generated profit tax	AMD 112.5 billion	AMD 107.2 billion	AMD 120.3 billion	AMD 112.5 billion
IMPACT: comparison with current structure		-4.7% [AMD 5.3 billion]	6.9% [AMD 7.8 billion]	-0.1% [AMD 0.07 billion]

Source: IMF Staff, based on data provided by SRC.

**52. Scenario 2 simulates the effect of revocation of all preferential treatment for select sectors.** Table 11 shows the sectors where the tax-preferential treatments were removed, as well as those where tax expenditures were preserved, the latter being yellow-highlighted. The reason for maintaining tax expenditures in the selected (highlighted) sectors is twofold. (1) A preferential tax treatment of certain sectors, such as *education*, on social policy grounds is a common and largely accepted practice. (2) The mission could not identify the legal base and sources of tax expenditures in select sectors, such as *financial services and insurance activities*. Neither the industry experts nor tax policy practitioners could explain this non-uniform treatment. Given this uncertainty, tax expenditures in the financial sector were preserved.

**Table 11. Selecting Sectors for Tax Expenditure Analysis**

Sector Code	Sector	Tax incentives removed?
A	Agriculture, forestry and fishing	yes
B	Mining and quarrying	yes
C	Manufacturing	yes
D	Electricity, gas, steam and air conditioning	yes
E	Water supply; sewerage, waste management	yes
F	Construction	yes
G	Wholesale and retail trade; repair of motor	yes
H	Transportation and storage	yes
I	Accommodation and food service activities	yes
J	Information and communication	yes
K	Financial and insurance activities	no
L	Real estate activities	yes
M	Professional, scientific and technical activities	yes
N	Administrative and support service activities	yes
O	Public administration and defense; compulsory	no
P	Education	no
Q	Human health and social work activities	yes
R	Arts, entertainment and recreation	no
S	Other service activities	yes
U	Activities of extraterritorial organisations and	no



**53. Under Simulation 2, in addition to repealing all tax expenditures in select sectors, the statutory tax rate is reduced by one percentage point, to 19 percent.** Given the size of CIT expenditures in Armenia, *a reduced but uniform corporate tax rate, applied to a broader tax base* yields about AMD 8 billion more revenue than the prevailing corporate tax system.

**54. Finally, Simulation 3 analyses a scenario under which all tax expenditures would be removed, and a uniform tax rate will be applied so that the system generates a revenue-neutral outcome.** A standard corporate tax rate of 17.5 percent, given the specificities of Armenia's taxpayer population, would yield the same revenue as the one generated by the current tax system. It is important to note that these simulations are of a static (not a dynamic) nature, based on a single-year CIT tax returns database provided by the SRC. They assume no behavioral response, either positive or negative, to the proposed changes of the tax law parameters. Negative behavior changes to the removal of tax incentives could see investors reduce or even cancel their operations. Positive reactions could see investment, both domestic and foreign, surging in response to a reduced statutory CIT rate.

### **Drawing Conclusions from the Micro-Simulation Analysis**

**55. If Armenia were to undertake a bold tax reform aiming to establish an investment-conducive environment, it is advisable to minimize the use of tax incentives and instead impose a low and uniform CIT rate.** Box 4 explores relevance of tax incentives for investment decisions. The micro-simulation analysis suggests that Armenia could raise the same revenue from a 17.5 percent uniform statutory tax rate, without tax incentives, as it does from the current tax system (again, assuming no behavioral effects).

#### Box 4. How Relevant are Tax Incentives to Investment Decisions?

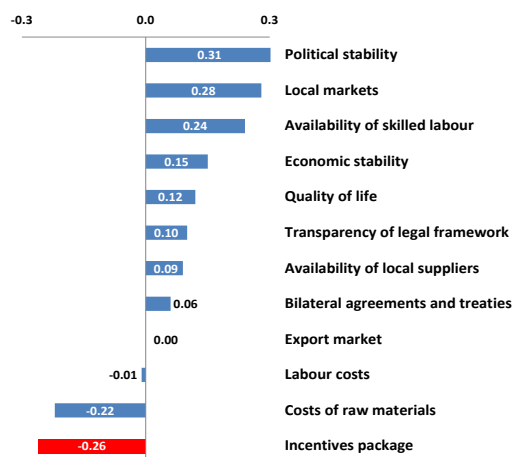
Not unlike many other developing countries, Armenia currently believes that the use of tax incentives stimulates investment and are an important policy instrument in creating an appealing investment climate. The relevant policy question briefly explored here is whether tax incentives are the best vehicle for establishing an environment that is investor-friendly?

In 2010, the United Nations Industrial Development Organization (UNIDO) conducted a business survey of 7,000 companies in 19 Sub-Saharan African countries active in agriculture, mining, manufacturing, utilities, construction, and services sectors). The investors were asked to rank the importance of twelve location factors and to assess how they might have changed, improved and worsened, in the last years (Figures 1 and 2).

**Figure 1. Ranking of Investment Factors' Importance by African investors**



**Figure 2. Change of Importance of Investment Factors over a Period of 3 Years**



Source: UNIDO (2011), Africa Investor Report 2011. Towards Evidence-Based Investment Promotion Strategies, United Nations Industrial Development Organization.

The results of the survey are powerful, but not surprising. Economic and political stability were ranked as the most important factors. Critically important to potential investors are the transparency of the legal framework, the cost of compliance with laws, regulations and administrative practices, as well as the availability of skilled labor. Tax incentives package (marked in red in Figures 1 and 2) came second to last in importance within the set of 12 factors under assessment. Even more interestingly, the factors judged to have improved the most in importance for investors were political stability, local market conditions and the availability of skilled labor, while the tax incentives package deteriorated the most in importance over a period of three years (Figure 2). The message conveyed by African investors through the survey suggests that tax incentives are of many, but not the most important factors that determine the attractiveness of an investment destination.

**56. A universally applicable tax system would go a long way towards creating a level playing field for investment activity and make the tax system more neutral in its impact on investment decisions.** Additionally, a uniform statutory tax rate would signal to investors the investor-friendliness of the business environment. Indeed, statutory CIT rates are commonly used in cross-country comparisons by global investors as an important factor in the decision-making process for new investment. When considering investment options investors analyze the entire tax landscape. However, their first point of reference is the signaling effect of the statutory tax rate – perhaps the most visible tax measure in consideration of potential investment.

**57. Adopting a uniform business tax rate in Armenia would remove the source of some important investment distortions and promote greater efficiency.**

As shown above, achievement of a uniform rate in the 17.5 percent is contingent upon the removal of all tax expenditures, including tax base allowances, non-uniform tax rates, and indefinite tax holidays. Unless these measures are implemented in whole, it would not be possible to lower the CIT rate to the levels indicated without triggering revenue losses. In theory, tax incentive policy should aim at influencing investment decisions at the margin and minimize factors affecting the returns from infra-marginal and earlier investments. In practice, trying to identify the “marginal” activity to target the incentives is seldom possible and often counterproductive. A CIT reduction constitutes a more efficient investment incentive since it does not distort investment choices between those eligible for tax incentives and those that are not.

**58. Rationalizing tax incentives and reducing the CIT rate contribute materially to base-broadening and removing incentives to avoid tax.**

Appendix 4 discusses in detail the costs of tax incentives, the difficulty with calculating their forgone revenues, and offers some advice on how to establish a cost-benefit analysis capacity for the associated costs with tax preference schemes. Regular cost-benefit analysis of preferential tax treatment would improve government decision making. Appendix 9 discusses the benefits of implementing the four minimum standards in terms of the Base Erosion and Profit Shifting (BEPS) actions (as per MoF request). The notable variation in effective tax rates predictably invites aggressive tax planning, including the use of transfer mispricing. The differences in effective rates between various tax regimes create opportunities to shift taxable profits and deductions across entities with different tax treatments, either domestically or internationally. This adds further pressure on tax revenues.

## **Recommendations**

- Rationalize tax incentives and privileges, thereby ensuring equal treatment of all sectors.
- Adopt a uniform CIT rate to remove the source of investment distortions, promote greater efficiency, and reduce profit-shifting opportunities.
- Gradually reduce the statutory tax rate to 17.5 percent; communicate the intended rate reduction upfront to increase predictability and transparency of tax policies.
- Use the revenue “surplus” generated by the CIT restructuring to finance PIT reforms that aim to improve its progressivity and equity.
- Conduct regular and thorough cost-benefit analysis of preferential tax treatment to support government decision making.

## **B. Tax Code’s Special Tax Systems**

**59. There used to be five different presumptive tax regimes in lieu of the profit tax, which commonly permits the deduction of business expenses.** This has been reduced to three

in the 2016 Tax Code. These regimes can be economically unattractive for start-up firms, facing a loss position. There is no local income tax or business tax on income in Armenia. From 1 January 2018, the presumptive tax regime and the simplified tax regime for jewelers have been abolished.

### The Revised Patent Fee Regime

**60. The “patent fee regime” is mandatory for sole proprietors and companies engaged in the following business activities (article 276 of the New Tax Code (NTC):** For catering and restaurant services but only until 1 July 2018—thereafter this sector will be taxed at a turnover tax rate of 5 percent irrespective of the turnover even if it exceeds AMD 58.35 million (proposed VAT threshold)—taxi services; bus transportation services; barber shops; vehicle maintenance services; vehicle parking services; table tennis and billiard games; gaming and vending machines; dental rooms and dental mechanics; totalizators and Internet totalizators; and jewelry sales on jewelry markets and malls. This regime replaces the income tax and VAT. The lump-sum payment (patent fee) is due on a quarterly basis and varies depending on the type of activity.

### Turnover Tax Regime

**61. An optional turnover tax regime—the option can be exercised on an annual basis—is available for businesses whose annual turnover does not exceed AMD 58.35 million.** The tax base is the revenue/turnover derived by the business and is due on a quarterly basis. The rates depend on the type of business activity, and are payable at the following rates and in the case of capital income (financial service industry excluded) operate like a withholding tax:

<u>Activity</u>	<u>Rate (%)</u>
Trade	5
Recyclable materials sales	1.5
Newspapers sales by publishers	1.5
Manufacturing	3.5
Rent, interest, royalties, alienation of assets	10
Notary services	10
Lottery revenues	25
Other activities	5

**62. Turnover taxpayers engaged in trading activities are eligible for a tax rate credit of 4 percent of the purchasing costs of the imported goods destined for trading activities.** The amount of tax payable on income received from trading activities is subject to a minimum of 1.5 percent of the total trade turnover. The unused portion of the tax credit can be used in future tax periods. Taxpayers engaged in the following types of business are not eligible for the turnover tax regime: producers or importers of excisable goods; companies under the patent fee regime; banking, loan, insurance, and investment companies; security market participants, pawnshops, currency exchange offices; casinos and gambling offices; and auditing companies.

## Family Company Regime

**63. An optional regime (the “Family company” regime) is available for businesses owned and managed solely by members of the same family (mothers, fathers, brothers, sisters, spouses and children), and whose annual turnover does not exceed AMD 18 million.** Also, all employees of the company must be members of that family. Such companies are exempt from regular taxation (including corporate income tax and VAT). Instead, a fixed monthly individual income tax payment of AMD 5,000 applies for each employee of the company. Taxpayers engaged in the following types of business are not eligible for this tax regime: trade companies, companies under the patent fee regime; producers or importers of excisable goods; banking, loan, insurance, and investment companies; currency exchange offices; lotteries and gambling office (casinos); and auditing companies.

## Global Lessons in Taxing Micro, Small to Medium-sized Businesses (SMEs)

**64. The challenges with designing and administering a simplified tax system for SMEs are summarized in Box 5.**<sup>24</sup> This should guide further refinements of the Armenian regime with the view to assist small firms to grow but simultaneously to protect the corporate tax base.

### Box 5. Issues and Options for Taxing SMEs

- **General description of the SME tax group**—Small and micro enterprises constitute between 85–95 percent of the bulk of business taxpayers but their tax revenue contribution is mostly small. To deal with this group coherently in terms of the overall tax system, it should only include business income taxpayers below the VAT registration threshold. It is a heterogeneous group of street and produce market vendors, artisans, subsistence farmers, small individual entrepreneurs, professionals, small shopkeepers and businesses with several employees.
- **Justification for considering SME taxation as a special case**—The tax treatment and accurate registration of SMEs is important for reasons beyond tax collections. SMEs generate employment; taxing them consistently would increase horizontal and vertical equity; it would enhance economic efficiency; support a country's tax morale by attempting to level the playing field; advance government's accountability and transparency; and negotiating with SMEs their taxes would enhance the accountability and transparency of public institutions which is effective in addressing corruption.
- **The indicator-based patent tax regime**—It is normally used for micro or sole traders, substituting for income tax and social contributions. Countries adopt a fixed fee across all economic activities as it would keep it simple (differentiation across activities leads to abuse, rent-seeking and corruption); the flat fee is not adjusted for profitability or turnover; typically it is a small fee to prevent evasion; since it does not address real profitability of a business it is regressive which should encourage business to formalize which is good for growing firm size; migration to formal sector may be difficult; and no bookkeeping is required.
- **Presumptive taxation based on indicators**—Instead of income taxation, physical indicators or financial information are used as proxy income indicators regarding activity or location; it can become very complex such as the French *du forfait* regime; there is no reliable comparability across sectors but varying definitions of small business (related to turnover or employees); it requires little bookkeeping but could create distortions vs. the general regime.
- **Turnover-based SME taxation**—The system is only available to firms under the VAT registration threshold; it consists of a flat tax of say 3-5 percent, imposed on gross receipts in lieu of income taxation and it provides a link to VAT which is also based on turnover; effective tax rate varies inversely with profit margins; and it triggers cascading effect and it would require simple bookkeeping such as recording sales.

<sup>24</sup> Khwaja (2013).

### Box 5. Issues and Options for Taxing SMEs (concluded)

- **Cash-flow based presumptive tax**—In lieu of accrual accounting, it requires cash-based single-entry bookkeeping by offsetting against gross receipts total expenditures/costs with immediate expensing of capital expenditure; it, makes tax depreciation superfluous; and it replaces income tax and achieves equal effective tax rates across sectors.
- **Tax design and avoidance challenges**—As amply evidenced globally, presumptive regimes encourage larger businesses in the standard/general tax regime to split income (size) to benefit from the SME-regime's lower effective rates. Hence, one should exercise care in not introducing low turnover rates as existing owners can create new small firms instead of consolidating their expansions. Where the SME regime's tax burden deviates significantly from the wage tax burden, employees in the PIT regime will convert into independent contractors. Significantly lower tax burdens in the presumptive regimes create lucrative tax planning avenues for related parties with big corporations to establish small firms only for tax avoidance purposes—e.g., loans to small SME operations instead of equity injections or delaying payments to reduce cash receipts. The biggest drawback is that because of lower compliance standards in the SME regime, the difficulty in verifying tax facts (total sales, input costs, number of employees) provides ample opportunities to stay in the "shadow."
- **Tax policy advice for correcting slippage and leakage from the general tax system**—Focus on using a well-considered VAT registration threshold as the cutoff turnover threshold for the SME tax regime. This ensures that medium-sized business are subject to the general tax regime; one still needs to clarify the thresholds between micro and small businesses with only turnover being the criteria for differentiation; businesses requiring VAT registration (VAT-able sales exceed registration threshold) must be taxed under the general income tax system; any professional service must be excluded from the SME regime; and allow for streamlined and synchronized VAT returns, CIT filing, and tax payment obligations as this will facilitate migration into the general regime.
- **Tax administration**—Special audit and tax filing support by the tax administration to SMEs will shore up trust and tax morale; tax audits of presumptive taxpayers should be risk-based addressing abuse by large taxpayers; and SME assistance and advisory programs with focus on improving SMEs bookkeeping standards encourages compliance.

**65. The 2015 TA mission/2016 TA Report analyzed the Special Tax Regimes and raised a number of concerns with it (see pp 37-47).** The mission recommended a simpler, uniform and more practical approach for taxing SMEs by not focusing on granting tax relief but rather seeking to mitigating the regressive tax compliance cost of small and growing firms. It is encouraging that two of the previous five presumptive regimes have or will be withdrawn but the inefficiencies in terms of design and revenue costs for government continue with the revised remaining three. The 2015 TA Mission's arguments against the special tax systems for SMEs suggested the following recommendations, still being relevant, for the three SME regimes:

### Recommendations for a More Pragmatic Approach

- Consider introducing a comprehensive presumptive regime – a simple lump sum tax for microbusiness taxpayers (i.e. uniform patent fee) and a single turnover-based tax for SMEs below the VAT registration threshold without any sectoral differentiation for both categories.
- Assure proper segmentation of taxpayers—align presumptive taxation thresholds with the new reduced VAT registration threshold.
- Impose one rate (ranging from 3-5 percent) or amount for the patent tax regime as well as the turnover tax; exclude as a high priority all certified professionals (e.g., engineers, medical service providers, lawyers, accountants), and any legal person from presumptive taxation.

- Restaurants and medical practitioners with turnovers above the new VAT registration threshold of AMD 58.35 million should be in the standard VAT, PIT, and CIT regimes.
- Once having migrated into the standard regime, a taxpayer cannot elect to return to the presumptive regime at the beginning of the next fiscal year.
- Provide for simplified accounting and quarterly filing for medium-sized taxpayers as they migrate from the SME turnover regime into the standard CIT system.

## IV. INCREASING REVENUES FROM TAXATION OF REAL ESTATE

### A. Institutional Environment

**66. From 2015 to 2018 the Government of Armenia implemented significant consolidation of communities.** The 915 communities have been substantially reduced to 502 with yet further rationalization envisaged. The creation of ‘cluster (multi-settlement) communities’ and formalizing inter-community unions seem to be the future practice of ensuring a manageable local government system. This is commendable in an environment where administrative changes are not readily accepted. A further achievement is the availability of community data on the websites of regions and the Ministry of Territorial Administration and Development (MTAD), and the improved transparency of the activities of community councils (e.g., live broadcasting of council meetings). Appendix 6 discusses other institutional matters.

**67. Although the Municipal Management Information System (MMIS) was introduced in 2007, some communities are still not using it.** The MMIS provides a solid platform for effective own-source revenue management (including property taxation) by the communities. The MMIS also achieves more efficient management of community budgets and assets, the implementation of civil oversight of community performance—thus, aiding to reduce corruptive practices. The city of Abovyan (Appendix 7), for example, operates on a cashless basis. Community consolidation has brought some services closer to citizens as these are now conveniently delivered at Citizens Services Offices (i.e., operating as “one stop shops”).

### B. Real Estate Environment

#### Current Property Registration System and Processes

**68. The State Committee of the Real Property Cadaster (SCRPC)** is responsible for recording all real estate (i.e., immovable property) transfers. It is the only government agency that is fully self-financed. It has seven branch offices (“territorial subdivisions”) across the country. Rights originating from real estate transactions (e.g., the transfer of ownership, right of use,

mortgage, servitude, other encumbrances, rights to personal property, as well as other rights stipulated by law) are subject to state registration.

**69. The SCRPC maintains the legal cadaster.** Armenia has been divided into cadastral territories, each with a unique cadaster code. Each cadastral territory is further divided into cadastral sub-territories, which cannot violate the borders of the communities and where each cadastral sub-territory is assigned an individual cadaster code. The cadastral sub-territories are divided into separate sectors, districts, and units, where each is assigned an individual cadaster code. Lastly, buildings and structures also have individual cadaster codes linked to the cadaster code of the corresponding plot. In short, the SCRPC is confident that it has an almost comprehensive record of each land parcel and (legal) building in Armenia. Databanks on real estate and rights and encumbrances to it exist in the territorial subdivisions of the State Register and are considered part of the information system of the overall State Register.<sup>25</sup>

**70. There are approximately 2.6 million properties in Armenia.** These consist of 1.64 million land parcels and 979,799 buildings. By 2004, when the Armenia Title Registration Project was completed, almost all the properties had been surveyed and by 2008 the central database contained more than 1.8 million property records. Transaction fees are nominal (about USD 15). There is no property transfer tax levied, nor, for natural persons, any capital gains tax when real estate is transferred. The short turn-around time for property transfers and the fact that much can now be done using the e-government platform, enhances public trust. However, the mission was informed by the Community Finance Officers Association (CFOA) that in some small villages there are still properties that have not been registered.

**71. Communities have access to the SCRPC's system and must monthly provide data on any changes to be made to the State Register.** Until 2012 staff from the SCRPC undertook site inspections to verify and measure all the changes (e.g., new construction, renovations or additions). However, due to capacity constraints within SCRPC this function has been outsourced to private contractors who have qualified staff to measure changes (e.g., square and cubic meters of buildings). Obtaining these data required by law is a laborious task.

## **Agricultural Land**

**72. A "land balance" of all agricultural land is performed annually with reference to total area (in hectares, (ha)).** The land tax base for 2017-2019 puts the total number of agricultural "units" at 880,841 (with a surface area of 651,564 ha). However, agricultural land was last "valued", for tax purposes, in 1997. These values were subsequently indexed in 1999. No amendments were affected to these "values" since. Given the current determination of "cadastral values" of land and buildings for purposes of the Real Estate Tax, agricultural land will not be

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<sup>25</sup> The SCRPC records linear infrastructure and even records transactions regarding the installation of electricity meters on private land.



revalued in the short term. According to the SCRPC it is too expensive to revalue all agricultural holdings, but detailed annual agricultural output is published by the Statistical Committee.<sup>26</sup>

**73. Most agricultural holdings are too small to be farmed commercially (see Table 12).**<sup>27</sup> In many instances citizens received title to land, but with no intention to farm commercially or to farm at all. During the era of privatization, many citizens received a number of small agricultural units, often located in different communities. The vast majority of agricultural land holdings are used for subsistence farming only. There is doubt whether there is an effective measure (by law) that would prohibit the further subdivision of agricultural land. According to European Union (EU) criteria holdings smaller than 1 hectare are not deemed to be for “agricultural use”.<sup>28</sup> This standard would apply to 60 percent of the holdings in Armenia (Table 12). This is important as government subsidies in the EU can only be provided in respect of holdings above the legal threshold. In Armenia, subsidies are provided even though the holdings are not taxed. To the extent these subsidies pertain to subsistence farming they are in reality social “benefits”. Redirecting these subsidies for other programs could be more growth-enhancing.

**74. Armenia’s geography and topography are diverse.** Some areas are extremely mountainous with a severe winter climate, whereas valleys in the south may produce up to four harvests per year. A uniform approach as regards the taxation of all agricultural land holdings is therefore likely to be problematic.

**Table 12. Armenia: Surface Area and Parcel Numbers of Agricultural Land**

Surface Area (ha)	%	Parcels	%
Up to 0.1	0.7	Up to 0.1	23
0.1 to 0.19	0.8	0.1 to 0.19	7
0.2 to 0.49	3.2	0.2 to 0.49	12
0.5 to 0.99	10	0.5 to 0.99	18
1 to 1.99	20.8	1 to 1.99	20
2 to 2.99	15.6	2 to 2.99	8.5
3 to 4.99	17.4	3 to 4.99	6
5 to 9.99	16.5	5 to 9.99	4
10 to 19.99	7.3	10 to 19.99	1
20 to 49.99	4.3	20 to 49.99	0
50 to 99	1.7	50 to 99	0
100 to 199	0.8	100 to 199	0
200 and above	0.9	200 and above	0
<b>100</b>		<b>100</b>	

Source: Statistical Committee, 2014.

## Multi-apartment Housing Stock

**75. The multi-apartment housing stock constitutes a significant portion of the overall number of buildings in Armenia.** In 2016, there were 19,005 apartment buildings in the country; 10,888 controlled by communities and 8,117 controlled by condominiums or accredited

<sup>26</sup> Formerly known as the National Statistical Service of the Republic of Armenia (NSSRA).

<sup>27</sup> This came about partly as a result of the land reform program in the 1990s. Land was distributed free of charge as private property to more than 310,000 individuals – World Bank 2008. This resulted in a fragmentation of agricultural holdings with many families owning noncontiguous land.

<sup>28</sup> In Scandinavian countries the cut-off size is 2 ha – according to the chairperson of the Statistical Committee.

property managers. The total number of apartment units in 2016 was 441,591.<sup>29</sup> According to a 2010 study commissioned by the World Bank,<sup>30</sup> a serious problem exists with regard to the current state of management and deficient maintenance of especially multi-apartment buildings owned and managed by communities. However, it is a problem in respect of many apartment buildings managed by owners or management agencies (i.e., in case of condominiums). This issue cannot be delinked from the stated objective to increase reliance on the real estate tax in future. Poorly-maintained apartment buildings impacts on the assessed values of the most significant component of the total building stock of Armenia (see below Table 17).

**76. Table 13 provides a summary of the multi-apartment housing stock in Armenia in 2008 by age.** Although dated, it is notable—and important for property tax purposes—that more than 60 percent of these building are older than 40 years and thus received a 40 percent statutory depreciation allowance in the relevant coefficient for determining their cadastral value. The reality is that many apartments in especially Yerevan are depreciated every three years under the current property tax regime. If land values are not increased and tax rates remain static, there is practically no buoyancy in the recurrent property tax system.

**Table 13. Armenia: 2008 Multi-Apartment Housing Stock by Age**

	<b>Total buildings</b>	<b>&lt; 1950</b>	<b>1951-1970</b>	<b>1971-1980</b>	<b>1981-1990</b>	<b>1991-2000</b>	<b>&gt; 2001</b>
Armenia	21,500	2,734	6,288	5,233	4,813	2,035	364
	100%	13%	29%	24%	22%	9%	2%
Yerevan	4,700	361	1,720	1,318	1,219	61	28
	100%	8%	37%	28%	26%	1%	1%

Source: RA Housing Stock and Communal Service 2008 – as quoted in Amann and Papa, 2010.

## Discussion

**77. The critical need to maintain and, where required, replace the housing stock reinforces the importance of a recurrent property tax as a benefit tax.** The mission has been informed that changes to the law on condominiums are imminent. Although it is beyond the mission's brief to review the current and draft law as it pertains to condominiums, the introduction of compulsory levies to be collected from the owners of apartments for the maintenance of common property (e.g., roofs, outside walls, entrance halls and staircases) is strongly supported. However, the introduction of these contributions may coincide with an increase in the property tax burden of the owners of apartments—especially for those apartments where the replacement of statutory depreciated values under the current regime with

<sup>29</sup> *Statistical Yearbook of Armenia 2017*: 191. A total of 416,812 units were in urban and 24,779 in rural areas.

<sup>30</sup> Amann and Papa, 2010. This report states: "Not less than 75% of all roofs and roof drain systems are in urgent need for repair. A growing number of residential buildings are in urgent danger of physical destruction. This situation aggravates the serious seismic risk in Armenia. Investments in housing repairs are insufficient. In 2008, less than AMD 1,000m (USD 2.7m) was invested in the whole stock of multi-apartment buildings. The extremely low maintenance fees of below AMD10 per m<sup>2</sup> per month (2.4 cent) allow for not even the most urgent repair works. Similar serious is the collection rate of hardly over 60 percent. Debts on maintenance fees are very difficult to levy."

market-related values will be significant. This reality of increased property tax liabilities must be appropriately managed and communicated to the public.

**78. The many “asset rich-cash poor” households living in high-value neighborhoods further contribute to the poor maintenance of many apartment buildings.** From a tax point of view this social issue must be treated with circumspection and sensitivity. However, owners and the broad public have an interest in the upkeep of an important part of the urban property tax base. As much as this phenomenon exists because of material increases in property values over time, it makes the case for the taxation of “economic rent” created by public service delivery to all property owners, those who can, but refuse to pay tax as well as those who want to but cannot afford to do so. This issue will be addressed when hardship relief is discussed.

### **Recommendation**

- The impact of higher compulsory contributions to maintain the common property of apartment buildings on poorer taxpayers needs to be addressed through hardship relief.

## **C. Current Land and Property Tax Legislation**

### **Land Tax**

**79. The land tax is levied under the *Law on Land Tax of 1994*.** Since 2006 the tax is collected by communities—before then it was done by the SRC. The taxpayers are landowners as well as permanent and temporary users of state-owned land. If land is leased, the tax is paid by the lessor. The tax differentiates between agricultural and non-agricultural land. For agricultural land the base is the “net income” determined with reference to the cadastral value (AMD/ha) and the tax rate is 15 percent. For non-agricultural land the base is the cadastral value expressed as AMD per hectare and differentiated tax rates are applied with reference to use. The rate for land used for industrial purposes is 1 percent if located in urban areas and 0.5 percent in rural areas. For forest stock and any other non-agricultural use, the rate is 1 percent.

**80. With a few exceptions, taxpayers engaged in commercial farming are exempt from the profit tax.** By paying a land tax they at least would contribute. Taxpayers receiving more than 25 percent of their income from non-agricultural activities are not exempt from the profit tax on income from these other activities. Various tax benefits (i.e., exemptions) and rebates of 50 percent (e.g., for citizens exempt from income tax in respect of land they own) apply. Legal entities (except commercial farms) self-assess and submit their tax returns by September 1 each year to the communities. Natural persons and commercial farms are billed by the communities. Institutions pay tax quarterly whereas citizens and commercial farms pay in two installments.

## Property Tax

**81. Property tax is levied in terms of the Law on Property Tax of 2002 and is collected by communities since 2006.** Taxpayers are owners of property located and registered in Armenia. Central and local government bodies and the Central Bank are tax exempt. Taxable objects include buildings and “constructions”, as enumerated, as well as vehicles.<sup>31</sup> Buildings and constructions are categorized on the bases of use (e.g., residential, garage, “public” (i.e., commercial or industrial)), type (e.g., detached house, garden house, and apartments), as well as state of construction (i.e., completed, under construction, and newly built).

**82. The tax base is the cadastral value of buildings or structures.** For example, for apartments it is a composite formula which is the product of the total (internal) area of an apartment in square meters times a coefficient for location (area zoning); roofing; internal apartment height (i.e., volume); quality of apartment floor; degree of damage of the building; wear and tear of the building (up to a maximum of 40 percent); and degree of completion of the building. Although the mathematics is relatively simple, this system requires a lot of data. It is common knowledge that cadastral values are for the most part much lower than market value.<sup>32</sup>

**83. Differentiated tax rates are applied to some of the diverse property categories.** Differentiation is done with reference to use (e.g., residential, commercial, and industrial), type (e.g. residential apartments and garages), and value (residential properties). In respect of residential properties, a progressive rate structure is applied. It commences with a AMD 3 million zero-percent value threshold.

**84. Various tax benefits (i.e., exemptions) are listed in the law.** These include: storage reservoirs, linear infrastructure, persons who are serving in the military, property of deceased soldiers with children under the age of 18. Communities are also entitled to use 10 percent of the annual property tax revenue for targeted hardship relief and without compromising community budgets. Those eligible for relief are identified through the social security ‘means-tested’ system. Individuals pay property tax annually to the community budget, whilst institutions pay quarterly.

**85. In 2013, the tax on real estate (i.e., buildings) was 26.6 percent of total local taxes and duties.** It decreased over time and in 2016 was only 23.3 percent. The overall revenue increase from property taxes is primarily attributable to the tax on imported vehicles (Table 14). From 2012 to 2016, land tax decreased both in nominal terms and as a percentage (from 21 percent to 15.3 percent) of total local taxes and duties.

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<sup>31</sup> The property tax on vehicles is not discussed in this report.

<sup>32</sup> Central Bank of Armenia, 2018.

**Table 14. Property and Land Tax Revenue for 2012-2016**

	2012		2013		2014		2015		2016	
	AMD mln	%	AMD mln	%	AMD mln	%	AMD mln	%	AMD mln	%
Property Tax: Vehicles	6,761.7	33.8	7,462.6	35.3	9,122.0	39.2	9,795.8	41.2	10,657.5	43.4
Property Tax: Real Estate	5,327.2	26.6	5,306.3	25.1	5,380.4	23.1	5,584.7	23.5	5,702.0	23.2
Land Tax	4,209.3	21.0	4,157.6	19.7	4,108.0	17.7	3,952.2	16.6	3,761.4	15.3
<b>Property Tax &amp; Land Tax</b>	<b>9,536.5</b>	<b>47.6</b>	<b>9,463.9</b>	<b>44.8</b>	<b>9,488.4</b>	<b>40.8</b>	<b>9,536.9</b>	<b>40.1</b>	<b>9,463.4</b>	<b>38.5</b>
<b>Total Taxes and Duties</b>	<b>20,034.5</b>	<b>100.0</b>	<b>21,121.5</b>	<b>100.0</b>	<b>23,260.1</b>	<b>100.0</b>	<b>23,790.3</b>	<b>100.0</b>	<b>24,553.6</b>	<b>100.0</b>

Source: Statistical Yearbook of Armenia 2017.

## D. The Real Estate Tax Proposed by the Tax Code

### Taxpayer and Tax Base

**86. Section 11 of the Tax Code provides for a real estate tax.** This tax was supposed to be implemented on January 1, 2018. However, the implementation of Section 11 was postponed to January 1, 2020 through an amendment of the Tax Code enacted in December 2017. It maintains the existing architecture of the land and property tax regimes in terms of rate structure, tax relief, exemption, tax billing and collection, while raising the cadastral value of property units (land and/or buildings) to more closely approximate their respective market values. In short: Section 11 is a substantive step towards a future market value-based property tax.

**87. Natural and legal persons are liable for the tax on land and buildings owned and located in Armenia.** As was the case with the land tax and property tax, state administration institutions, community administration institutions (i.e., communities), and the Central Bank of the Republic of Armenia are tax exempt. Tax objects include land (e.g., undeveloped, agricultural, or developed land) and capital improvements thereon. The following property is subject to tax: residential houses (i.e., detached dwellings), residential apartments, summer houses, cottages, garages, public (i.e. commercial and business) buildings, industrial buildings, as well as partly-constructed and newly constructed buildings.

### Exemptions

**88. Apart from the exempt status afforded to central and local government as well as the Central Bank, Article 230 provides the following list of property tax exemptions (i.e., tax benefits):** natural reserves, national parks, botanical gardens, state forests, property owned by diplomatic / international organizations, newly planted vineyards and orchards until commercial harvest commences, places of worship, monuments and sites of historical importance, sites with linear infrastructure,<sup>33</sup> water reservoirs, properties belonging to persons killed during combat until a child of such a person attains the age of eighteen, postal communication networks, and property in free economic zones (the latter is not supported), persons who are doing compulsory military service in the Armed Forces (unless the property is

<sup>33</sup> This includes automobile roads; railway lines; bridges and pipes; automobile and railway tunnels; hydro-technical tunnels; industrial transport (monorail runway, conveyor transport, pipe and container); elevators; urban electrical transport corridors; gas, oil, water, heat supply networks; sewage collectors; trunk pipelines; etc.

rented out), or who has completed military service for a property to the extent that it does not exceed AMD 40 million, is not rented out, or was only acquired after termination of service.

**89. A 50 percent rebate applies in respect of some organizations.** These are: agricultural and forestry research organizations, testing, experimental, seed-growing, planting, pedigree livestock-breeding and sort-testing organizations, stations and other establishments of scientific and research organizations and educational institutions, pursuant to the list confirmed by government. Upon a suggestion of the community head, a community council may provide subsidies to taxpayers not exceeding 10 percent of the property tax revenues of the community budget. These subsidies may not be recouped from the state budget.

## Cadastral Values

**90. The Cadaster Committee is tasked with the provision of the cadastral values used for land and property tax purposes.** The last valuation was undertaken with a reference date of July 1, 2016. This critically important task is presently performed by a small staff component—consisting of three specialists and several data analysts. None of these staff members are certified valuers. The small cohort of 70 certified valuers in Armenia are all employed in private practice. Some of them are currently (2018) involved in the creation of the new land value zones.

**91. Presently there are eighteen land value zones for tax purposes.** These date back to 2002 (with some amendments made in 2005). However, material changes have occurred in the land market since then. For purposes of the unified Real Estate Tax new land value zones are currently being created and according to the SCRPC will be completed in 2018. The SCRPC is confident that the new value zones will approximate market value more than the current zones.

**92. The new land value zones are created using market evidence.** Sales data was collected for the last five years on transactions across the country. Private sector valuers were contracted to review 40,000 transactions pertaining to land parcels (and 10,000 transactions relating to buildings).<sup>34</sup> These transaction prices constitute dots on the cadastral map. Based on these base values, more than 30 “blocks” were mapped to determine value zones. The outsourced work is monitored by the SCRPC. There is no clarity on the final number of land value zones across the country, but according to the SCRPC it may be between 30 and 40. The higher the number of zones, the more closely—at least in theory—can market values be approximated.

**93. Cadastral values are determined every three years.** Amendments to coefficients and/or values per square meter are only legislated as and when deemed necessary through a government decree. Changes (e.g., subdivisions, new construction, changes in ownership, etc.) are reported by communities and recorded by the SCRPC. Research done by the Central Bank of Armenia suggests that cadastral values are significantly lower than market value.<sup>35</sup>

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<sup>34</sup> According to the SRC a further 100,000 transactions will be analyzed to fine-tune the zones.

<sup>35</sup> See Central Bank of Armenia, *Tax Reforms and Their Macroeconomic Effect*, 2018.

## Tax Rates

**94. Armenia applies differential rates based in a combination of use, location and/or property type, as well as progressive tax rates in respect of residential use based on value.**

The following rates are applied to *different types and uses of land*: (1) a 15 percent rate for the cadastral value (expressed as “net income value”) of agricultural land; (2) 0.6 percent for community rural land with residential development rights; (3) 1 percent for land used for industrial purposes (including mines, transport, communication, radio, television, defense, land occupied by gas pipelines, and water resources) if located in urban areas and 0.5 percent if located in rural areas (i.e. outside settlements); (4) 1 percent for forest stock; (5) 1 percent for all other non-agricultural lands; and (6) public and industrial buildings at 0.3 percent.

**95. Differential tax rates are also applied in respect of buildings.** Differentiation is applied as follows: (1) for residential buildings the rates are progressive, starting at 0.1 percent for values exceeding AMD 3 million and additional rates of 0.2, 0.4, 0.6 and 1.0 percent for property valued above AMD 40 million; (2) for commercial and industrial buildings the rate is 0.3 percent; and (3) for garages the rate is 0.2 percent. The respective tax rates for commercial and industrial buildings, and garages, are also applied to (1) similar buildings whilst under construction; (2) recently completed or renovated, but not yet registered with the state registry; or (3) illegally constructed. Local communities have limited autonomy to raise the centrally-determined rates by up to 10 percent for raising property taxes that are assigned for local budget financing purposes. The *annual agricultural land tax* rate, based on cadastral value, is 15 percent of the “calculated net income” of the cadastral value—as is the case under the present system. Special exemptions are set during periods of drought.

## Tax Administration and Enforcement

**96. One of the few changes effected by the Tax Code is to eliminate the voluntary system of property tax assessment and declaration by companies, which they then submit with payment.** Communities will be directly responsible for maintaining the calculation of tax liabilities per property parcel for all taxpayers—natural persons and legal persons or institutions (business and industry). Communities will also retain responsibility for billing and collection of payments to the community budget for property tax for all taxpayers.

**97. The Tax Code should ideally refer to the enforcement mechanisms used for the collection of local taxes.** Delinquent taxpayers are handed over to the enforcement agency in the Ministry of Justice. This agency uses whatever appropriate enforcement mechanism is required in terms of the law to recover the outstanding tax and retains a 5 percent collection fee. Although a sale in execution is a statutory option, this is not used in practice due to the political implications. Also, courts are seldom used due to the cost and time it takes to resolve disputes.

## E. Evaluation of the Real Estate Tax and Draft Valuation Law

**98. The primary goal with the inclusion of a unified real estate tax in the Tax Code seems to be simplification.** When this tax becomes effective on January 1, 2020, the two laws currently governing land tax and property tax respectively will finally be repealed. The authorities are keen to increase the revenue take from the recurrent property tax given the realization that cadastral values more closely aligned with market prices will translate into increased tax liabilities. Yet, the public will likely resist on the basis that the increased tax burden is unaffordable (see discussions hereafter). The mission was tasked to provide advice on improving the revenue productivity of the property tax. This entails a review of the design of the tax (e.g., tax base determination, rate setting, and granting of relief) in order to get broader buy-in from taxpayers and resolving other challenges with aligning cadastral values with prevailing market prices.

**99. Since the 2015 TA mission, the Armenian authorities took two important steps as regards the taxation of real estate.** The first was the implementation of the Tax Code on January 1, 2018. Although the implementation of Section 11, which deals with real estate tax, had to be postponed for two years, it was a first step towards a market value-based property tax.

**100. The operation of the two taxes on real estate has largely been maintained in the Tax Code.** The most important changes are: (1) the separation of immovable and movable property (with the tax on vehicles now contained in Section 12 of the Tax Code); and (2) the consolidation of two separate laws in Section 11 of the Tax Code. The determination of separate assessments of values for land and buildings has been maintained. A single tax bill will be calculated with reference to the assessed values and relevant tax rates of the land and building components. Section 11 of the Tax Code largely maintains the status quo until a comprehensive market value-based property tax system is implemented in Armenia.

**101. The second important step in the migration to a market value system was the preparation of a new draft law containing the methodologies for determining “cadastral values”.** Once enacted, this law will provide the methodologies for determining taxable values in what should be viewed as an interim phase (commencing January 1, 2020) towards a market value-based system. The procedures (i.e., different formulae) for determining cadastral values, as proposed in the Draft Law on Cadastral Values, are less complicated than the procedures used for the property tax and reiterated in Annex 1 of the Tax Code. However, these processes must be explainable to taxpayers in simple terms. This will likely require the drafting of manuals that should contain some examples of how to calculate values and resulting tax liabilities. In the absence of an objection and appeal process—given that the values are tax values, not market values—it will assist taxpayers to understand the basis of their tax liability.

### Proposed Real Estate Tax

#### *Taxpayer, tax base, and cadastral value*



**102. Identifying owners and “permanent” users of state-owned land as taxpayers conforms to international practice.** Land and “structures” (primarily buildings) are broadly defined and in line with international norms as regards taxable objects. The explicit inclusion (rather than an exemption) of unfinished construction and newly-constructed buildings is a very good practice as these buildings consume local services.

**103. The rather detailed depreciation coefficient applied to multi-apartment housing stock may indeed be an approximation of Armenian reality.** When it is, however, combined with land values and tax rates that remain static over time, it has a significant impact on buoyancy of the base and ultimately on tax revenues. The resultant lack of buoyancy is a constraint often associated with systems that approximate rather than determine actual market values. If the coefficients in the formulae for the valuing land and buildings remain static—as is the case under the current system in Armenia—there is limited potential for increasing the base and ultimately tax revenue. This is most apparent in the case of land.

### ***Tax benefits***

**104. Political, socio-economic, and practical considerations all impact on the property tax—and related designs of tax benefits.** Tax incentives or privileges are sometimes reflected in adjustments to the tax base (through exclusion of properties); by way of property assessment (allowing for a value reduction or preferential valuation); adjustments to the tax rate (through rebates, exemptions, differential rates, rate capping, phase-in provisions, or extended tax holidays); deferment of the tax liability (i.e., mortgaging outstanding payments); and income tax deductibility. Tax jurisdictions usually employ these measures to accommodate economic hardship cases or to pursue some development or investment policy.

**105. The Tax Code provides an extensive list of “tax benefits”.** To a large extent these conform to international norms. The rather peculiar benefits for those doing or who have just completed compulsory military service make sense in the Armenian context. The mission was informed that these individuals receive no salary while doing military service and only applies to residential property that does not generate rental income. As such they would generally qualify for hardship relief. The tax benefits listed in the Tax Code are generally justifiable and do not constitute a significant erosion of the tax base. International best practice would, however, suggest that the list should not be extended.

**106. Armenia is seeking to increase revenues of the property tax.** It is likely that a growing property tax liability will lead to public resentment and increased demands for a variety of relief measures. Relief based on economic or social grounds should preferably be granted through properly designed tax relief schemes (e.g., rebates or deferment), not through blanket exemptions. Hence, the authorities should elect early on measures that accommodate true hardship cases without undermining the integrity of the property tax, and without unnecessarily eroding its revenue potential. Targeted tax relief—either permanent or temporarily—could be offered. Finally, the granting of hardship relief should ideally be for a time-limited period only.

## **Value threshold**

**107. There are measures that could provide general relief, such as forgiving property tax for those living in properties below a stated size or value threshold.** The poor often live in areas or neighborhoods with limited infrastructure and, as a consequence, low assessment values for their properties. A value threshold is preferable to one based on the size of a property. The latter is regressive because it gives more relief to those in luxury apartments or homes in good locations than to those in modest apartments or homes of similar size in poorer locations.

**108. Value thresholds are encountered internationally (e.g., Cambodia, Egypt, Lithuania, and South Africa).** In Egypt, the threshold was set so high that more than 90 percent of the tax base is excluded. In South Africa (SA), the threshold is applied only in respect of residential property. The SA law prescribes a low minimum value threshold, which applies country-wide, but municipalities have the statutory authority to determine a higher threshold on the basis of their own peculiar circumstances (e.g., average residential property values and income levels). Across South Africa the present threshold varies between the statutory minimum of approximately USD 1,300 (used in some poor rural municipalities) and USD 22,000 (in Johannesburg). The value threshold amounts to a deduction from the taxable value as it is impermissible to tax the value below the threshold of residential properties, so even the wealthier residential taxpayers receive some benefit.<sup>36</sup> As suggested above, introducing a low minimum value threshold below which no property tax is payable is considered a practical mechanism to accommodate taxpayers with low incomes in neighborhoods with predominantly low value properties.

**109. However, the Armenian value threshold of AMD 3 million for residential properties is problematic.** It applies to more than 86 percent of the total building stock. In Abovyan, 80 percent of the residential properties fall below this threshold and cannot be taxed. This is also true for many other communities, especially those in remote areas. It cannot simply be assumed that all property owners of remote villages are poor. Property value is generally a good proxy for the service levels, but not for a taxpayer's ability to pay. Although a "blanket approach" has some administrative appeal, it may have unintended consequences. South Africa applies a low, minimum value threshold across all municipalities. Even this threshold may be waived if it would prove detrimental to a municipality's tax base. Municipalities determine their own value-thresholds (there is no maximum). Typically, municipalities with a large tax base and high-value properties have high value thresholds to assist vulnerable residents in low-value areas. The value threshold is a crude measure to address property owners who are "asset rich, but cash poor". Yerevan may need to have a higher value threshold, but this should not undermine the tax base of smaller communities in other regions in the country.

**110. The mission would like to caution against increasing the current residential value threshold as an option to address the plight of the poor as revenues and the burden from**

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<sup>36</sup> For example, in Johannesburg a residence valued at USD 30,000 will only be taxed on USD 8,000 (i.e., the amount exceeding the threshold).

**the property tax are gradually increased.** It is appealing from a political visibility point of view, but its revenue impact is already material, and a threshold increase may be counterproductive and for some communities catastrophic. Relief should rather be granted through temporary rebates or the deferral or mortgaging of the tax debt—discussed below. Most importantly, and if administratively feasible, it should be means-tested.

**111. The value threshold must be revisited.** Its impact on effective tax rates is evident from Table 15. A more appropriate value threshold must be determined so as not to be too generous or too restrictive. This is indeed a risk if a single threshold is applied country-wide. It could be that a regional threshold would be more suited to the real estate market. Research by the Central Bank indicates that 27.0 percent of residential property in Armenia fall below the AMD 3 million threshold; 41.8 percent between AMD 3 million and AMD 10 million.<sup>37</sup> So, almost 70 percent of the residential properties in Armenia pay no tax or a tax with a maximum nominal rate of 0.1 percent. The highest effective rate – for a property valued at AMD 10 million is 0.071 percent.

**Table 15. Effective Tax Rates for Residential Property**

Tax Base	Tax Rate	Illustrative Value	Effective Tax Rate
up to AMD 3 million inclusive	0 percent	AMD 1.5 million	0.000 percent
over AMD 3 million and up to AMD 10 million inclusive	AMD 100 plus 0.1 percent of the part exceeding AMD 3 million of the tax base	AMD 6.5 million	0.055 percent
over AMD 10 million and up to AMD 20 million inclusive	AMD 7 100 plus 0.2 percent of the part exceeding AMD 10 million of the tax base	AMD 15 million	0.114 percent
over AMD 20 million and up to AMD 30 million inclusive	AMD 27 100 plus 0.4 percent of the part exceeding AMD 20 million of the tax base	AMD 25 million	0.188 percent
over AMD 30 million and up to AMD 40 million inclusive	AMD 67 100 plus 0.6 percent of the part exceeding AMD 30 million of the tax base	AMD 35 million	0.277 percent
over AMD 40 million	AMD 127 100 plus 1 percent of the part exceeding AMD 40 million of the tax base	AMD 60 million	0.545 percent

Source: IMF staff calculations.

**112. Another way of addressing potential hardship is through hardship relief schemes that will ideally target only those in need of relief.** Examples of property tax hardship relief programs exist in many countries (e.g., Australia, Canada, Estonia, Moldova, South Africa, and the United Kingdom). In most instances, it will range from partial relief (e.g., a rebate of a certain percentage) to a full exemption. It is often based on pensionable age and/or disability, and usually “means-tested” (see the example in Table 16)—as not all pensioners, or elderly or disabled individuals are necessarily poor. Taxpayers should annually apply in writing for the relief. They must also submit sufficient proof that they indeed qualify. Also, it should only apply in respect of a taxpayer’s primary residence. Although the central government could publish guidelines in this regard, ideally each self-governance unit should design its own jurisdiction-specific tax relief scheme. However, such a scheme presupposes the necessary capacity to properly design and diligently administer the provisions of the scheme. Table 16 provides an example of the current hardship relief scheme in the City of Tshwane (i.e., Pretoria), South Africa. It is “means-tested” and granted to temporarily unemployed residential taxpayers on application. Importantly, it considers the income of the total household, not only the income of the taxpayer.

<sup>37</sup> Only 7.6 percent of residential properties have values exceeding AMD 40 million.

**Table 16. Temporarily Relief based on Household Income**

Minimum Gross Monthly Household Income	Rebate (%)
ZAR 0 to ZAR 7,000	60
ZAR 7,001 to ZAR 8,000	50
ZAR 8,001 to ZAR 9,000	40
ZAR 9,001 to ZAR 10,000	30
ZAR 10,001 to ZAR 11,000	20
ZAR 11,001 to ZAR 12,500	10

Source: City of Tshwane 2018

**113. Through exemptions and rebates, although well-targeted, a local government forgoes revenue permanently.** It may also be difficult to quantify the revenue forgone. In some instances, it may therefore be more appropriate to rather defer tax liability of a cash-strapped taxpayer until the property is transferred through a deferment scheme.

***Possible deferment (i.e., “mortgaging”) of property tax liability***

**114. As an additional hardship-relief option, some jurisdictions (e.g., British Columbia, Canada and North Carolina, United States) operate a tax deferment scheme.** Deferment of property tax was explained in detail in the 2016 TA report.<sup>38</sup> In an often highly politicized property tax environment, tax deferment could be an effective measure to deal with “asset rich, cash poor” taxpayers (e.g., some pensioners) or even in respect of absentee landowners. It is an option that is well suited to transition economies where many tenants of government-owned apartments were granted ownership rights—especially where the values of these apartments have increased materially over time as the property market developed. This is the case in most Central and Eastern European countries and former member states of the Soviet Union.

**115. In terms of a deferment scheme, taxpayers allowed to participate in the scheme, can go in arrears with their property tax payments.** Interest at reasonable rate should be charged on the outstanding amounts. For the unemployed, the arrears of their property tax bills would start to become payable when they return to gainful employment, but with suitable phasing.<sup>39</sup> In all cases, under a deferment scheme, arrears would become due in full when the property is alienated (e.g., through sale or inheritance). At this point, the deferred tax is collected with interest. Internationally, deferment schemes are typically reserved for the elderly or exceptional circumstances only, given the potential impact that these legitimate “arrears” may have on a municipality’s cash flow. Careful design of the scheme is paramount: significant uptake of a mortgaging program that is too generous (e.g., as regards eligibility criteria and/or the interest charged on the deferred tax), may have an impact on a jurisdiction’s current revenues. For example, by June 2018, about 3 percent of British Columbia’s property taxpayers had approved tax deferrals. The deferred amount was about CAD 970 million—approximately 13

<sup>38</sup> 2016 TA report: 52-53; and 2016 TA Report Supplement: 61-62.

<sup>39</sup> For example, previously unemployed property taxpayers could be required to make accelerated repayments of say 120 percent of their current property tax until arrears are fully wiped out.

percent of the total potential revenue. Lastly, a deferment program also presupposes the administrative capacity within the municipality to design and manage the program.

### ***Tax rates***

**116. Differentiated tax rates are widely used globally.** The most common way of differentiating is between residential and non-residential property (e.g., United Kingdom). This is done in many countries and almost in all cases residential taxpayers will be taxed at lower rates than non-residential taxpayers. Generally, the differentiation is based on the following: (1) the use of the property (e.g., Canada, South Africa, United Kingdom); (2) the location, for example, urban as opposed to rural (e.g., Western Australia); (3) the type of property, for example, land and/or buildings (e.g., Armenia, Namibia, Romania); (4) value (e.g., Jamaica, Morocco); and (5) ownership, for example, natural persons as opposed to legal entities (e.g., Romania, Serbia).

**117. Armenia's current tax rate differentiation is too extensive.** There is differentiation on the basis of use, location, property type, and value—as noted above. With tax theory and international best practice, as well as equity, transparency and efficiency in mind, some simplification is called for. Simplification will also contribute to the eventual migration to a market value-based system where value rather than tax rate(s) should be the most important element in distributing the tax burden fairly and equitably.

**118. The progressive rate structure applied to residential property should seriously be reconsidered, as it is not appropriate for a local tax.** It introduces administrative complexity and opportunities for arbitrage. Relating it back to the fundamental principles of a tax system as stated in Article 3 of the Tax Code: the differentiation and progression cannot be justified based on simplicity, equality, and transparency. If the property tax is a benefit tax, why introduce progressive rates? Cadastral values, closely approximating the market, introduce progression.

**119. The same argument that applies to value thresholds, generally also applies to uniform, country-wide tax rates.** The basic policy principle remains valid: revenue is a function of base and tax rate. Tax base is generally determined nationally (although not always), but rates should be determined locally. It also conforms to the principles of fiscal decentralization and accords with the spirit of the EU Charter on Local Self-Government—signed (2001) and ratified (2002) by the Government of Armenia.<sup>40</sup> In countries with mature value-based property tax systems large cities often have tax rates that are lower than those applied in small towns, simply because of the size and value of their base. Allowing municipalities to determine their own tax rates, albeit within a range of minimum and/or maximum rates, or another form of oversight (e.g., ministerial approval), will give a small municipality with low property values an opportunity to increase its tax rates within the context and constraints of its own budgetary requirements. Of course, central oversight would be appropriate and is a common global practice.

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<sup>40</sup> The 2002 Law on Local Self-Government is modeled on the EU Charter.

**120. Static tax rates should also be reviewed.** When these are combined with land values that remain static and building values that are depreciated over time, they have an eroding impact on the buoyancy of the base and ultimately on tax revenues. Best practice suggests, therefore, annual rate setting.

### ***Tax administration***

**121. The CFOA confirmed that the MMIS is not functioning in all small communities.** The lack of a proper IT system increases the risks for corrupt practices. It gives further impetus to the need to further consolidate small communities or work towards the creation of inter-community unions. In some villages unregistered land is impacting on the property tax base coverage.

**122. Absentee landlords abound throughout Armenia.** This creates problems for communities in areas of billing, collection and enforcement. If the tax debts are small (as is mostly the case for the land tax) it is hard to act against delinquent taxpayers. The enforcement agency is also not interested to assist with the collection of outstanding amounts that are small.

**123. The mission does not support the amendment of the installment cycle from six monthly to annually for companies.** It unnecessarily benefits companies and adversely affects the cash flow of communities with significant economic activity. This may not yet be an issue—given the low burden of the tax, but as its importance increase over time, it will be an issue.

**124. Administrative court procedures are expensive and take a long time to resolve.** This was confirmed by the CFOA and authorities in Jrvezh and Abovyan (see Appendix 7). Therefore, “outsourcing” enforcement to a specialized unit within the Ministry of Justice is supported since it also allows the community to maintain a less adversarial relationship with its citizens.

### ***Recommendations***

- Consider lower, regional value thresholds for residential property.
- If a national value threshold for residential property is retained, it should be lower than the current AMD 3 million.
- Simplify the tax rate structure, by differentiating only with reference to use.
- Implement annual local rate setting as part of the decentralization initiative in the medium term—but within a centrally-determined range of rates.

### ***Draft Law on Valuation for Real Estate Tax Purposes***

**125. A draft law on the methodology to be used to determine cadastral values is currently in preparation to accompany Section 11 of the Tax Code.** This draft law was shared with the mission and will be reviewed only briefly—as it has not yet been approved by Parliament and much of the detail (e.g., sizes of coefficients for quantitative and qualitative characteristics of

buildings) must still be defined by the government. But, as stated above, once enacted this law may become an important stepping stone towards the eventual goal—a tax based on market value. The coefficients stipulated in the draft law are slightly less detailed than the ones in the current law and the proposed Tax Code. This is a step in the right direction. The goal with the current and proposed methodologies remains the same: i.e., these are measures to approximate, not to determine, “market value”. Still, it harbors an inherent danger: how much data are required for such an approximation for tax purposes? It must be kept in mind that an approximation of value is often a simple, pragmatic approach and ideally a process that could involve the taxpayer, rather than a government department or agency. Examples from several cities in India suggest that four to six simple factors, each with only a few variables, can approximate value for tax purposes in a manner that taxpayers can relate to and can do themselves. For illustration purposes, Appendix 8 summarizes the simple unit area value system used in New-Delhi, India.

**126. The proposed formulae still rely on a significant quantity of data.** It is questionable whether some of the coefficients significantly add to the approximation to the extent that the gathering and maintenance of these data are justifiable. It implies a direct and indirect cost. Costs are currently incurred in employing private companies to measure the interior floor area (square meters), height of each floor (i.e., story), inter-floor ceiling type, quality of finishing, etc. Furthermore, there is too much subjectivity built into some of the criteria—e.g., the level of damage to the property. The more data required to determine the values to be used the more complex the system becomes. It is in essence a balancing act between simplicity and equity. The loss of transparency and simplicity also imply an indirect cost. Taxpayers need not necessarily grasp the underlying principles and relative “value” of each individual multiplier but should understand the aim of the formulae and perceive these to treat equally situated taxpayers equitably. As stated, a simplified tax system relying on static coefficients lacks buoyancy. It is therefore important that at least the determination of land values should closely approximate market value. Land is where the buoyancy is best captured, and it is also the component of real estate that does not experience as much physical change, i.e., depreciation of buildings.

### **Recommendation**

- Simplify the determination of cadastral values as proposed in the Draft Law even further by deleting characteristics in the formulae that only have a minimal impact on value.

## **F. Tax on Agricultural Land**

**127. Many countries tax agricultural land.** Some countries (e.g., Republic of Ireland and the United Kingdom), however, completely exempt agricultural land from tax. In countries that indeed tax agricultural properties, they will often attract some form of favorable tax treatment with regard to the property tax. A common practice (e.g., New Zealand and all 50 states in the United States) is to provide for preferential valuation – i.e., in lieu of assessing farms at their market value (being analogous to tax them at the capitalized cash flow from their potentially best use), they are assessed only at the value of their current use. The value of agricultural land is

informed by its potential selling price as if it were to continue to be used as a farm. Yet, there are alternative uses for a farm such as for property development as a result of urban sprawl.

Montenegro and South Africa value agricultural land at market value. However, the tax rate that can be applied to such land in South Africa is limited to 25 percent of the tax rate determined by the relevant municipality for residential property. Namibia also taxes commercial farms. The tax base is the unimproved land value of these farms as determined by the Ministry of Land Reform. Moreover, in Namibia foreign ownership and ownership of more than one farm attract a higher tax rate. As in Armenia, the Russian Federation taxes agricultural land based on cadastral values.

**128. Area-based assessment for an agricultural land tax is common.** It is encountered in the Caribbean, in Central, Eastern and South-Eastern Europe (e.g., Kosovo, Moldova, Poland, Romania, Slovenia), Belarus, Georgia, and Tajikistan. The best example for the area-based regime is the taxation of agricultural land where farm property is assessed per hectare/acre. The system can be further refined by varying the unit value/rate according to the farm property's inherent productivity index which is informed by location (region, accessibility to markets, availability of irrigation, etc.), soil fertility (water, climatic conditions, soil quality, hilliness), or the type of crops grown on the land.

**129. The mission proposes the adoption of a flat area-based land tax for land used for agricultural purposes in those instances where the market value approach cannot deliver an acceptable outcome.** This is the case when a region does not experience a modest frequency of sales transactions. The valuation of commercial farms is complex and in the absence of more frequent market sales becomes challenging. Generally, this component of the draft property tax design is in line with the mission's preference for an overall pragmatic tax design focusing on simplicity and to broaden the tax base. To reflect the economic challenges faced by agriculture and the vast number of small subsistence farms (see Table 12), the mission is of the view that an area-based system, possibly with an area-threshold, should be applied. For example, the more than 78,400 agricultural holdings of less than 0.1 hectare could be excluded, unless used profitably.<sup>41</sup>

**130. For commercial farms the current value-based system land tax should be retained as an interim measure.** Ideally, the seriously outdated cadastral values, last updated in 1999, should be reassessed—although the mission is cognizant of the SCRPC's comments on the costs involved. As Armenia prepares for the implementation of a market value-based system, it will be important to also determine the market value of all agricultural holdings. In addition, if a subsistence farmer holds several agricultural parcels the area-threshold should preferably only apply to one holding. Agricultural land, which is either idle or unproductive and being held for speculative purposes, should attract a penalty tax rate designed to persuade the owner to either use the land productively or to sell the land.

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<sup>41</sup> According to the 2014 Agricultural Census there were 206,338 agricultural holdings smaller than 1 ha in 2014.



## Recommendations

- Small subsistence farms should be taxed using a simplified area-based approach.
- When market values are introduced, commercial farm land should also be assessed to market value and an appropriate tax rate specified.
- In the interim, the 1999 cadastral values of agricultural land must be reassessed or indexed to better approximate market values; and the land tax should be levied accordingly.

## G. Revenue Potential of an Enhanced Property Tax System

### Real Estate Tax

**131. Internationally, and especially in developing countries, property tax rates are generally very low, explaining partially property taxes' low revenue importance expressed as percentage of GDP.** Armenia intends to raise more revenues from the real estate tax—if a property tax collection range of 0.6 to 2 percent of GDP is pursued—it would be globally towards the high end. This goal would necessitate a close approximation of market values for both land and buildings through regular revaluations and responsive (nominal and effective) tax rates.

### *Enhancing revenues from the (interim) Real Estate Tax*

**132. Moving over time from cadastral values to market values will enhance the revenue take from both the land and buildings considerably.** Land tax revenue has been in decline from 2012 to 2016, although 2017 saw an almost 11 percent increase—probably as a result of the new cadastral values that were implemented for non-agricultural land on July 1, 2016. The property tax from buildings increased somewhat in 2014 as new cadastral values were decreed with effect from July 1, 2013 (see Table 14). This reconfirms the importance of regular reassessments of value to ensure tax base buoyancy and optimal valuation coverage. However, the real growth in property tax revenues came from the tax on vehicles.

**133. It is generally accepted that cadastral values are well below market values.** A study by the Central Bank of Armenia (2018) argues that cadastral values are, on average, between 60 and 70 percent lower than market values. The data analysis provided by the Central Bank on residential apartments were used to illustrate the revenue potential of a property tax that more closely approximates the market than is currently the case. The residential apartment sector constitutes almost 44 percent of Armenia's building stock. Given the data limitations, some broad assumptions were made. It is quite apparent that a tax levied on a more market-related tax base can generate more revenue just from residential apartments than is currently collected from the property tax on all buildings and constructions.

**134. Two simple scenarios are presented to illustrate the potential revenue in case of residential apartments—being the most important sector of the built environment.** As is

evident from Table 17, residential apartments constitute 43.96 percent of the total number of buildings and constructions. For both scenarios average market prices (per m<sup>2</sup>) were used—as presented by the Central Bank (Central Bank, 2018). These are different for Yerevan and the 10 regions. An illustrative tax rate of 0.1 percent is used. This is the tax rate applied to residential buildings (i.e. houses and apartments) in the cadastral value band between AMD 3 million (the value threshold in the current law) and AMD 10 million. A 100 percent collection rate was assumed for purposes of both scenarios.

**Table 17. Armenia's Total Building Stock**

Region/ Yerevan City	Total Number of Buildings/ Constructions	of which:							
		Apartments	Residential houses	Lodges	Non- residential	Multi- Apartment Buildings	Commercial	Industrial	Garages
Yerevan	361,944	243,503	57,833	1,750	1,835	74	23,562	5,676	27,711
Ararat	17,443	4,880	10,304	4	5	3	1,396	614	237
Aragatsotn	63,189	12,189	44,715	8	35	5	3,408	1,928	901
Armavir	44,491	6,154	33,241	1,160	15	7	1,931	1,430	553
Gegharkunik	72,029	14,224	50,092	276	21	11	3,800	2,786	819
Kotayk	67,495	17,511	43,771	142	10	9	3,307	2,060	685
Lori	96,804	42,671	37,129	5,729	55	26	5,026	2,832	3,336
Shirak	92,165	35,871	46,642	64	147	115	4,594	2,463	2,269
Sjunik	72,054	24,253	40,987	12	37	183	3,723	2,051	808
Tavush	47,390	20,076	20,092	293	51	22	3,348	1,381	2,127
Vayots Dzor	44,795	9,389	31,313	35	34	37	2,398	1,000	589
Total	979,799	430,721	416,119	9,473	2,245	492	56,493	24,221	40,035
Source: Armenian authorities.									

Source: Armenian authorities.

**Scenario 1: Uniform apartment size applied county-wide with no value threshold**

**135. Scenario 1 (see Table 18) is premised on a broad assumption:** An average size of 75m<sup>2</sup> for the more than 430,700 apartment units across Armenia (of which more than 56 percent are located in Yerevan). As a country-wide value threshold erodes the tax base and the mission argues only for hardship relief in the form a deferment rather than a differentiated rate structure (implied by the present 0 percent threshold), no value threshold is applied.

**Table 18. Potential Revenue from Taxing Residential Apartments at Market-Related Values**

Region	No. of Apartments	Average Market Price (AMD/m)	Average Apartment Size (square meter)	Total Market Price (AMD)	Total Market Price (USD)	Tax per Unit (AMD) at 0.001	Tax per Unit (USD) at 0.001	Total Tax for Apartments (AMD)	Total Tax for Apartments (USD)
Yerevan	243,503	298,000	75	22,350,000	46,563	22,350.00	46.56	5,442,292,050	11,338,108
Aragatsotn	12,189	95,000	75	7,125,000	14,844	7,125.00	14.84	86,846,625	180,930
Ararat	4,880	98,000	75	7,350,000	15,313	7,350.00	15.31	35,868,000	74,725
Armavir	6,154	130,000	75	9,750,000	20,313	9,750.00	20.31	60,001,500	125,003
Gegharkunik	14,224	80,000	75	6,000,000	12,500	6,000.00	12.50	85,344,000	177,800
Lori	42,671	75,000	75	5,625,000	11,719	5,625.00	11.72	240,024,375	500,051
Kotayk	17,511	110,000	75	8,250,000	17,188	8,250.00	17.19	144,465,750	300,970
Shirak	35,871	100,000	75	7,500,000	15,625	7,500.00	15.63	269,032,500	560,484
Syunik	24,253	95,000	75	7,125,000	14,844	7,125.00	14.84	172,802,625	360,005
Vayots Dzor	9,389	115,000	75	8,625,000	17,969	8,625.00	17.97	80,980,125	168,709
Tavush	20,076	100,000	75	7,500,000	15,625	7,500.00	15.63	150,570,000	313,688
<b>Total/Average</b>	<b>430,721</b>	<b>117,818</b>	<b>75</b>	<b>8,836,364</b>	<b>18,409</b>			<b>6,768,227,550</b>	<b>14,100,474</b>

Source: Armenian authorities.

Note: The Statistical Yearbook of Armenia 2017 records 441,591 apartment units for 2016.

**136. At a tax rate of 0.1 percent, the estimated revenue from apartments is estimated at AMD 6.77 billion (or 0.11 percent of GDP, 2018).** This exceeds the total 2016 revenue from the property tax on all buildings and construction by a substantial margin. The caveat is of course that this estimate is based on very broad assumptions. However, it clearly illustrates the revenue benefit of moving closer to a market-value based real estate tax.

### **Scenario 2: Regionalized apartment sizes and regional value thresholds**

**137. Scenario 2 (Table 19) attempts to mimic the market on a regional basis where smaller average apartment sizes are more likely in smaller cities.** However, in this scenario the average apartment size for Yerevan was increased to 100 square meters. Lower value thresholds are applied by region to account for lower property values in regional towns and cities and to counter the base erosion implied by a national threshold. However, the AMD 3 million threshold was retained for Yerevan.

**Table 19. A Regional Approach to Taxing Residential Apartments at Market-Related Values**

Region	No. of Apartments	Average Market Price (square meters)	Average Apartment Size (square meters)	Total Market Price (AMD)	Total Market Price (USD)	Value Threshold (AMD)	Taxable Value (AMD)	Tax per Unit in AMD (at 0.001)	Tax per Unit in USD (at 0.001)	Total Tax for Apartments (AMD)	Total Tax for Apartments (USD)
Yerevan	243,503	298,000	100	29,800,000	62,083	3,000,000	26,800,000	26,800.00	55.83	6,525,880,400.00	13,595,584.17
Aragatsotn	12,189	95,000	50	4,750,000	9,896	2,500,000	2,250,000	2,250.00	4.69	27,425,250.00	57,135.94
Ararat	4,880	98,000	50	4,900,000	10,208	2,500,000	2,400,000	2,400.00	5.00	11,712,000.00	24,400.00
Armavir	6,154	130,000	75	9,750,000	20,313	2,500,000	7,250,000	7,250.00	15.10	44,616,500.00	92,951.04
Gegharkunik	14,224	80,000	50	4,000,000	8,333	2,000,000	2,000,000	2,000.00	4.17	28,448,000.00	59,266.67
Lori	42,671	75,000	50	3,750,000	7,813	2,000,000	1,750,000	1,750.00	3.65	74,674,250.00	155,571.35
Kotayk	17,511	110,000	75	8,250,000	17,188	2,500,000	5,750,000	5,750.00	11.98	100,688,250.00	209,767.19
Shirak	35,871	100,000	50	5,000,000	10,417	2,000,000	3,000,000	3,000.00	6.25	107,613,000.00	224,193.75
Syunik	24,253	95,000	50	4,750,000	9,896	2,000,000	2,750,000	2,750.00	5.73	66,695,750.00	138,949.48
Vayots Dzor	9,389	115,000	75	8,625,000	17,969	2,000,000	6,625,000	6,625.00	13.80	62,202,125.00	129,587.76
Tavush	20,076	100,000	75	7,500,000	15,625	2,500,000	5,000,000	5,000.00	10.42	100,380,000.00	209,125.00
<b>Total/Average</b>	<b>430,721</b>	<b>117,818</b>	<b>64</b>	<b>8,279,545</b>	<b>17,249</b>	<b>2,318,182</b>	<b>5,961,364</b>	<b>5,961.36</b>	<b>12.42</b>	<b>7,150,335,525.00</b>	<b>14,896,532.34</b>

Source: Armenian authorities and Fund staff calculations.

**138. It is especially noticeable that increasing the average size of Yerevan's apartments to 100 square meters has a material impact on the estimated revenue—**given that 56 percent of the apartments are located in this city. It clearly underscores the dangers of "blanket" assumptions. Under this scenario, the revenue estimate exceeds AMD 7 billion and its increase is due to the presumed lower regional tax-free thresholds (with the exception of Yerevan).

**139. Residential houses constitute a further 42.5 percent of total building stock.**

Although very limited market information was available, a similar exercise (i.e., the scenarios for apartments) for this sector suggests that about AMD 3.6 billion can be raised from residential houses with a 0.1 percent tax rate, and by retaining the current value threshold. About AMD 3.9 billion (Table 20) can be raised if identical regional thresholds apply as per Table 19). The

following key assumptions were made: (1) average house prices (per square meter)<sup>42</sup> of AMD 287,000 for Yerevan and AMD 89,000 across the ten regions; (2) an average house size of 100m<sup>2</sup>; and (3) 100 percent collection ratio.<sup>43</sup>

**140. Key to enhancing revenues from the property tax is to keep taxpayers well informed on the steps to be taken, the likely impact on different classes of taxpayers, as well as what the increased revenue will fund.** Increasing property taxes will be met with resistance and possibly growing non-compliance. In such an environment it will require significant political will to implement the reforms and ensure proper collection and enforcement. Significantly increasing the burden of the property tax must be carefully managed and discussed in public campaigns. Experience from Northern Ireland's property tax reform (2004-2007) and South Africa (1998-2004) may be insightful (Appendix 5).

**Table 20. A Regional Approach to Taxing Residential Houses at Market-Related Values**

Region	No. of Houses	Average Market Price (AMD/m <sup>2</sup> )	Average House Size (m <sup>2</sup> )	Total Market Price (AMD)	Total Market Price (USD)	Value Threshold (AMD)	Taxable Value (AMD)	Tax per Unit in AMD (at 0.001)	Tax per Unit in USD (at 0.001)	Total Tax for Houses (AMD)	Total Tax for Houses (USD)
Yerevan	57,833	287,000	100	28,700,000	59,792	3,000,000	25,700,000	25,700	53.54	1,486,308,100	3,096,475
Aragatsotn	10,304	89,000	100	8,900,000	18,542	2,500,000	6,400,000	6,400	13.33	65,945,600	137,387
Ararat	44,715	89,000	100	8,900,000	18,542	2,500,000	6,400,000	6,400	13.33	286,176,000	596,200
Armavir	33,241	89,000	100	8,900,000	18,542	2,500,000	6,400,000	6,400	13.33	212,742,400	443,213
Gegharkunik	50,092	89,000	100	8,900,000	18,542	2,000,000	6,900,000	6,900	14.38	345,634,800	720,073
Lori	43,771	89,000	100	8,900,000	18,542	2,000,000	6,900,000	6,900	14.38	302,019,900	629,208
Kotayk	37,129	89,000	100	8,900,000	18,542	2,500,000	6,400,000	6,400	13.33	237,625,600	495,053
Shirak	46,642	89,000	100	8,900,000	18,542	2,000,000	6,900,000	6,900	14.38	321,829,800	670,479
Syunik	40,987	89,000	100	8,900,000	18,542	2,000,000	6,900,000	6,900	14.38	282,810,300	589,188
Vayots Dzor	31,313	89,000	100	8,900,000	18,542	2,500,000	6,400,000	6,400	13.33	200,403,200	417,507
Tavush	20,092	89,000	100	8,900,000	18,542	2,000,000	6,900,000	6,900	14.38	138,634,800	288,823
<b>Total/Average</b>	<b>416,119</b>	<b>107,000</b>	<b>100</b>	<b>10,700,000</b>	<b>22,292</b>			<b>8,381.82</b>	<b>17.46</b>	<b>3,880,130,500</b>	<b>8,083,605</b>

Source: Armenian authorities and Fund staff calculations.

Assumptions: (1) 2016 average market prices by Global Property Guide ([www.globalpropertyguide.com/Asia/Armenia](http://www.globalpropertyguide.com/Asia/Armenia)); (2) Average house size of 100m<sup>2</sup>; (3) As separate taxable objects, garages are excluded; (4) regional threshold applies; and (5) 100 percent collection ratio.

## Vacant Urban Land and Unoccupied Buildings

**141. The mission was informed that land hoarding is an issue in Armenia.** There are many vacant land parcels in urban areas. Furthermore, there are unoccupied and derelict buildings in urban areas. Vacant land in urban areas is currently in principle taxable in Armenia, albeit only to a limited extent. This is also the case in Montenegro and Romania. The principle of taxing vacant land is strongly supported as property-specific local services (e.g., fire protection, storm water drainage, streets, street lighting, etc.) are available to these properties and they should make at least a fair contribution to the maintenance of these services. At the present tax rates for urban land, ranging from 0.5 to 1.0 percent and based on very conservative cadastral values, the tax

<sup>42</sup> Average prices for 2016 provided by the Global Property Guide ([www.globalpropertyguide.com/Asia/Armenia](http://www.globalpropertyguide.com/Asia/Armenia)).

<sup>43</sup> Garages, constituting a separate category of taxable objects in terms of the law, were ignored.

revenue is insignificant, and the tax does not incentivize development or redevelopment of the land. The contrary is more likely: it allows for hoarding by land speculators without penalty.

**142. A significantly higher tax rate in respect of vacant land in urban areas and derelict unoccupied buildings could be introduced as an incentive to develop such land or redevelop properties.** This is done in cities in a number of countries (e.g., Australia, Botswana, Brazil, Colombia, Namibia, Philippines, and South Africa). In some instances, vacant or idle land (as defined) is simply taxed as part of the recurrent property tax. In these cases, a differential tax rate, at a materially higher level than the standard tax rate is applied as a measure to incentivize improving the land or putting it into productive use. In the capital city of South Africa, Pretoria, the 2018-2019 tax rate on vacant plots is 3.65 higher than the tax rate for residential properties, whereas in Johannesburg it is four times higher. Global practices vary widely, as is evidenced by Table 21 (see also Haas and Kopanyi, 2017).

**Table 21. Taxing Vacant Properties: Global Practices**

<b>Tax Treatment of Vacant or Unoccupied Properties</b>	<b>City Examples</b>
Excluded or exempted	Bangkok; Cairo; Karachi
Exemption on application for unoccupied buildings	Accra; Dar es Salaam
Tax vacant and unoccupied property at standard tax rate	Jakarta; Kingston; Nairobi; São Paulo
Tax vacant and unoccupied property at higher rate	Bangalore; Kuala Lumpur (residential)
Tax vacant and unoccupied property at significantly higher rate	Belo Horizonte; Bogotá; Buenos Aires; Cape Town; Gaborone; Johannesburg; Manila; Mexico City; Porto Alegre; Seattle; Seoul; Tswane; Washington DC; Windhoek

Source: McCluskey and Franzsen 2013; Haas and Kopanyi 2017.

**143. Windhoek, Namibia and Seoul, South Korea, use a somewhat different approach.** In Windhoek, vacant land parcels in new township developments are taxed at normal rates for a specified number of years. Thereafter the tax rate doubles if the parcels remain undeveloped for a further specified period. Once this period has lapsed, the rate is again increased. The rationale is incentivizing development of land parcels in respect of which the municipality has provided services and infrastructure. In Seoul, the tax rate (based a market value) on vacant land plots increases from 2 percent to 5 percent after two years, 7 percent after three years, 8 percent after five years, 9 percent after seven years and eventually 10 percent after 10 years. To achieve the goal of forcing the owner to either develop or sell the property requires a tax rate that will indeed influence behavior. A further challenge will be to define “vacant urban land”. In this regard, the definitions of “unimproved land value” and “improvements” in the valuation and taxation laws of Queensland and Western Australia may be considered.<sup>44</sup> These will have to be adapted to the Armenian context.

<sup>44</sup> McCluskey and Franzsen, 2005.

## Recommendation

- Define and include “vacant urban land” in Section 11 of the Tax Code and introduce a higher tax rate for this category than the rate(s) for residential properties.

## H. Towards a Market Value-Based Tax

**144. Table 22 provides a basic roadmap for consideration in respect of the implementation of a market value-based property tax in Armenia.** The table only lists the most important tasks that must be performed and should be read together with Appendix 5.

**Table 22. Roadmap for the Introduction of a Market Value-based Property Tax**

Task	Responsibility	Date or Proposed Time Line
Design and test the qualitative and quantitative characteristics required for the proposed Law on Valuation for Real Estate Tax Purposes	Central government	July 2018 to July 2019
Finalize and adopt the Law on Valuation for Real Estate Tax Purposes	Central government	By July 2019
Implement the Law on Valuation for Real Estate Tax Purposes	Central government	January 1, 2020
Implement Section 11 of the Tax Code	Central government	January 1, 2020
Develop the valuation profession and create valuation capacity in the SCRPC	Central government, SCRPC, and private sector	Commence as soon as possible as it is a long-term project
Establish a valuation department within the SCRPC	Central government	By July 2019
Draft and adopt a law providing for the certification of valuers and minimum professional standards	Central government	By July 2020
Develop appropriate valuation methodologies and standards for a market value-based property tax	Valuation department	By July 2021
Draft a new market-based property tax law to replace Section 11 of the Tax Code	Central government	?
Set up a valuation tribunal or regional tribunals	Central government	?
Prepare valuation rolls for Yerevan and the 10 regions	Valuation department and/or private sector	?
Develop the capacity of community councils and to implement and administer the market value-based tax	Central government and communities	?
Provide taxpayer education and sensitization	Central government and communities	?
Implement the valuation rolls, adhering to the objection and appeal process	Central government and valuation tribunal(s)	?
Implement the new property tax system	Central government and communities	?

Source: Fund staff assessment.

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## Appendix 1. Provided TA Advice During the 2015 FAD Mission—2016 TA Report

Summary of Recommendations
<b>Chapter I: Comparative Tax Structure and Principles of Holistic Tax Reform</b>
With the intent of improving income distributions of individuals explore comprehensive adjustments to all taxes in order to protect the vulnerable against unfair distributions of tax burdens—e.g., by maintaining the tax-free threshold and taxing fully capital income.
Broaden consumption taxes and impose excises on goods and activities that guarantee buoyant collections and compensate for negative externalities.
Avoid tax deferrals of VAT and excises on imports by arguing that it improves growth and investments—some of the deferrals will become permanent revenue losses.
<b>Chapter II: Taxation of Employment and Capital Income</b>
<b>Taxation of Employment Income:</b>
Do not introduce a 20 percent flat rate tax on employment income.
Introduce a tax-free threshold, starting at 35,000 AMD/month, and gradually increasing over time.
In support of distributional fairness, introduce a progressive rate structure, to mitigate revenue loss.
<b>Taxation of Capital Income:</b>
Introduce a 10 percent withholding tax on income from residents and capital gains received by residents.
In the case of individuals, restrict the exemption from capital gains tax on housing to the sale of a taxpayers' primary residence; applying only if mortgage payments are non-deductible expenses.
Deem all short-term gains on financial assets (realization within two to three years of acquisition date) as ordinary income and tax these at marginal income tax rates.
<b>Taxation and Audit of Individuals:</b>
Introduce TIN numbers for all taxpayers.
Introduce mandatory reporting requirement for third party withholding agents.
Implement a pre-filled tax return system.
Enable tax audits on individuals.
<b>Anti-Avoidance:</b>
Introduce anti-avoidance rules against income splitting and grant the tax administration the power to adjust net income if there is deemed to be a diversion of income.
Introduce anti-avoidance rule for personal service companies with clear tests and deeming provisions to ensure that the appropriate amount of income is taxed under the PIT system.
<b>Chapter III: The Taxation of Business Income and Protecting its Revenue Base</b>
Reduce the thin capitalization (thin-cap) limitation to a debt-to-equity ratio of 1.5:1.

Summary of Recommendations
Additionally, review a “general interest limitation rule” which may be more robust than only relying on the thin-cap safe harbor rule, which can be manipulated to render it ineffective—if the debt to equity ratio is exceeded the interest limitation rule kicks in.
Adopt a general anti-avoidance rule.
Introduce participation exemption rules and rules for the reduction of withholding taxes on profit distributions to foreign legal entities.
Implement clear eligibility criteria for tax incentives, which leave no room for discretionary approval and make the Ministry of Finance responsible for the design and administration of these incentives.
Chapter IV: Presumptive Taxation, Turnover Tax and the VAT Threshold
Rationalize Armenia’s current 5-category presumptive tax model.
Over the long run, consider introducing a comprehensive presumptive regime: a single lump sum tax for microbusinesses and a single turnover-based tax for SMEs without any sectoral differentiation for both categories.
Operate a single rate each for the lump sum regime as well as the turnover tax; exclude professional services such as dental practices, notaries and companies from presumptive taxation.
Alternatively, maintain the patent fee regime but begin to narrow down its scope by gradually withdrawing this privileged system enjoyed by restaurants and medical practitioners.
Assure proper segmentation of taxpayers – align presumptive taxation thresholds with those of the VAT system and its proposed lower VAT registration threshold.
Keep the VAT registration threshold to no more than AMD 40 million and do not allow for VAT voluntary registration for those below say AMD 1.0 million.
Provide for simplified accounting and quarterly filing for medium-sized taxpayers as they migrate from the SME turnover regime into the standard Profit Tax system.
Chapter V: Taxation of Property
Market value assessment is preferred for urban areas as it provides a buoyant tax base.
Armenia should consider the use of simplified valuation approaches based on area in predominantly rural communities where little market transaction evidence exists.
An area-based approach would reflect location, use and several other value-enhancing factors such as the quality of road, water, sewage and electricity connections.
Limit exemptions to an absolute minimum.
In case low-income residential properties deserve relief, this could be achieved by adjustments to the value-based tax threshold.
Property tax relief for low income households, the elderly and those in hardship should be granted on application, reviewed annually, and be means-tested.
In the case of the elderly, and only if necessary, allow for the mortgaging of arrears of property rates that will get settled when the property is finally sold or bequeathed.
Introduce an area-based land tax on land used for agricultural purposes if insufficient sales transactions are recorded.

Summary of Recommendations
An <i>idle land tax</i> should be introduced targeting unproductive land held for speculation purposes.
Consider issuing property tax invoices on a monthly basis.
Arrange for more frequent installment payments of property rates.
For environmental considerations withdraw the age-tapering rule for vehicle property taxes and consider introducing higher tax rates for pricy vehicles with low rates for fuel-efficient vehicles.
Chapter VI: Excises and Proposed VAT Base Broadening
Continue with excise rate increases and base broadening, with a view to increasing excise revenues.
Index annually all specific rates—for the (estimated) rise in the consumer price index.
Over the long run, review the “single state duty” regime for gambling activities.
For gambling, consider introducing a net-margin VAT and WHT on winnings, withheld by casinos, apply normal VAT rules on their non-gambling supplies, and only do so if the tax administration is capacitated and ready to conduct such audits of wagers and payouts.
Introduce a number of specific charges payable by the consumer on the use of plastic shopping bags, plastic bottles, aluminum cans, and incandescent light bulbs.
Based on global practices, consider imposing a low excise on mobile phones’ airtime use.
VAT:
Provide timely input tax credit and refunds subject to clear procedures and deadlines.
Require businesses other than exporters and large investors to carry forward excess credits for a limited number of tax periods; consider indefinite carry-forward for high-risk sectors.
Reduce the cash flow impact and potential refund claims from import VAT through an import VAT deferral mechanism for reputable VAT taxpayers.
Make the rules for VAT refund precise, consistent and transparent.
Rules on refund requests and refund payments need to be made consistent across various parts of the Code (in particular the chapter on VAT and the part on tax administration).
Resistance against withdrawal of VAT exemptions for agricultural intermediary inputs could be mitigated by considering an optional flat rate VAT, and if it is feasible to administer it effectively.
Advance the proposed removal of exemption of certain agricultural inputs to an earlier date.
Chapter VII: Environmental Charges and Mining Fiscal Regime
Undertake a comprehensive review of the mining fiscal regime before making further modifications to royalty rates.
Simplify schedule of natural resource user fees.

Source: Grote, M., A. Shah, and W van den Brink, 2016. *Armenia—Review of the Draft Tax Code of October 2015*, Technical Assistance Report, IMF, Washington, DC.

## Appendix 2. Growth-Friendly Fiscal Policies<sup>45</sup>

Reforms in taxes and public spending can influence long-run growth—but country-specific conditions should guide the design of the fiscal package. Countries with fiscal space can increase spending in physical infrastructure development, supporting long-term growth, or they could embark on higher public spending on health and education. Where fiscal space is lacking, growth-promoting tax and spending reforms would need to be designed in a budget neutral manner. All fiscal reform packages should be designed to balance growth-equity trade-offs.

### A choice of the following growth-friendly tax policies:

- **The focus of growth-friendly tax policies depends on the tax structure and taxation levels of a country.** Few advanced economies have scope to raise tax revenues. Consequently, their tax policies should seek to eliminate distortions (e.g., removing VAT exemptions and reduced rates). Many emerging market economies, on the other hand, still could raise additional revenue in a growth friendly manner, including by improving compliance and reducing policy gaps.
- **Taxes on residential property and on excess returns or rents (extractive industries), particularly in resource-rich economies, are considered the least distortive for growth.** Broad-based consumption taxes (such as the VAT) do not discourage saving and investment decisions. Contrast this with income taxes and social contributions which are deemed to have the most adverse effects on growth as they interfere directly with economic decisions (e.g., labor force participation). Within income taxes, CIT as currently designed, are typically seen as the most harmful to growth, primarily because they discourage capital accumulation and productivity improvements, while introducing a bias toward the use of debt finance.
- **Shifting the composition of the tax system from direct to indirect taxes may have positive effects on growth, but this may come at the expense of equity.** For instance, the VAT is generally regressive in advanced economies—at least when assessed against current income rather than current consumption.
- **The design of individual taxes strongly affects their impact on growth.** Improving the design of the CIT, possibly through the introduction of an allowance for corporate equity (ACE),<sup>46</sup> might be better for growth than a poorly designed VAT. Similarly, well-designed

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<sup>45</sup> Prepared by the Staff of the IMF, 2014. Input to G20 meeting.

<sup>46</sup> Under an ACE, a corporation can deduct a notional interest rate on their equity. Indeed, most corporate tax systems in the world allow interest to be deductible as expenditure when calculating taxable profits. The normal return on equity is usually not deductible as a cost. Therefore, corporate tax systems discriminate against equity finance. It will cause higher indebtedness by firms seeking the lowest cost of finance. This creates distortions in the risk profile of asset portfolios. Moreover, because young and innovative firms usually face more severe credit restrictions on credit markets, the tax privileges associated with company debt, favors mature firms over start-ups. Tax arbitrage also erodes the corporate tax base, especially since firms today use hybrid capital structures where equity is classified as debt in the tax accounts, while in fact, it has features of equity. To avoid distortions and arbitrage, governments have introduced complicated anti-avoidance regulation and thin capitalization rules or capped interest deductions. A more straightforward alternative is to implement a more neutral treatment of debt and equity by means of a deductible allowance for corporate equity (see de Mooij and Devereux, 2009).

energy taxation can deliver a double dividend by correcting negative externalities associated with consumption and production of energy products and generate important revenues that can be used to reduce other more distortive taxes.

- **Tax expenditures (such as tax exemptions or reduced tax rates) are overall costly, ineffective and facilitate tax leakage.** For instance, allowances or deductions under the PIT help only those who fall into the tax net—effectively excluding many poor households—while CIT incentives are of little use to companies with no taxable income. Thus, eliminating distortive tax expenditures in a revenue-neutral way (e.g., by broadening the tax base) creates fiscal space for lowering the tax rate, and ultimately supports economic growth on a more sustainable basis. Well-considered measures to mitigate social costs for those currently benefitting from tax incentives can help ease resistance against their removal as a net benefit remains for all.
- **Specific tax expenditures may be justified for particular purposes.** For example, many advanced economies use tax credits for low-wage earners to provide income support and stimulate labor force participation. Such tax credits reduce the net tax liability and increase the net income gain from accepting a job relative to the alternative of being out of work. Similarly, during the Great Recession, advanced and emerging economies temporarily introduced more favorable depreciation schedules to support investment.
- **Tax reforms must be considered as a package—making complex trade-offs between distributional fairness and economic growth.** For example, a shift in the tax structure from PIT to consumption taxes, justified to reduce distortions and promote growth, could raise equity concerns due to the lower progressivity of consumption relative to PITs.
- **The assessment of each revenue measure (pro-growth or fairness-enhancing) should fully consider the risks of tax avoidance and evasion, as well as tax compliance and enforcement costs.** Thus, while recognizing the limits and potential of each tax instrument, effective reforms should take a comprehensive approach of the total domestic resource mobilization system and the revenue administration's capacity to deal with it.
- **Approaches in revenue administration and its accompanying reforms could be supportive of growth as well by addressing high levels of informality, lowering compliance costs, and reducing corruption.** That puts more money in the hands of the small business sector. This is of importance in emerging economies that have relatively small domestic revenue bases.

#### **More productive expenditures**

- **Fundamental expenditure reforms can support long-run growth by reducing inefficiencies and directing resources to areas with the greatest social rate of return.** In advanced countries, these reforms include containing increases in age-related spending, containing the government wage bill, as well as streamlining social benefits—while finding room for public investment that addresses infrastructure bottlenecks. In emerging countries, the focus of expenditure reforms should be on improving the composition of spending, rationalizing subsidies, and strengthening the public investment-growth link.
- **An increase in public capital investment can support long-term growth, but its financing costs, effectiveness and risks need to be assessed carefully.** Empirical evidence shows that the growth dividend of public investment will depend on the investment's return,

the way in which capital expenditure is financed, and the quality of the investment process (i.e., project selection and implementation). Projects should be carefully selected and implemented by making use of medium-term expenditure frameworks, competitive bidding, and internal audit.

- **Investments in human capital offer many advantages, including boosting long-term growth.** Well-designed social transfers and health and education spending can serve equity objectives, and—by building human capital—raise the long-term growth potential of the economy.
- **Reform of untargeted subsidies, especially on fuel, can also enhance productivity in several ways.** Cutting spending on costly energy subsidies can free up valuable resources to finance growth-enhancing spending towards “greener” technologies.
- **Reorienting spending to Active Labor Market Programs (ALMPs) can have a positive effect on labor market participation and long-term growth.** Countries may benefit from re-orienting spending on “passive” benefits towards well-designed ALMPs, such as job search assistance, wage subsidies and training, with some programs particularly tailored to the needs of unemployed youth.

### **Balancing growth–equity trade-offs**

**Both tax and expenditure policies need to be carefully designed to balance distributional and efficiency objectives.** These should minimize efficiency costs through applying the following principles: (i) use means-tested cash transfers where possible or use tagging where means testing is not feasible; (ii) make income taxation progressive; and (iii) design indirect taxes to raise revenue in an efficient manner (e.g., minimize the use of exemptions or reduced VAT rates).

## Appendix 3. The Distributional Impact of VAT and the VAT Incidence

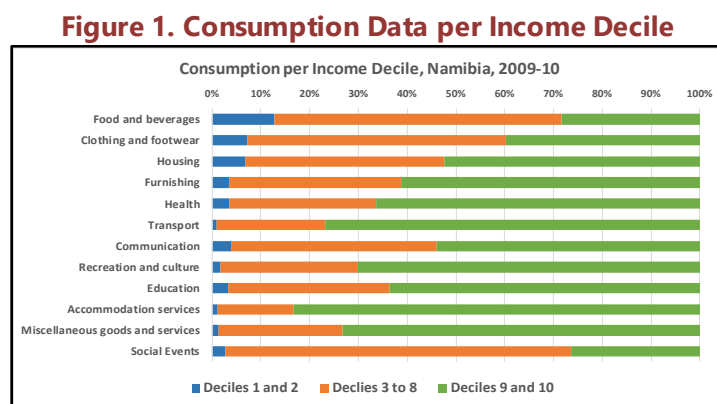
**The distributional impact of the VAT may be assessed by exploring the distribution of VAT payments by decile/quantile.** The latter can be measured by either income decile/quantile or expenditure decile/quantile—the difference being net savings. The ability to determine the distributional effects of VAT in quantitative terms depends on the availability of data on incomes and expenditures. Both rely on household expenditure surveys.

**Distribution of VAT payments by income decile/quantile.** This approach aims to produce estimates of the VAT burden in absolute terms and relative to household income. The approach requires annual data on:

- Household income partitioned by decile or quantile;
- Household expenditures by category of expenditures (e.g., food, shelter, transportation, entertainment) partitioned by decile or quantile, from a household expenditure survey; and
- VAT act and schedules of rates, exemptions and zero-rated final consumption.

**In the first tabulation (absolute burden), VAT payments are estimated by applying the VAT code (rates and exemptions) to each category of expenditures.** In the case of exemptions, assumptions are required with respect to the proportion of VAT on inputs that should be passed into higher consumer prices. VAT payments must then be computed for each income decile or quantile. In the second tabulation (relative burden), the VAT payments estimated for the first tabulation are divided by the household income in each VAT payment-income partition. The second tabulation can be used to assess the behavior of VAT payments as household income rises and therefore assess whether the VAT is regressive, proportional or regressive in each category of good and services and overall.

**Figure 1 shows the type of underlying data that serve as a starting point in calculating VAT payments.** In this particular case, the consumption data are partitioned in deciles.



Source: IMF staff, based on Namibian National Household Income and Expenditure Survey 2009-2010, <http://nsa.org.na/microdata1/index.php/catalog/6>

**Distribution of VAT payments by expenditures decile/quantile.** The data and approach are identical to that for the Distribution of VAT payments by income decile/quantile save for one detail: in the second tabulation, VAT payments are divided by household consumption expenditures rather than income. Since expenditures provide a better indication of utility than income, and saving, dissaving and smoothing take place over time, expenditure weights provide a more accurate picture of changes in the burden of VAT relative to household expenditures in different expenditure deciles/quantiles.

**The analysis can serve as a starting point to simulate the impact of changes in VAT rates.**

The baseline scenario would be given by relative VAT burden calculations for the existing VAT system. Then, a similar calculation can be made for the changed VAT burdens. The third tabulation would show the absolute change in burden [(VAT payments post-policy) (VAT payments pre-policy)] for each consumption expenditures decile/quantile. The fourth and final tabulation would show the VAT relief divided by consumption expenditures for each consumption expenditures decile/quantile.

**Incidence analysis attempts to determine who in the economy bears the burden of tax-**

**ation.** To be more precise, the analysis seeks to determine who in the private sector sacrifices the resources transferred to the public sector. The initial hypothesis of this analysis is that statutory incidence (who remits the tax) differs from economic incidence (who bears the burden of tax). This is because prices may adjust in response to the tax. It is often assumed that changes in VAT rates will be fully passed through to the final consumer, but this might not be generally true, especially if there are multiple VAT rates.

**Incidence studies often assume that producers will fully increase their prices with the tax and hence fully shift the burden forward to consumers.** This assumption is natural if one considers a uniform VAT on all consumption. In that case, the price of all consumption increases simultaneously so that consumers have no incentives to substitute from one type of consumption to another. However, in the presence of differential VAT rates or exemptions, VAT changes will affect relative prices and will induce substitution effects. This can have important implications for VAT incidence between the supplier and the consumer.

**The simplest analysis of the tax incidence of a sales tax relies on the analysis of supply and demand curves in a market for a particular commodity subject to tax.**

This analysis is referred to as partial equilibrium analysis since it considers the impact of the tax only on that particular market and not on prices and quantities of goods and factors of production in other markets. In a partial equilibrium analysis, the tax can be shifted forward to consumers by charging higher product prices or shifted backward to factors of production by reducing compensation or return. Unless special conditions exist, both producers and consumers will share the burden of taxation. Consumers bear more tax than producers if their demands are less price sensitive or if producers cannot accept lower prices since their per unit costs of production are inflexible (perhaps as a result of inflexible input prices). On the other hand, producers bear more tax than consumers if they provide a product in which costs are flexible or consumers resist price



increases by shifting to other products. The side of the market that responds less to the price change induced by the tax bears more of the burden than the side of the market that responds more to this price change. Different market conditions allow for different tax shifting patterns (forward versus backward) regardless of the way in which the tax is levied. Imperfect competition extends the range of possibilities in terms of shifting impacts.

**Partial equilibrium analysis provides a useful starting point but ignores interactions**

**between markets.** For example, if consumers shift from one good to another in response to a tax increase, the consumption and prices in the other market change as well. To assess these effects, one requires general equilibrium analysis, which accounts for all interactions between markets. In general equilibrium, all prices may change in response to a VAT change and the ultimate incidence of the tax change depends on the complex interactions between markets.

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## Appendix 4. Cost-Benefit Analysis for Tax Expenditures

### Definition of corporate tax expenditures

**Tax expenditures are “provisions of tax law, regulation or practices that reduce or postpone revenue for a comparatively narrow population of taxpayers relative to a benchmark tax” (Anderson, 2008).** They are a channel for financing government policies outside the budgetary framework. Conceptually, a country’s tax benchmark includes the rate structure, accounting conventions, deductibility of compulsory payments, provisions to facilitate tax administration, and international fiscal obligations. In practice, countries define tax expenditures differently, primarily because of varying classifications of tax measures as part of a benchmark tax structure, or an exemption to it.<sup>47</sup> Generally, tax expenditures take a number of forms, notably: low overall tax rates for sectors or regions, preferential tax rates for certain investments, tax holidays, capital recovery allowances, investment tax credits, exemptions for withholding taxes on dividends and interest payments, excess deductions for designated expenses, special export incentives, reduced import duties, duty waivers, duty drawback schemes, and tax deferrals.

### Do tax expenditures positively influence investment behavior and growth?

**There are two basic arguments in support of the application of investment tax incentives in developing countries:** (1) additional investment must be attracted to accelerate economic growth; and (2) tax relief or preferences can effectively stimulate investment. According to Bolnick (2004), both propositions seem intuitively to be correct. However, they need careful qualification as to their effectiveness and impact of investment tax incentives in a country. One should recognize that investment *productivity* is just as important as the *quantity* of investment in determining growth. Whilst a tax incentive can draw investments into a country, its growth impact can be stunted if the incentive reduces productivity or competition. It is equally uncontested that taxation rules impact on some investments. Empirical evidence on tax holidays suggests their attraction for “footloose projects” (e.g., the textile industry). Thus, if the tax holiday expires in one country, the firms simply pack up and relocate to the next country with incentives.

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<sup>47</sup> See select country definitions of the term “tax expenditure” (Polackova Brix et al., 2004): *Australia*: “Tax expenditures are tax concessions designed to provide a benefit for a specific activity or class of taxpayers;” *Belgium*: “Tax expenditure is defined as a provision that lowers tax revenue; results in a deviation from the benchmark tax system; aims to encourage a specific behavior, favoring economic, social, or cultural activities and could be replaced by a direct spending program;” *The Netherlands*: “A tax expenditure is government spending in the form of a loss or deferment of tax revenue that is due to a tax provision insofar as that tax provision is not in accordance with the benchmark tax structure of the tax law;” and the *United States*, Congressional Budget Act of 1974: “Revenue losses attributable to provisions of Federal tax laws which allow special exclusion, exemption or deduction from gross income or which provide special credit, preferential rates of tax / a deferral of tax liability” ... “An exemption or relief which is not part of essential structure of a tax instrument but has been introduced into tax code for extraneous reasons ...”

**So, there are cogent arguments for and against the application of tax incentives in support of investment.** To decide on balance which of the pros and cons are more credible depends on the investment environment and circumstances in a country. Given that the decision to grant tax incentives happens in a highly-politicized environment, the chances are that the *benefits* of incentives are grossly overstated whereas the *cost* are understated or completely ignored creating a bias towards implementation of poor tax incentives such as tax holidays (Bolnick 2004). Against this background, the mission thought it would be useful to provide the authorities, next to a tax expenditures assessment of forgone revenues for the CIT Incentives, with other tools for analyzing the cost and benefits of tax incentives. This would assist the MoF to adjust the future incentive framework with the view to increasing investment flows into the country that maximize growth but with the least revenue loss.

### **The motivation for corporate tax expenditures**

#### ***Designing an efficient and competitive tax system***

**Domestically, a growth and productivity enhancing (or “competitive”) tax regime is understood to be one that is the least distortive of market forces, and that encourages the supply of entrepreneurship, investment and skills.** Broader tax bases are typically less distortive, because for a set revenue envelope, they afford lower marginal tax rates which are commonly associated with an improving tax compliance behavior. The exception to the non-distortionary character of a competitive tax regime is if prices do not accurately reflect externalities generated by the activity of a private firm (i.e., spillovers from one firm’s R&D to others). Internationally, a competitive tax regime must be compared to that of other countries not just in terms of the statutory tax rate it applies to corporate income, but more importantly in terms of effective tax rates, which incorporate tax planning and avoidance strategies undertaken both domestically and across borders by MNEs (OECD, 2011).

**By offering tax expenditures such as tax holidays, Armenia in the past was aiming to accelerate the rate of investment and ultimately increase employment.** Tax holidays as a tax incentive in free economic zones (FEZs) completely exempt all profits from taxes indefinitely in Armenia. Whatever the intentions of the government may be, tax holidays while beneficial to investors are associated with large fiscal costs. Several of the above-mentioned concerns as to the inefficiency, inequity and ineffectiveness of tax expenditures are amplified in the case of corporate tax incentives. Moreover, empirical evidence suggests that the tax burden is not the main factor in business investment decisions. According to a survey of firms investing internationally by the World Bank, national taxes rank number 11 among the top 20 important factors in determining their location decisions (Table 1). Accessing markets, political stability, labor markets and other operational costs are more important than taxes on location decisions of the firms. Tax measures are poor substitutes for these key determinants of investment. In such cases, the first-best solution would be to address these underlying problems directly.

**Table 1. Objectives and Determinants of FDI Location**

Objectives of Firms Investing Overseas 1/	Most Important Determinants of Location
1 Improved market access	1 Access to customers
2 Reduced operating costs	2 Stable social and political environment
3 Other factors	3 Ease of doing business
4 Source of raw materials	4 Reliability and quality of infrastructure and utilities
5 Consolidated operations	5 Ability to hire technical professionals
6 Develop new product lines	6 Ability to hire management staff
7 Improved productivity	7 Level of corruption
8 Develop new technologies	8 Cost of labor
9 Improved labor force access	9 Crime and safety
10 Reduce risk	10 Ability to hire skilled laborers
	11 National taxes
	12 Cost of utilities
	13 Roads
	14 Access to raw materials
	15 Availability and quality of university and technical training
	16 Available land with all services in place
	17 Local taxes
	18 Access to suppliers
	19 Labor relations and unionization
	20 Air service
Source: MIGA, Foreign Direct Investment Survey, World Bank/Miga, January 2002.	
1/ Ranked by order of importance.	

**Importantly, the most important tax considerations for business investment decisions are not necessarily the relative tax burdens of competing economies.** It may be more relevant whether the tax system is stable, predictable, less discretionary and transparent. Stable tax policy is an essential feature of a tax system and investment environment. Frequent policy changes create uncertainty for investors and may dissuade current or potential investors from investing. Low CIT rates or abundant exemptions may not be able to compensate for location specific weaknesses in flagged investment determinants. In contrast, tax policy and administration can be used to promote the strengthening of domestic business conditions by relying more heavily on less distortionary broad-based consumption and recurrent property taxes, as well as by broadening the base for and improving compliance with personal and corporate income tax regimes (OECD, 2011).

**Tax preferences distort investment decisions and often constitute a deadweight loss**—i.e., local favorable conditions in the business environment or natural resource abundance may have led to investments anyway. Consequently, forgone revenue in terms of the tax expenditure structure could have been put to better use elsewhere such as improvement to the physical infrastructure in support of moving “tradeables” with minimum of costly delays. Tax incentives are bad in practice because frequently they are poorly implemented and monitored, cost-ineffective and inefficient in their design, often inviting abuse and corruption. Globally, there is limited evidence that tax policy in respect of incentives has any significant effect on investment—commonly the tax structure and its stability is more important.

### **Goals of tax expenditures and potential pitfalls**

**Tax expenditures can be used as substitutes for direct government spending or financial assistance to achieve certain social or economic policy goals.** For example, they can be used to attenuate the burden on the poor of a regressive tax instrument, or to encourage the allocation of resources by the private sector towards activities that may be socially underprovided (i.e., market failure, credit constraints). Among the positives highlighted in favor

of tax expenditures (relative to otherwise equivalent direct public spending) are encouragement of private sector participation and decision-making in economic and social programs, and the reduced need for government supervision of such spending (Polackova Brix et al., 2004), including possible administrative economies of scale and scope (OECD, 2010). Consequently, unless tax expenditures are exposed to adequate scrutiny, they may invite fiscal opportunism.

**Tax expenditures erode revenue bases by reducing its breadth and increasing the availability of loopholes for taxpayers** (see Box 1 for more arguments against incentives). They provide open-ended government spending, facilitate rent-seeking and add complexity to the tax laws, which makes it more difficult to estimate tax revenues. It suggests many tax expenditure schemes may be a response to interest groups rather than actual needs for government intervention, thereby increasing inefficiency in the allocation of resources. In addition, tax expenditures can often be offset by other domestic or foreign tax provisions, thus being potentially ineffective at achieving their purported goals. Furthermore, since by construction tax expenditures exclude non-taxpayers (including participants in the informal economy) from receiving benefits, they tend to be comparatively regressive.

#### **Box 1. The Ten Most Common Arguments Against Tax Incentives**

1. **Revenue loss**—triggered by the existence of a deadweight loss (investment may have happened anyway) or redundancy as incentivized investment is no longer viable. In the absence of tax sparing provisions in the host country's treaty network with capital-exporting home country, the foreign tax jurisdiction preserves its taxing right (i.e., reverse foreign aid). Also, revenue losses stem from tax holiday firm displacing current taxpaying firms.
2. **Revenue leakage**—through avoidance and evasion (e.g., company churning, income shifting, interest pump, false export declarations, and tailor-made loopholes) secondary revenue losses are created that dwarf in most instances the direct revenue loss from the incentive.
3. **Adverse impact on tax administration**—tax administrators become incentive monitors and regulators.
4. **Economic cost of fiscal adjustment**—curtailing government expenditure through loss of tax base, or the need to increase tax burden (mostly VAT) on vulnerable or other deserving economic activities.
5. **Economic distortions**—incentivized firms may become less productive, efficient and competitive.
6. Generally, tax expenditures impact negatively on **equity and fair tax treatment across sectors**.
7. **Lack of transparency**—in incentive adjudications gives rise to rent seeking behavior.
8. **Governance problems**—leading often to opaque discretions and corruption.
9. Other **fiscally more sustainable alternatives** are available (e.g., see accelerated depreciation allowances).
10. Tax incentives are **too costly, merely attracting footloose investments**, without lasting employment effect.

#### **Principles and concepts for cost-benefit analyses**

**This section reviews principles and concepts for carrying out cost-benefit analysis (CBA) of corporate tax incentives for investment.** The review distinguishes between incentive effectiveness and efficiency, and the need to consider both. The 2018 UN-CIAT 2018 study on tax incentives (pp.103 – 108) provides a template of quantitative steps towards a thorough cost-benefit analysis. A recent study prepared by the G20 provides a helpful additional resource and

guide, including a template to guide policy analysts.<sup>48</sup> For a treasury it is important that it reminds the executive and legislature that tax incentives are base-eroding tax measures that tend to undermine the three basic canons of sound taxation: efficiency, equity and simplicity. Yet, tax incentives have a role to play when they are introduced to address market failure (say, insufficient private sector spending on Research and Development), or if countries need to compete for mobile investment projects while preserving a general tax base or pursuing agglomeration economies. Irrespective of these justifications, only tax incentive programs that can clear some robust cost-benefit assessment hurdle (i.e., economic and revenue impacts) should be continued with.<sup>49</sup>

**Revenue cost effectiveness measures consider estimates of additional investment resulting from an incentive, relative to the subsidy provided.** Central to assessments of the cost effectiveness (and efficiency) of tax incentives is the likely investment response to tax relief. When considering empirical evidence and investor surveys, it is important to distinguish mobile and immobile business activities, and account for non-tax investment conditions in a given host country, as important factors influencing redundancy—i.e., instances where tax incentives have negligible effects on investment and gross domestic income.

**Cost-benefit analysis (CBA) introduces efficiency considerations, and the need to account for the opportunity cost of incentives in terms of forgone revenues.** Importantly, CBA accounts for implications to society of forgoing alternative uses of public funds, including paying down public debt, or funding infrastructure and other projects that typically rank higher in importance to investors than tax incentives. A key consideration is whether alternative uses may generate relatively high pre-tax rates of return to society, and thus offer greater efficiency. This consideration is captured in the marginal cost of public funds (MCF), a parameter which exceeds unity due to the marginal excess burden (MEB) of taxation.<sup>50</sup>

### **Effectiveness, efficiency and the marginal cost of public funds (MCF)**

**Tax incentives are mainly aimed at stimulating investment FDI.** FDI is generally believed to bring not only capital and (high-wage) jobs to a country, but also competition, thereby increasing efficiency in domestic markets more widely, contributing to growth. Tax incentives are often used to promote specific economic activities as part of an industrial development strategy

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<sup>48</sup> For a detailed presentation of a general framework for carrying out cost-benefit analysis of tax incentives, see the background document to the report to the G20 Development Working Group, 'Options for Low Income Countries' Effective and Efficient Use of Tax Incentives for Investment (IMF, OECD, WB and UN (2015)). The mission shared these documents with the authorities in Armenia.

<sup>49</sup> United Nations and Inter-American Center of Tax Administrations (CIAT), 2018.

<sup>50</sup> The  $MCF=1+MEB$  captures the fact that the societal cost of a ruble of forgone tax revenues exceeds one ruble, due to the marginal efficiency burden of taxation. Factoring in the MCF into welfare analysis recognizes both distortions (efficiency costs) that arise where other tax rates must be increased to cover revenues forgone by tax expenditures, and alternative public expenditure where gross rates of return to society are higher.

and/or to address regional development needs. Broadly, a tax incentive serves a useful social purpose if the social benefits it generates exceed the associated social costs (see Box 2).

### Box 2. Elements of a Cost-Benefit Assessment of Tax Incentives

Investment tax incentives ultimately aim to contribute to the welfare of residents of a country, assessed in terms of the amount of income generated in the country. As elaborated below, the following elements are critical for the **social benefits**:

- *Size of the net investment effect*—the rise in investment should be corrected for redundancy effects (investments that would have occurred without the incentive) and displacement effects (the reduction in any other investments) to infer the net incremental increase in capital due to the incentive.
- *Productivity spillovers*. To the extent that new investment boosts productivity elsewhere in the domestic economy, such as in supplying or competing firms (often seen as a benefit from inward FDI), this magnifies social benefits by raising income levels more widely.
- *Net impact of higher investment on jobs and wages*. New jobs can yield significant social gains if they reduce unemployment. However, if new jobs displace existing jobs, the social benefits depend on the productivity (and wage) differential between the new and old jobs.

The **social costs** of tax incentives depend on the following factors:

- *Net public revenue losses*—public revenues are forgone by tax incentives, where they are redundant or create revenue leakage (e.g., tax planning opportunities such as aggressive domestic transfer pricing practices). Tax on income from investment spurred by incentives can recover some of the revenue loss.
- *Administrative and compliance costs*, which can rise due to tax incentives, especially if they are complex or create opportunities for rent seeking and corruption.
- *Scarcity of public funds*. Often overlooked is that one currency unit of tax revenue has a higher social value than one currency unit of private income, because it is the greater value of the public expenditure it finances that justifies transferring resources from public to private sectors through distortionary taxes. To compare changes in private income and tax revenue, the latter need to be weighted by the marginal cost of public funds (MCF), which will be greater than unity due to the marginal excess burden of taxation.
- *Distorted resource allocation*. Discrimination in favor of some and against other investment implies that taxes, rather than productivity differences, determine resource allocation. This distortion reduces average productivity and lowers income per capita.

### Assessing effectiveness of tax incentives

**When evaluating the net benefits of introducing a tax incentive or carrying out an ex-post cost-benefit analysis, a key input is a quantitative assessment of the increase in the level of investment and capital stock.**<sup>51</sup> Unfortunately, accurate estimates of the investment response to tax incentives are difficult to make, for many reasons. One complicating factor is that tax elasticities are likely to vary, and possibly significantly, across different business activities, sectors, host countries and time.

<sup>51</sup> The response of investment to a tax incentive would influence the cost (not only the benefit) of the incentive. However, while some models used to estimate revenue impacts incorporate estimates of behavioral effects, many models do not, given uncertainty over the tax elasticity of investment.

**The effectiveness of a tax incentive may be assessed in terms of its stated objective (e.g., increasing investment), either irrespective of associated costs, or relative to estimates of forgone tax revenues.** Raising investment by more than the amount of forgone revenue is usually a necessary but not a sufficient condition for ‘cost effectiveness’, as the higher investment should be of the kind envisaged to yield the desired social benefits in broader welfare terms. Empirical evidence suggests that host country incentives influence FDI in some cases, although this is less so in the case of developing countries. Findings of redundancy, generally confirmed in investor surveys, may be explained where host country investment conditions that are important to most MNEs are for example, poor infrastructure, macroeconomic instability, unclear property rights, or weak governance or judicial systems.

**Calculations of the ‘dollar cost per dollar of investment’ or ‘dollar cost per job created’ are popular metrics for measuring the cost-effectiveness of tax incentives.** The number of jobs can be measured either for all investors enjoying the incentive, or only for those that are ‘marginal’, in the sense that they would not have invested without the incentive. Dollar costs can either be based on total revenue forgone from a tax-expenditure review, or only those from the non-marginal investors. Clearly, calculations of this kind are simplified, and findings are to be interpreted with caution. The dollar cost per job provides a quick ballpark figure that can inform policymakers on the relative cost-effectiveness of an incentive, which can be compared with the costs of creating jobs by direct spending measures—sometimes with striking results.

**Many studies have found that tax incentives have resulted in little new investment, as indicated by redundancy ratios, with insights into the factors determining effectiveness.** For instance, FDI that is resource-seeking (to exploit the presence of natural resources), market-seeking (to penetrate a local market), or strategic asset-seeking (to exploit local know-how or technology) is generally found to be less responsive to tax than FDI that is efficiency-seeking (to exploit cost advantages in production for the world market). Indeed, tax incentives tend to have the greatest impact on investment oriented toward exporting firms.

**The effectiveness of incentives in attracting investment also depends on the international tax rules in place.** MNEs taxed on a “territorial” basis in their home country can retain the benefits of host country tax incentives, since there is no offsetting home country tax on the foreign source income. MNEs might be subject to home country tax on foreign source income due to controlled foreign corporation (CFC) rules,<sup>52</sup> or tax upon repatriation under a ‘world-wide’ system. The tax incentive can then become ineffective since the benefits are offset by increased tax payments in the MNE’s home country—although tax deferral until repatriation of income often effectively mitigates such an effect. Also, tax-planning by MNEs (through transfer pricing) to avoid host-country taxes may blunt the impact of tax incentives. A MNE that can readily avoid

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<sup>52</sup> CFC rules vary but are provisions that bring immediately into tax *passive income*—the complement of active business income—arising abroad that has not paid at least some minimum amount of tax. For worldwide countries, CFC rules in principle provide some protection against tax avoidance through deferral; for territorial countries, they simply ensure that only active income is exempt in the residence country.



host-country taxes (e.g., using interest deductions to shift profits to a low tax jurisdiction, i.e., thin capitalization) may see little additional benefit from tax incentives.

**Where tax incentives increase FDI, domestic investment may be displaced—reducing effectiveness in terms of the net impact of the incentive on the domestic capital stock.** This happens if FDI involves a mere transfer of ownership (merger or acquisition) or if domestic investment is “round-tripped” through an offshore entity to benefit from a tax incentive. Displacement can occur in labor markets also, where jobs in new firms displace employment in other sectors. FDI may yield various social benefits such as economic diversification, knowledge/technology spillovers, new management practices, reduced unemployment, and improved conditions in less-developed areas (Blomstrom and Kokko, 1998; OECD, 2002). FDI spillovers may positively impact other firms in the same sector (“horizontal” spillovers) and/or firms that provide supplies to or purchase output from qualifying firms (“vertical” spillovers).

### **Assessing efficiency of tax incentives**

**Efficiency in the use of tax incentives means that objectives are achieved at low social costs.** Such costs include revenue losses for government and other social costs, for example due to less efficient resource allocation. Redundancy is relevant to assessments of efficiency since it implies a loss of government revenue from projects that would have been undertaken without tax incentives. Redundancy implies that tax incentives are a mere cash transfer to the investor—implying a net social loss to the extent that the marginal cost of public funds exceeds unity (and an even greater loss in national terms if the investor is foreign). On the other hand, for projects that would not have been undertaken without the incentive, there is no direct revenue loss—so long as taxation of the incentivized activity is not entirely eliminated, there may in fact be a net revenue gain from those projects. To minimize the revenue cost of tax incentives, they should only be offered to those marginal investors who would not have invested otherwise.

**A further consideration is scope for indirect revenue reductions, which arise where taxpayers abuse a tax incentive regime (e.g., mischaracterize non-qualifying expenditure or income as qualifying).** For example, if tax incentives are targeted at FDI, local firms may use foreign entities to route their local investments (“round-tripping”) to appear as FDI and qualify. Similarly, if tax benefits are targeted at new firms, taxpayers may restructure an existing business as a new corporation, to qualify. Other leakages occur where taxpayers use profit-based tax incentives to reduce tax on income from non-qualified activities (e.g., by shifting taxable income to a related firm qualifying for a tax holiday or residing in tax-free economic zone (McLure, 1999; Easson, 2004). Curbing this requires effective anti-abuse rules and strong administrative capacity.

**Additional costs include public funds allocated to administer tax incentives, and business compliance costs.** Such costs increase with the complexity of the design and assessment process of tax incentives and with scope for rent seeking. Administrative costs are a serious concern where scarce resources are diverted from core activities to mobilize tax revenues.

**A tax expenditure review does not take into account behavioral effects of incentives, or associated revenue leakage and abuse.** For policy evaluation, each Dram of tax revenue forgone is scaled up by the marginal excess burden of taxation (MEB), implying a marginal cost of funds that exceeds unity ( $MCF = 1 + MEB$ ). This recognizes that taxes generally reduce employment and investment, thereby imposing an additional cost to society. The MCF (social cost of a dollar of tax revenue) in advanced economies is generally estimated around \$1.20 to \$1.30 due to these distortions.

### *Evaluating the equity and efficiency of tax incentives for investment*

#### *Concerns over competitiveness*

**Providing an environment that is attractive to investment is recognized as key to a national strategy to secure productivity gains and economic growth.** The ability to offer an internationally competitive tax system is an important factor shaping the investment climate, with CIT identified as that part of the tax system that impacts most directly on MNEs. Host country tax comparisons tend to be made with similarly situated countries, in terms of location and market size. A common view is that host country tax considerations are likely to matter more to investment location choice when other key investment drivers are roughly equivalent. Thus, while tax considerations generally are not a principal factor determining investment flows, the possible influence of tax on investment choice is generally thought to be greater amongst countries where there is a “level-playing field” in other areas.

#### *Market failure arguments*

**The classic case for tax incentives for investment is the “market failure” argument.** For example, private investors do not take into account the positive spillover effects from their investment in a host economy, resulting in a socially sub-optimal level of investment. Potential benefits include transfers of skills and providing training to employees that could be applied elsewhere in the economy. Measuring spillover benefits and linkages to investment is obviously difficult, and the empirical evidence is mixed (see Box 3 hereunder).

#### *Redundancy-raising efficiency and equity concerns*

**In responding to pressures to address market failure, an important consideration is redundancy.** A central question is whether tax relief will stimulate investment and increase the capital stock, or merely provide a reduction in tax on projects that would have gone ahead without the tax relief, despite difficult host country conditions (e.g., because the risk-adjusted rate of return is very high, as is often the case with returns in the extractive sector). CIT plays an important withholding function, raising revenues on domestic-source income that might otherwise escape the tax net. When offering tax incentives, there is always some amount of investment that would have occurred even in the absence of the incentive. Given the desire to

tax corporate profits, policy makers are interested in minimizing instances of redundancy—that is, instances where relief is provided without any positive impact on investment.

### **Box 3. Evidence of Productivity Spillovers from FDI**

Empirical studies of **horizontal spillovers** look at the systematic variation of productivity growth in an industry and its intensity of FDI. Early studies for Morocco, Russia and Venezuela find no support for such productivity spillovers in manufacturing industries; instead, and counterintuitively, they all report negative correlations (Haddad and Harrison, 1993; Aitken and Harrison, 1999; Yudaeva et al., 2003).

Gorodnichenko et al. (2007) find that horizontal spillover effects are generally insignificant in an analysis for 17 countries in Eastern Europe and Central Asia. In a meta-analysis of 32 empirical studies on technology spillovers from FDI, Woodster and Diebel (2006) conclude that intra-sectoral FDI spillovers are non-existent in developing countries.

Evidence for advanced economies is usually more supportive of horizontal spillovers. For instance, studies using data for the US and the UK typically report positive correlations between domestic plants' productivity and FDI intensity (Xu, 2000; Keller and Yeaple, 2003; Haskel et al., 2007). Here, spillovers also tend to be more prevalent in high-technology sectors and when own R&D is undertaken, reflecting a greater ability to understand and assimilate new technologies (Griffith et al., 2004). Lack of absorptive capacity may explain why horizontal spillovers are less prevalent in developing countries.

Studies on **vertical spillovers** usually explore backward effects of FDI to domestic suppliers, again by measuring productivity gains in the manufacturing sector. A study for Zambia, for instance, finds significant knowledge transfers from foreign to local firms (Bwalya, 2006). Similar positive spillover effects are found for Indonesia and Lithuania (Javorcik, 2004; Girma et al., 2007). For the 17 countries in Eastern Europe and Central Asia, Gorodnichenko et al. (2007) consistently report positive backward productivity spillovers. For strategic industries in China, Du et al. (2011) find support for backward and forward vertical FDI spillovers.

**Thus, there is policy interest in tax incentives and tax incentive designs that are more prone to forgoing tax revenue, without yielding additional investment.** The search for efficient targeting and design of tax incentives recognizes that forgoing tax in one area requires increased reliance on other (generally distortive) taxes, or reduced public expenditures including in areas that are important to investors). Given the need to raise tax revenues, there is policy interest in taxing profit on business activities that are relatively insensitive to tax (and tax more lightly business activity that are more geographically mobile (e.g., through targeted incentives). Another (related) efficiency goal is to avoid unintended variations in effective tax rates across sectors, which may lead to misallocations of capital in the economy, and thus lower overall GDP.

**Redundancy is also of concern given the risks to voluntary compliance with the tax system when there are widespread perceptions that the sharing of the overall tax burden in the economy is unfair.** Where targeted tax relief provides subsidies to certain investors, perceptions of unfairness are rational. These perceptions tend to be reinforced where subsidies are provided year on year, with little/no additional investment and employment in the economy.

*Better understanding of tax effects through structured analysis*

**Another motivation for policy makers to assess tax effects on investment is to further develop human capital within MOF to assess and design tax policies.** When tasked with identifying better tax designs to best address competing tax policy goals (raising revenues,

competitiveness, efficiency, equity, simplicity), analysts need frameworks of analysis to help guide their assessment of possible tax effects on investment. As an element of this, it is important that policy-makers can identify the various channels through which tax may influence investment decisions. Adjusting the statutory CIT rate, influences the cost of debt finance, as well as the net cost of acquiring capital by influencing the value of deductible tax depreciation. Depending on its design, introducing an investment tax credit can reduce the amount of depreciable capital. By explicitly modeling these various interactions, this type of inquiry sheds light on the various ways in which tax incentives may impact investment. Also, the value of various weights matter.

**Intuitively, spending a marginal Dram on tax incentives competes with other uses of funds (e.g., cutting other tax rates or increasing expenditure on infrastructure or education).**

High public returns on these uses raise the opportunity cost of tax incentives by an estimated 20 percent of revenue forgone, and thus call for a 20 percent higher payoff to justify them.

Estimates for developing countries are scarce, but constraints on the instruments for domestic revenue mobilization available to them likely mean that the MCF may substantially exceed unity.

**Inefficiencies arise from distorted resource allocations.** Tax incentives place non-incentivized investments at a competitive disadvantage. The risk is that, in seeking to pick winners, there may be inefficiently low investment in non-incentivized activities. Incentivized firms may be able to offer higher wages to and attract workers in non-incentivized firms. Diversion of labor and capital away from non-incentivized firms may very detrimentally hinder economic growth.

**In principle, efficiency may require taxing activities that are more mobile across countries less heavily than those less mobile.** This is in line with the standard principle of efficient tax design that taxes with less tax-sensitive bases (property taxes) should be taxed more heavily, as the tax has a lesser impact on investment decisions. In practice, targeting mobile activities has been a major policy concern. Differentiated tax rates across sectors may serve as a pragmatic device for imposing higher burdens where rents (that is, profits in excess of the minimum required return by investors as in the case of extractive industries) are more substantial.

**However, targeting mobile bases can entail difficulties, and be inferior to outcomes involving more policy coordination.** Applying different rates to different sectors creates opportunities for profit shifting between the two. And since tax bases are less mobile from a collective perspective (that of a trading bloc, for instance) than between individual countries, low tax rates set in pursuit of national objectives may forego opportunities for efficient taxation from a multi-lateral perspective. Where there is reason to suppose, substantial rents are being earned, targeted taxes may be a better way to approach them rather than by differential rates—hence the distinct resource rent taxes often found in, and recommended for, resource-rich countries.

## Appendix 5. A Future Market Value-based Property Tax for Armenia

**The mission advocates simplicity in design and certainty in the administration of the property tax.** Limit discretionary decision powers by office bearers regarding policy adjustments and administrative practices.<sup>53</sup> Given the capacity constraints within the SCRPC in respect of valuation skills, the authorities will have to commit resources to develop the necessary in-house skills and capacity with the ultimate objective of transiting from the current cadastral value system to a full-fledged market value property tax. The availability of good data on land and buildings and significant experience in determining cadastral values constitute a sound foundation for taking the next steps towards a market value-based system.

**A successful property tax transition to a full market value-based property tax must rely on the centralization of and a uniform approach to valuation, cadaster management, and revenue administration, or the careful monitoring thereof.** As these functions are already centralized within the SCRPC in Armenia, this should assist the transition. Given the institutional incapacity of small communities, they may need the SRC's assistance in the administration of tax collection—if not as collecting agent, at least in providing training and IT support. Larger towns (e.g., Abovyan) and the City of Yerevan are already effective in billing and collection.

### Centralized valuation agency

**There are various options available when valuing properties for purposes of property taxation.** These are: (1) A government department; (2) A dedicated government division or agency; (3) Local government units (i.e., 'in-house' departments at local level); (4) The private sector; (5) Self-assessment; or (6) A combination of the above. Table 1 provides examples of countries or jurisdictions utilizing one or more of these options.

**Irrespective of the model selected in respect of the valuation function, central government should perform an oversight function.** Again, three options present themselves: (1) *ad hoc* political oversight (e.g., as provided for in the South African property tax law); (2) continuous oversight by a technical entity or office (e.g., Office of Valuer-General, New South Wales, Australia); or (3) a separate division within the relevant government department (option 1) or division (option 2) (see above). This office must review the quality of the overall valuation task. In jurisdictions where valuation has been decentralized, this office generally also plays a pivotal role in ensuring the application of uniform standards and guidelines. In a decentralized environment, this office can also undertake the valuation of cross-boundary properties such as linear infrastructure networks (e.g., pipelines and railway lines). Where capacity constraints exist, specialized valuations of unique properties could also be performed at this centralized level.

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<sup>53</sup> The 2017 Kosovar Draft Law on Immovable Property Tax may be instructive.

**Table 1. Responsibility for Valuation in Selected Countries**

Country or Jurisdiction	Responsibility for Valuation	Valuation Cycle in Years
Australia	State government agencies	1 (Queensland); 6 (Tasmania)
Canada	Crown (i.e., government) corporation (provincial)	1 (British Columbia); 4 (Ontario)
Latvia	State Land Service	No data
Lithuania	Real Property Register	No data
Montenegro	Municipalities	No data
Northern Ireland	Valuation and Lands Agency	None
Slovenia	Ministry competent for real estate	Annually
South Africa	Municipalities or private sector	4 (for metro's) or 5 (for other)
United Kingdom	Valuation Office Agency	None
Source: Franzsen & McCluskey, 2005; Reforming Property Taxation in Southeast Europe, 2006.		

### The need for periodicity and national uniformity for revaluations

**The credibility and buoyancy of a value-based system are dependent on comprehensive and regular general revaluations.** The periodicity is primarily determined by two issues: (1) the dynamics of the property market; and (2) the availability of resources. In some jurisdictions (e.g., Hong Kong, Singapore, and British Columbia, Canada) all properties are reassessed annually. In other jurisdictions, the valuation cycle may be a fixed cycle of, for example, three years (Australia), four years (Ontario (Canada)), five years (Malaysia), or even longer (Kenya). An option used in some countries is to simply state that a general revaluation of all properties must be done at least once within a specified period, but that it may occur sooner if required by market conditions. A further option is to have different valuation cycles in larger urban centers (where markets may be dynamic) and small rural towns (where markets may be static)—as in South Africa and Western Australia. The decision should be based on local market conditions, but to leave it open-ended (as is the case in the United Kingdom) would be a mistake. Whether a three-year cycle, as is currently prescribed for the cadastral value system is appropriate for Armenia should be determined with reference to the property market and capacity constraints.

**Although this may be prescribed by law, jurisdictions are in practice often hindered to do regular revaluations.** The actual costs of revaluation can be high and must be budgeted. However, the political and actual costs of postponing revaluations could be much higher. The more regular revaluations occur, the easier it is for local governments to deal with the inevitable shifts in values within and between property-use categories and also within different locations within the jurisdiction. Irregular revaluations undermine the credibility and fairness of the system. Apart from revaluing all properties at appropriate intervals, the valuation systems must constantly be maintained through (at least) annual supplementary valuations of properties that have been developed, demolished, consolidated, and subdivided. To deal with value increases between revaluations, especially where these occur irregularly, some countries opt for the indexation of values. Although this may ensure some growth in taxable values (especially if tax rates remain static), it does not adequately address the problem of shifts in real values between use categories and also different locations. Another option is to annually set the tax rates to

account for “static” values for the duration of the valuation cycle. This is the most common approach implemented globally.

**Capacity within the SCRPC must be further developed to ensure that the institution can deal with all the responsibilities a modern market value-based system requires.** The scale of the task and the time it requires should not be underestimated.

### Objection and appeal process

**An essential feature of a mature value-based property tax system is an objection and appeal process.** Such a system provides taxpayers the opportunity to challenge the accuracy of valuations of individual properties. At the point where the current property tax system is eventually replaced by a market value-based system, all the necessary features underpinning the proper functioning of such a system (including an appropriate tribunal to adjudicate appeals) must be in place. Lessons can be drawn from the 2003 property tax reform in Montenegro and, more recently, the attempted implementation of a value-based system in Slovenia.<sup>54</sup> Again, the effort in setting up the structures and drafting the law and regulations should not be underestimated.

**There should also be an opportunity for the community council (representing taxpayers collectively) to object to the assessed value of a specific property within its jurisdiction.** Lastly, central government should have to review the accuracy and validity of the valuation exercise (i.e., the valuation rolls of one, more, or all cities and communities) in its totality—as discussed above. This review function can be performed on an ad hoc basis at the instance of the responsible minister, or by the dedicated government agency tasked to perform an oversight function with the latter being the better option.

### Simplified tax rate structure

**Best practice suggests that one should pursue simplicity when it comes to rate setting to minimize complexity in administration and to encourage compliance.** If there is rate differentiation regarding type, quality, and use of properties, taxpayers will seek to motivate or artificially reclassify use or values simply for benefiting from the lower rate. Hence, a single rate may be the correct approach as good valuation can reflect accurately on differences in ability-to-pay—making discriminatory rates superfluous.

**Rate differentiation complicates the design, the transparency and the administration of a property tax.** Best practice is to determine centrally a rate range, but in application, a municipality should only apply one rate for both residential and commercial properties. A similar rate would induce investment choices that are based on the best use of property. The tax burden would then shift from commercial to residential properties in view of the fact that currently 5 percent of all properties—being of commercial use—generate on average more than 70

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<sup>54</sup> FDI-CEE Report, 2006: 19 (as regards Montenegro).

percent of municipalities' communal fee revenues. This rebalancing of revenue take from business to residential properties should commence as early as possible if such policy choice were to be made.

**In transition economies it is not uncommon that a natural person has cumulative ownership of undeveloped and improved properties.** Under these conditions, authorities are often tempted (e.g., Romania) to introduce a progressive property tax rate to address vertical equity considerations and an assumed ability-to-pay. However, the primary justification for a property tax at local level is to compensate government for the benefits from local services delivered to property owners. Therefore, a taxpayer with multiple properties should pay, as a minimum, the property tax payable by each property in the relevant jurisdictions where the properties are situated as this would represent an approximation for the services consumed by each property.

**Best practice is a simple or single rate structure to minimize complexity in administration and to maximize tax compliance.** Equity considerations can be best accommodated through good valuation of properties (the end-phase of the property tax transition in Armenia) and thus, can deal with ability-to-pay aspects. Besides the constitutional risk of introducing a higher property/land tax rate only on idle land, international lessons with such approach are disappointing and seldom have much effect.

### **Managing the reform**

**Careful preparation and sequencing of reform steps is crucial.** This holds at both the technical and political levels, where strong leadership is essential for successful reforms. It also requires up-front establishment and empowerment of steering committees at both the technical and the political levels. The success of the significant property tax reform in Northern Ireland (2002-2007) is mainly attributable to transparency, professional consultations, and an effective communication strategy. This reform was premised on four principles, namely (1) quality data and information; (2) expert people (e.g., valuers, statisticians); (3) expert systems (e.g., IT; Geographic Information Systems (GIS)); and (4) openness and transparency (i.e., keeping the public informed throughout the process). Similarly, property tax reform in South Africa (1998-2004) was undertaken in an open and transparent manner. For example, two versions of the property tax bill (an early draft (in 2000) as well as an almost final draft (in 2003)) were published in the *Government Gazette* for public comment. Furthermore, workshops were held with public and private sector stakeholders and public hearings were held in Parliament.

**An intricate reform such as the migration from an area-based system to a value-based system requires time and effort.** Skills need to be developed, officials trained and the public and politicians need to be educated. Transitional arrangements will likely be required as the new system is phased in over time. For example, in South Africa a country with a value-based tax dating back to the 19<sup>th</sup> Century, property tax reform was necessitated by constitutional, institutional and political reforms. The process commenced in 1998 and a new law was only passed in 2004. The law at first provided for a four-year phase to implement. This period had to



be extended to six-year with the last municipalities implementing the new system only in 2011. Lessons may also be drawn from the 2003 property tax reform in Montenegro where the valuation methodologies and procedures pertaining to the valuation of properties were not timeously promulgated by the MoF, compromising the implementation of the market value-based property tax system.

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## Appendix 6. Supplementary Information on Real Estate Taxation

### Institutional environment

**Local self-governance was introduced to Armenia in 1996.** This was a direct result of the 1995 Constitution that provides for some form of decentralized governance and the adoption of the (first) Law on Local Self-Government (1996) and the Law of the Budget System (1997)—that also regulates municipal budgets. This law was amended between 2008 and 2010 to allow for further local discretion in budgetary decisions. In 2005, the Constitution was amended to allow communities more freedom to set their own taxes. The Constitution was materially amended in 2015 as a result of a referendum. Art. 9 of the Constitution guarantees local self-governance and Chapter 9 provides for some broad principles in this regard. Art. 185.3 states: “The Council of Elders of a community shall establish local taxes and duties within the scope of the rates prescribed by law.” In 2002, Armenia ratified the European Charter of Local Self-Government and passed the current Law on Local Self-Government. In 2008, the Law on Local Self-Government in Yerevan City was adopted—giving Yerevan community status. Although there are municipal associations (e.g., Communities Association of Armenia and the Communities Finance Offices Association), these are somewhat fragmented.

**An important step in the process of greater local self-governance was the decentralization of the collection of local taxes (i.e., land tax and property tax) to communities in 2006.** In some communities, financial resources are insufficient for effective local self-government and service delivery. Most of the available resources are directed at maintaining the administration. This suggests a mismatch between staff numbers, on the one hand, and the volume and quality of the services provided by them, on the other. Moreover, community infrastructure and community-owned housing stock cannot be maintained. In 2011 the Government approved the *Concept Paper for Community Consolidation and Inter-Community Union Formation*. This paved the way for community consolidation that may achieve more efficient use of available resources. Although some administrative jobs were lost as a result of the recent round of municipal consolidation, other higher-level, service-oriented jobs were created. Staff (i.e., human resources) is generally now more capable and service delivery has improved. The overall salary cost has been reduced, and simultaneously better services are being delivered.

**Article 104 of the Constitution appears to confer wide-ranging powers on local communities to regulate, manage and administer local public affairs.** In practice, however, communities play a limited role. Most public services, even those with “local significance”, are delivered by state agencies, either directly or indirectly. It is to be noted that the great majority of public services which most affect the local population, and which are the most important and costly, like primary and secondary education, public health, social welfare, housing, public transport, water, gas and electricity and environmental protection are state functions, albeit

frequently shared with local communities as delegated powers. These and many other public services do not fall within the responsibility of communities but are a competence of central government and the regions (as administrative arms of central government). Central government determines the manner of service delivery and the financial arrangements related thereto. Communities have only minimal exclusive powers, for instance pre-school education, management of cemeteries, and refuse collection.

**In 2017 the share of local budget expenditures in the consolidated budget was 9.6 percent.**

From 2012 to 2017 per capita local budget income increased from AMD 31,556 (about USD 66) to AMD 37,945 (about USD 80) in 2017, whereas local expenditures per capita increased from AMD 32,196 to AMD 37,298 over the same period. The main spending areas in 2017 are general public services (about 25 percent) and education (about 33 percent). At January 1, 2018 the overall average population per municipality was 6,688 whereas for the 52 enlarged municipalities the average is 12,560. The current 502 municipalities have an average area of 58.9 km<sup>2</sup> (prior to enlargement this was 32.3 km<sup>2</sup>). The average size for the 52 enlarged municipalities is 289.4 km<sup>2</sup>. More importantly, there was a year-on-year increase (2016 to 2017) in own revenues in eighteen of the enlarged municipalities, ranging from 25 to 55 percent. The consolidated communities have greater resources, including financial and human resources, real estate (e.g., buildings) and moveable property (e.g. equipment), which are essential for community development and the maintenance of infrastructure.

**The community consolidation process should also be viewed in the context of the systemic reforms implemented in local self-government.**

The adoption of the revised Law on Financial Equalization in 2016 should further assist to reinforce the achieved positive results. In terms of this law, one of the criteria used to determine the subsidies provided to the communities for purposes of financial equalization is the number of settlements within a community. Consolidated communities receive larger financial equalization subsidies than the sum of the subsidies previously allocated to their former constituent communities. This provides additional revenue for improving the community services within the enlarged communities and should also incentivize further consolidation, possibly negating the disincentive created by the overreliance on the population per community criterion.

**Many institutional issues must still be resolved.** Important amongst these is that community budgets often do not allow communities to fulfill their responsibilities. To develop stronger, more sustainable communities, further consolidation needs to take place. The creation of strong local government associations that can assist with capacity building is essential. Administrative (i.e., legal and professional) oversight is the responsibility of MTAD—centrally and through its regional offices. The Audit Chamber, provided for in Chapter 13 of the Constitution, must conduct audits in the area of public finance and ownership, over the lawfulness and effectiveness of the use of State Budget and community budgets funds, loans and credits received, as well as state- and community-owned property. However, the mission was informed that there is very limited capacity to undertake audits of all communities—yet another reason to further

consolidate communities. Also, the law should ideally explicitly provide that communities who increase their revenue take from the property tax will not experience a reduction in their financial equalization subsidies. In sum, these reform initiatives are a condition for selling to the public the need for gradually increasing the property tax burden, which would support improved service delivery to the consolidated local communities.

### **Recommendations**

- Insert a provision in the relevant local government law that will incentivize the collection of own-source revenues
  - Do not reduce the financial equalization subsidy for those communities who successfully collect their property taxes.
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## Appendix 7. Review of Land and Property Tax Administration in Abovyan and Jrvezh

### Abovyan City

- *Background:* Abovyan is the capital city of the Kotayk Region, adjacent to the City of Yerevan. It has a population of about 50,000 people and surface area of about 700 km<sup>2</sup>. The city has a functioning “one-stop-shop” citizen office to assist the citizenry.
- *Land tax:* There is no agricultural land in this highly-urbanized community. The land tax paid is thus all in respect of urban land. For land tax purposes there are two land value zones in Abovyan. Data is maintained in both electronic and hard copy format. Land tax constituted only 3.6 percent of own revenue in 2017 (Table 1).
- *Property tax:* About 80 percent of residential property is below the AMD 3 million value threshold and therefore does not pay property tax. Cadastral values for business and industrial properties are significantly lower than market values. Property tax on buildings constituted only 9 percent of own revenue in 2017 (Table 1).
- *Tax administration:* The municipality is using the Municipal Management Information System (MMIS). Data are exchanged with various government ministries (e.g., the Police service for changes in vehicle ownership, the Cadaster for changes to property and property ownership, etc.). When an occupancy certificate is issued, the data are shared with the citizen (i.e., property owner), the Cadaster Office, the SRC, the Regional Government, and MTAD.
- *Billing and payment:* Although it could be done electronically for many taxpayers, billing is done through the mail. Abovyan is a cashless municipality. All payments are made at a terminal at the municipal office, the post office, or one of twelve commercial banks. Payments can also be made electronically. Negotiations are underway with banks to also collect through a debit order system. This should enhance compliance and reduce administration cost. Collection levels are the second highest in Armenia.
- *Enforcement:* Delinquent taxpayers are handed over to the enforcement agency (in the Ministry of Justice). This agency uses whatever appropriate enforcement mechanism and retains a 5 percent collection fee. Although a sale in execution is a statutory option, this is not used in practice due to adverse political implications. Courts are seldom used due to the cost and time it takes to resolve disputes. The rule that outstanding or contested tax amounts in excess of AMD 200,000 (i.e., about USD 415) had to be referred to an administrative court, has been abolished.
- *Challenges that remain:* Absentee landownership is significant (some 30-40 percent); land value zones that are determined with Yerevan as center; the large number of residential properties below the value threshold; and generally low cadastral values.

## Jrvezh Community

- *Background:* Jrvezh is located in the Kotayk Region and has a population of about 10,800 people. It covers an area of 49 km<sup>2</sup> of which only 4.9km<sup>2</sup> is urban. It constitutes three recently (2017) consolidated communities.
- *Land tax:* Agricultural land tax constitutes about 95 percent of the overall land tax revenue (given the number of rural properties in the community). Urban land is not sufficiently taxed. As a result of the outdated cadastral values for land, the revenue for urban land is very low. If more revenue can be generated, better service delivery to the citizenry would become a realistic proposition. Land tax constituted only 1.7 percent of own revenue in 2017 (Table 1).
- *Property tax:* Due to the depreciation of buildings and a static tax rate, building values and thus revenue has decreased in recent years. Cadastral values are only aligned with market values in very rare cases. Generally, it is estimated that market values are three to four times higher than the currently recorded cadastral values. There are no apartment buildings in this community. The revenue collected from real estate exceeds the amount collected on vehicles. The average property tax per property unit is about AMD 15,000 (USD 30.00). Property tax on buildings constituted 23.6 percent of own revenue in 2017 (Table 1).
- *Tax administration:* The municipality is using the Municipal Management Information System (MMIS). Data are exchanged with various government ministries and institutions. It operates comprehensive databases for the land tax and property tax. A different IT system is used for interaction with the MoF.
- *Billing and payment:* Billing is done through the mail. Reminders are sent by email and through telephone calls. The collection level prior to consolidation was about 100 percent, now it is down to about 90 percent. Payments can be made at the municipal office or through the banks or via an electronic transfer.
- *Enforcement:* Delinquent taxpayers are handed over to the enforcement agency (in the Ministry of Justice). This agency operates under the administrative law, retains a collection fee, and uses whatever enforcement mechanism is appropriate (e.g., freezing accounts, arresting property, etc.). Courts are seldom used due to the cost and time it takes to resolve disputes. The rule that contested or outstanding tax amounts in excess of AMD 200,000 (i.e., about USD 415) had to be referred to an administrative court, has been abolished.
- *Hardship relief:* This is granted by the council on a case-by-case basis, although it is rarely granted. The reason for that is to treat similarly situated taxpayers fairly.
- *Revenue:* Revenues are used for street lighting, waste disposal, water pipelines, etc. Savings on the current account are transferred to the capital budget.
- *Challenges:* Increasing the revenue take from urban land parcels in terms of the land tax. The new Tax Code, once it becomes operative in respect of the real estate tax, will not materially change the manner local taxes are presently levied and administered.

**Table 1. Revenues for 2017**

<b>Abovyan Community: Revenues for 2017</b>			<b>Jrvezh Community: Revenues for 2017</b>		
	<b>AMD ('000)</b>	<b>%</b>		<b>AMD ('000)</b>	<b>%</b>
<b>Property tax from real estate</b>			<b>Property tax from real estate</b>		
Buildings - natural persons	36,673	5.0	Buildings - natural persons	8,929	22.1
Buildings - legal entities	29,631	4.0	Buildings - legal entities	595	1.5
Land tax	26,419	3.6	Land tax	685	1.7
<b>Subtotal</b>	<b>92,722</b>	<b>12.6</b>	<b>Subtotal</b>	<b>10,209</b>	<b>25.2</b>
Property tax on vehicles	203,028	27.6	Property tax on vehicles	9,474	23.4
Local duties	29,367	4.0	Local duties	6,352	15.7
State duties	28,617	3.9	State duties	-	0.0
Other own sources	382,732	52.0	Other own sources	14,418	35.6
<b>Total own sources</b>	<b>736,466</b>	<b>100.0</b>	<b>Total own sources</b>	<b>40,453</b>	<b>100.0</b>
Grants	704,426		Grants	24,056	
<b>Total</b>	<b>1,440,892</b>		<b>Total</b>	<b>64,509</b>	

Source: Armenian authorities and Fund staff calculations.

## Appendix 8. Unit-Area Approach in New Delhi, India

An example of an area-based assessment approach is used by the New Delhi Municipal Corporation (Table 1). The Corporation moved to this simplified methodology in response to the problems in applying their previous value-based property tax (on annual rental value).

Under the area-based assessment approach the tax is calculated by multiplying the land area and/or the building area by a per unit assessment rate. The assessment value is based on specific physical characteristics of the property such as location, size, use, age (buildings). The data requirements for administering an area-based system are less than for a value-based approach. Additional property characteristics can be incorporated as adjustment factors to try and have a closer proxy to “value”.

**Table 1. New Delhi Area-based System - the Multiplicative Adjustment Factors**

Use	Factor	Occupancy	Factor	Structure	Factor	Age	Factor
Health, religion, education	1	Owner-occupied (for residential)	1	Pucca	1	Post-2000	1
Industrial (vacant), utility, telecommunication	2	Tenant	2	Semi- pucca	0.7	1990 - 2000	0.9
Industrial (occupied), museums, theatres	3			Kutcha	0.5	1980 - 1990	0.8
Business, retail	4					1970 - 1980	0.7
Hotels, towers	10					1960 - 1970	0.6
						Pre-1960	0.5

Source: McCluskey, Bahl and Franzsen, 2017.



## Appendix 9. BEPS Implementation and Exchange of Information

### BEPS Context and Armenia's Commitments

**In terms of the OECD Base Erosion and Profit Shifting (BEPS) Project, 116 Countries committed themselves to the Implementation of the Four Minimum Standards of OECD BEPS Project under Inclusive Framework.** The four minimum standards include measures developed under Action 5 (*Countering Harmful Tax Practices*); Action 6 (*Preventing Treaty Abuse*); Action 14 (*Dispute Resolution*); as well as Country-by-Country (CbC) reporting under Action 13 (*Transfer Pricing Documentation*).

**Armenia is a signatory of the OECD Multilateral Convention on Mutual Administrative Assistance or network of agreements covering all EU Member States.** The country signed in January 2018 the Mutual Administrative Assistance Convention (MAC) and is committed to sign and ratify the MAC or to have in place a network of agreements covering all EU Member States by 2019. As to adhering to the principles of fair taxation, Armenia is committed to amend or abolish any of the identified preferential regimes by 2018. During the process of clarification with the EU Code of Conduct Group, Armenia committed to have an effective MAC until the end of 2019. With regard agreements covering all EU Member States, Armenia has Double Tax Treaties with all EU member states except Portugal. Armenia committed to abolish preferential corporate tax regimes in respect of "Large Exporters" and so-called "Government-approved Projects", an issue relevant for the EU Association program. It has no relevance for BEPS.

**Armenia is committed to become a BEPS associate of the Inclusive Framework by the end of 2018 to be scrapped from the EU "grey list".** At this moment there is no commitment by Armenia to implement BEPS minimum standards. On the issue of Exchange of Information on Request (EOIR), Armenia, as a Global Forum Member, must subject itself to EOIR Rating Round 1 and 2 which are scheduled for 2019. This is the basis for advancing the commitments and capacity toward an Automatic Exchange of Information (AEOI), as part of the signed Mutual Administrative Assistance Convention—there are not yet firm commitments on the first exchanges under the AEOI. As to Armenia's BEPS membership of the Inclusive Framework (IF) it has to operationalize its commitments in terms of Action 5 (the elimination of any harmful tax practice and exchanging information on tax rulings); Action 6 (preventing treaty abuse); Action 13 (inclusion into domestic law provisions that would allow CbC by way of an information exchange network); and Action 14 whereby measures are put in place to advance effective dispute resolution. As regards Armenia, there is currently not any work done for the elaboration or implementation of minimum standards. Nevertheless, after joining the BEPS project, i.e. starting from the 2019, Armenia will be committed to implement the four minimum standards which means the country needs initial diagnostics, marking the beginning of a new era of international taxation.

**The existing international tax rules have been exploited by multinational enterprises (MNEs) resulting in widespread tax avoidance.** The consequence of aggressive tax avoidance by some MNEs is that their affiliates in low tax jurisdictions (LTJ) report almost twice the profits, relative to assets, compared to the rest of their MNE group.<sup>55</sup> The OECD has estimated that the annual tax revenue lost annually because of aggressive tax avoidance is USD 100-240 billion.<sup>56</sup> The impact of MNEs' tax avoidance is greater where countries are more reliant on CIT revenue—Armenia being no exception (see Table 2).<sup>57</sup>

**In September 2013, the G20 Leaders endorsed the BEPS Action Plan<sup>58</sup> with 15 action items.**<sup>59</sup> The package of 13 reports on the 15 action items was finalized in 2015. It is expected that the BEPS measures will counter aggressive tax avoidance and prevent double non-taxation.<sup>60</sup> The 15 BEPS actions are to be implemented by participating countries through domestic law and tax treaties to improve transparency and tax coordination.<sup>61</sup> The 15 actions include four 'minimum standards', which all participating countries have to adopt within a certain time frame. Some actions have been adopted in the OECD's standard setting framework (i.e., in the Transfer Pricing Guidelines and the Model Tax Convention) and the remaining actions will guide countries towards a converging set of rules and practices. Participation in the work of the Committee on Fiscal Affairs of the OECD has been made available to interested non-member (and non-G20) countries through the Inclusive Framework (IF) on BEPS.

### **Inclusive Framework (IF)**

**Armenia intends to become a BEPS associate member 2019.**<sup>62</sup> Participating countries in the IF must agree to implement four BEPS minimum standards, which commits them to:

1. Counter harmful tax competition and submit to a peer review process (Action 5).
2. Adopt treaty provisions to counter treaty shopping (Action 6).
3. Introduce standardized Country-by-Country reporting by MNEs (Action 13).
4. Resolving treaty disputes through the mutual agreement procedure (Action 14).<sup>63</sup>

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<sup>55</sup> OECD, *Secretary General Report to G20 Finance Ministers* (October 2015), p. 5, para. 2.

<sup>56</sup> Ibid.

<sup>57</sup> Ibid.

<sup>58</sup> OECD, *Action Plan on Base Erosion and Profit Shifting* (2013).

<sup>59</sup> Secretary-General Report (2015), p. 5, para. 2.

<sup>60</sup> OECD, *Secretary General Report to G20 Finance Ministers*, para.7.

<sup>61</sup> Ibid., para. 6.

<sup>62</sup> <https://www.oecd.org/tax/beps/inclusive-framework-on-beps-composition.pdf>.

<sup>63</sup> The members of the IF will also: develop standards for remaining BEPS items; monitor the minimum standards and other issues including the difficulties arising from the digital economy; assist the implementation of BEPS measures by providing further guidance and the development of toolkits for low-capacity developing countries. OECD, 'Background Brief: Inclusive Framework on BEPS, (2017), p. 5.

**In the case of Armenia, there exists no detailed roadmap on how to implement the BEPS minimum standards.** Armenia has joined the multilateral instrument (MLI: Action 15), that provides for the expeditious implementation of the minimum standards that should be adopted through treaty measures. It is at this stage in the ratification process. The plan for the remaining BEPS actions is more fluid, however.

**Work connected to the automatic exchange of information (AEOI) is set up in the Road Map which is elaborated on jointly with the OECD Global Forum Secretariat.** Even though Armenia does not have a detailed commitment for the first AEOI, an AEOI questionnaire issued by the Global Forum has been completed and the Authorities are now waiting for comments and recommendations from the OECD. No firm strategy as of yet has been developed by Armenia but it is understood that after becoming a BEPS Associate, the Authorities will be obliged to commit to the four (4) minimum standards.

**This section of the report discusses BEPS minimum standards, the MLI and suggests how to prioritize other BEPS actions deemed most relevant for Armenia.**<sup>64</sup> This second set of actions items are on: strengthening controlled foreign corporation (CFC) rules (Action 3); limiting base erosion via interest deductions (Action 4), both to be implemented domestically; taxing offshore indirect transfer of immovable property (Action 6); and preventing the artificial avoidance of the permanent establishment (PE) status (Action 7). The last two measures are to be implemented through tax treaties. Armenia is aware of these developments, but no firm evaluation has been done yet. At this stage, the MoF does not have enough capacity to prioritize these BEPS Actions.

## **BEPS Minimum Standards**

### ***First, countering harmful tax practices (Action 5)***<sup>65</sup>

**Harmful tax practices, including lack of transparency in issuing administrative rulings, may provide tax avoidance opportunities.** It was defined as a minimum standard that taxpayers benefiting from a preferential tax regime must have a substantial activity in the jurisdiction in question. This “nexus approach” assesses whether preferential tax regimes align the taxation of profits with the substantial activities that generate them. For example, a taxpayer may only benefit from a special tax regime on intellectual property (IP) income so long as it incurred qualifying research and development (R&D) expenditure that generated the IP. Expenditures in a country are therefore used as a proxy for substantial activity. The “substantial activity”

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<sup>64</sup> The BEPS action items that are not considered in this report are: Action 1 Address the Challenges of the Digital Economy; Action 2 Neutralize the Effects of Hybrid Mismatch Arrangements; Actions 8-10 Assure that Transfer Pricing Outcomes are in Line with Value Creation; Action 11 Measuring and Monitoring BEPS; and, Action 12 Require Taxpayers to Disclose their Aggressive Tax Planning Arrangements.

<sup>65</sup> OECD/G20, *Counter Harmful Tax Practices More Effectively, Considering Transparency and Substance: BEPS 5 – Final Report* (2015).

requirement test will be used to determine whether a preferential tax regime is a harmful tax practice.

**Countries must be transparent about rulings that may give rise to BEPS concerns.**<sup>66</sup> The minimum standard sets out a framework for compulsory spontaneous information exchange on rulings providing for preferential regimes and a general best practice framework for designing and operating a rulings system. At this stage, the mission has been informed that Armenia does not provide in its legislation for the issuance of private rulings.

## **Second, preventing treaty benefits in inappropriate circumstances (Action 6)**<sup>67</sup>

### ***Treaty shopping***

**Double taxation treaties (DTT) can be subject to abuse, benefiting third parties residing outside the contracting states.** Specifically, treaty shopping involves a non-resident making investments in a country through a third state to obtain treaty benefits rather than investing directly into the targeted country. The intermediary jurisdiction is chosen because it has a favorable tax treaty with the targeted country and a low effective domestic tax burden without withholding tax at source.

**Although some countries include in their treaties an anti-treaty shopping clause, Armenia has not included such provisions in their DTTs.** However, by having signed the MLI, Armenia will enjoy protection under all the concluded tax treaties and if contracting states have ratified the relevant tax treaty with Armenia, the anti-treaty shopping clause will be effective. Also, Armenia has updated its DTT model with the new provisions of the OECD 2017 Model Treaty (including art 29) for the upcoming DTT negotiations; of course, the previous DTTs are covered by the MLI.

### ***The minimum standard***

**The BEPS report recommends that countries use a three-pronged approach to counter treaty shopping.** This recommendation follows from a review of countries' current best practices and it includes:

- A statement in tax treaties that the countries entering it intend to avoid creating opportunities for tax avoidance or evasion;
- The use of a limitation on benefits (LOB) test to ensure that treaty benefits are restricted to residents that satisfy certain qualifications; and

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<sup>66</sup> BEPS 5 Report, p. 10.

<sup>67</sup> OECD/G20, *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances: Action 6 – Final Report* (2015).

- The use of a principal purpose test (PPT), which denies treaty benefits if one of the principal purposes of a taxpayer's arrangement is to obtain treaty benefits.<sup>68</sup>

**The PPT and LOB methods have their own strengths and weaknesses.** The main advantage of the LOB is that it provides more certainty and it is easier to administer.<sup>69</sup> It involves specific criteria for determining whether a taxpayer qualifies for treaty benefits, for example, the legal nature of the taxpayer and its activities in the residence state (see Box 1). The weakness of LOB is that it may not counter all forms of treaty shopping as specific anti-treaty shopping rules cannot anticipate all schemes.

#### **Box 1. Simplified LOB<sup>70</sup>**

- The LOB restricts treaty benefits to taxpayers who are "qualified persons." The first three tests are self-executing; the approval of a competent authority is not required. The discretionary relief test requires a competent authority to exercise a discretion. The qualified person tests are:
- The attributes test defines a qualified person based on the attributes of the taxpayer. For example, a company would qualify, if the principal class of shares is regularly traded on specified stock exchanges.
- The derivative benefits test provides that a company is a qualified person if the owners of the company would have been entitled to the same treaty benefits if the income had flowed directly to them rather than through the interposed company. The ownership threshold is at least 75 percent of the interest of the interposed company.
- The active conduct of business test provides that a company will be a qualified person for income that is part of an active business conducted by the company in its state of residence. This test recognizes that treaty shopping is unlikely to exist where the income derived by the company is derived from an active business in its country of residence. This test applies to companies that do not qualify under the attributes test.
- The discretionary relief test provides that a taxpayer that does not satisfy the requirements to be treated as a qualified person, can apply to a competent authority of its country of residence to be treated as such. The taxpayer must be able to establish that it does not have as one of its principal purposes the obtaining of treaty benefits.

**As the PPT and LOB are different tests an arrangement that satisfies the LOB may be denied treaty benefits under the PPT.**<sup>71</sup> The aim of the PPT is to deny treaty benefits to taxpayers if the principal purpose of certain arrangements is to secure treaty benefits.<sup>72</sup> The purpose of an arrangement is a question of fact, which must be determined after thoroughly examining all the circumstances of the arrangement. Applying PPT is not based on specific tests; it is discretionary, which has the benefit of flexibility but subject to uncertainty as it may be interpreted inconsistently between contracting states.<sup>73</sup>

<sup>68</sup> BEPS Action 6 Report, p 18, para. 19.

<sup>69</sup> Ibid., p. 19, para. 20.

<sup>70</sup> Ibid., pp 21-69.

<sup>71</sup> Ibid., Commentary, para. 4.

<sup>72</sup> Ibid., p. 55; Commentary para. 1.

<sup>73</sup> M. Herzfeld, 'Treaty Abuse -The Principal Purpose Test, Tax Notes International (2016) 388, p. 391.

**The LOB has several advantages over a PPT in terms of both simplicity and administration.**

An essential feature of a PPT is uncertainty. At times, it is difficult to determine whether one of the principal purposes of the transaction is to obtain treaty benefits. The onus of proof is on the tax authority. By comparison with a LOB, a tax authority only needs information from the payer of a dividend, interest or royalty that the taxpayer is a “qualified person” under the treaty. Consequently, the tax authority would be able to seek confirmation from the tax authority of the treaty partner country.

### **Recommendation**

- Use the LOB as a minimum standard in tax treaties (and in MLI).

### **Third, making dispute resolution mechanisms more effective (Action 14)<sup>74</sup>**

#### ***Mutual agreement procedures***

**Tax treaties normally contain a mutual agreement procedure (MAP) to solve differences in the interpretation of the treaty.** However, these procedures often take a very long time. The BEPS project targets the uncertainty arising from long disputes involving double taxation. The recommended measures are intended to ensure their expeditious and effective resolution. There are no recorded MAPs for Armenia’s 46 treaties in force.

**The minimum standard on this issue requires countries to include art 25(1)-(3) of the OECD Model Tax Convention in their tax treaties.** This article provides a mechanism for competent authorities of the contracting states to resolve differences on the interpretation or application of a tax treaty. The main aim of the MAP is to ensure that taxpayers who are entitled to treaty benefits are not subject to taxation contrary to the terms of the treaty. This minimum standard on MAP will be monitored by peer reviews in the IF.

#### ***Arbitration***

**The Action 14 Report also proposes compulsory arbitration as an option to resolve MAP disputes in a timely manner.** However, there is no consensus in the OECD and G20 states on the use of arbitration to ensure the resolution of MAP disputes.<sup>75</sup> While arbitration could be most beneficial in countries where MAP cases have been unresolved for a long time, many countries have a successful history of resolving MAP cases without it.

**Some commentators have expressed reservations about using compulsory arbitration given national sovereignty issues.**<sup>76</sup> Armenia does not have at this stage appropriate

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<sup>74</sup> OECD/G20, Making Dispute Resolution Mechanisms More Effective: Action 14–Final Report (2015).

<sup>75</sup> Tax Certainty, IMF/OECD Report for the G20 Finance Ministers, March 2017, p. 57.

<sup>76</sup> BEPS Monitoring Group, ‘Explanation and Analysis of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting,’ reproduced by Tax Analysts (2017), p. 5.

legislation dealing with arbitration. The biggest concern for the country at this stage is the steep costs associated with arbitration and Armenia's only reservation in MLI was the regulation regarding "arbitration". Arbitration decisions are confidential and do not set precedents; so, they do not necessarily add systemic certainty. Country experience suggests that applying MAP minimum standards however will require an increase in staff.

## Recommendations

- Resources need to be increased if Armenia adopts the MAP minimum standards.
- Get further international mainstreaming TA to decide whether compulsory arbitration in tax treaties and the MLI is in Armenia's interest.

## Fourth, transfer pricing documentation and country-by-country reporting (action 13)

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### Model legislation

**The new TP documentation requirement on MNEs, whereby relevant information will be reported in a country-by-country (CbC) format, is instrumental to the BEPS project.**

Armenia will receive worldwide information about the MNEs that operate in its territory and will have to gather and exchange similar information about MNEs headquartered in Armenia to tax authorities of the countries where they operate. The information from large MNEs will be in a CbC format, including the amount of revenue, profit before tax, income tax paid and accrued, number of employees, stated capital, retained earnings and tangible assets. No information exists at this stage how many Armenian companies would fall into this category.

**Model legislation has been drafted requiring the parent of an MNE group to file a CbC in the jurisdiction of residence.** The countries participating in CbC have developed an implementation package for the government-to-government automatic exchange of CbC reports.<sup>78</sup> Implementation arrangements entail satisfying confidentiality requirements.<sup>79</sup> The OECD intends to visit Armenia in September 2018 to establish whether the Armenian IT systems would pass the confidentiality tests.

### Surrogate parent entity

**The CbC measures provide for a "surrogate parent entity" to submit a CbC report on behalf of the group.**<sup>80</sup> This option prevents a MNE from being required to lodge a CbC in

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<sup>77</sup> OECD/G20, Transfer Pricing Documentation and Country-by-Country Reporting: Action 13- Final Report (2015).

<sup>78</sup> Ibid., p. 23.

<sup>79</sup> Ibid., p. 23, para. 60.

<sup>80</sup> Ibid., p. 39.

several jurisdictions if the parent of the group is not required to file it in its country of residence. The “surrogate parent entity” is a constituent entity of the MNE appointed by the group as the sole substitute for the parent to file the CbC report. Transitionally, for the first year of CbC reporting, surrogate parent entity may also be used (volunteered) if the MNE’s country of residence is unable to complete the requirements for CbC.<sup>81</sup> Armenia is not planning at this stage for a supplementary surrogate parent entity regulation.

### Recommendation

- Adopt the necessary legislation for CbC and automatic exchange of CbC reports.

### Multilateral Instrument (Action 15)

**The MLI allows for the timely implementation of certain BEPS measures.** The MLI is not a minimum standard. Its aim is to streamline the implementation the tax treaty related BEPS measures in a synchronized manner. It will implement the minimum standards to counter treaty abuse (Action 6) and to improve dispute resolution mechanisms (Action 14), preserving the bilateral tax treaty structure. Countries can join at any stage, but the initial signing ceremony took place in June 2017. The MLI is open to all countries even those that are not part of the IF. BEPS Action reports will be used for interpretation purposes.

**The way the MLI alters a tax treaty depends on the options the signatory countries choose in the MLI.** The MLI has an accompanying explanatory statement but not a commentary along the lines of the OECD and UN models. If signatories accept a provision of the MLI, the country is required to apply the provision to all its treaties that are covered by the MLI provided the other parties to the MLI accept the same provision. Signatory countries can opt out of certain specified provisions by making a reservation. Currently, Armenia has not yet decided whether to opt for any other BEPS action beyond the four minimum standards. As an aside, the mission was informed that there may be some value in considering including also measures changing the definition of permanent establishment (PE), as recommended in Action 7, discussed below.

### Recommendation

- Join the MLI as a signatory to implement the minimum standards Actions 6 and 14.

### Additional BEPS Measures beyond the 4 minimum standards: Short-Run

**Aside from BEPS minimum standards, a number of BEPS measures could be pursued by Armenia.** For example, limiting interest deductions (Action 4, to be done in domestic law) and strengthening the definition of PE (Action 7, to be implemented through treaties and an option in the MLI), could be taken up first.

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<sup>81</sup> Guidance on the Implementation of Country-by-Country Reporting, BEPS Action 13 (2016), pp. 3-4.



## **Limiting base erosion involving interest deductions (Action 4)<sup>82</sup>—Earnings stripping ratio**

**Thinly capitalizing a subsidiary in a higher tax jurisdiction is a common tax avoidance technique.** Domestic tax systems usually provide deductions for interest on loans incurred by business. The equity capital funding of a business is cost-free funding and is non-deductible. As money is fungible, MNEs may engage in tax avoidance by allocation equity capital to Low Tax Jurisdiction while allocating proportionally more debt to higher tax jurisdictions.

**The Action 4 Report recommends a fixed ratio rule that limits an entity's net deductions for interest to a percentage of its earnings before interest, taxes and depreciation and amortization (EBITDA).**<sup>83</sup> It suggests that the cap on deductible net interest should be within a 10–30 percent corridor.<sup>84</sup> The selected ratio could be applied with some flexibility, allowing the resident entity to claim additional deductions to the extent it does not exceed the net interest/EBITDA ratio of the worldwide group.<sup>85</sup> It is recommended that the fixed ratio limiting interest deductions be applied to both MNE and domestic groups; otherwise the rule may result in improper discrimination and conflict with tax treaty obligations.<sup>86</sup>

**Banking and insurance groups should be exempted from the fixed ratio rule.**<sup>87</sup> Banking and insurance groups typically are net lenders, so they will have net interest income instead of net interest expenses. The Action 4 Report recommends that these groups should be exempt from the fixed ratio. The exclusion should not apply to captive insurance companies; treasury companies; and non-regulated entities which operate quasi-financing.<sup>88</sup>

### **Restrictions on interest deductions in Armenia**

**Armenia has a 2:1 debt to equity thin capitalization rule.** The authorities have not yet reviewed further the effectiveness of this measure, but they have been getting advice to strengthen this. This could be further reviewed through a targeted TA intervention on international taxation. The 2016 TA mission presented the different earnings-stripping ratios with discussion. Countries' standard practice is a debt-to-equity ratio closer to 2 to 1, even 1.5 to 1 in several cases. The maximum earning stripping ratio recommended in Action 4 is 30 percent, which has been in the books in some countries for several years now. Also, the first ratio applies typically to all interest (net) payments, not just those to related parties.

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<sup>82</sup> OECD/G20, *Limiting Base Erosion Involving Interest Deductions and Financial Payment Action 4: Final Report* (2016).

<sup>83</sup> Ibid, see Ch. 6.

<sup>84</sup> Ibid, p. 54, para. 99.

<sup>85</sup> Ibid. p. 13.

<sup>86</sup> Ibid.

<sup>87</sup> Action 4 Report, pp. 79-80, para. 188.

<sup>88</sup> Ibid, p. 80, para. 189.

## Recommendation

- Consider the effectiveness of the current thin cap rule in Armenia and the implementation of the BEPS Action 4 fixed ratio rule that limits an entity's net deductions for (all) interest, and economically equivalent payments, to 30 percent of EBITDA (which is more watertight as it cannot that easily be manipulated than the 2:1 rule).

## Preventing the artificial avoidance of PE status (Action 7)<sup>89</sup>

**Under tax treaties, a foreign resident's business profits cannot be taxed in the host country in the absence of a PE.** If the PE threshold is satisfied, the host country (in this case Armenia) has the right to tax the profits attributable to the PE. The definition of PE is vital to the host country as it only retains its taxing rights over business profits attributable to the PE. MNEs have developed various schemes to avoid PE status, and thus the CIT, in the host country. Action 7 contains measures to counter common forms of avoidance of PE status. All of them could be adopted in Armenia.

**A foreign resident may have a dependent agent PE if his agent in the host country has the authority and exercises the power to enter contracts on his behalf.** The dependent agent PE definition was originally focused on enterprises that sell their products in foreign jurisdictions through travelling salespersons. But MNEs often run substantial business operations in host countries, and avoid the dependent agent PE definition and taxation in those countries.<sup>90</sup> A commissionaire, for example, sells goods in its own name but as an undisclosed agent of a foreign enterprise that owns the products being sold, so failing the dependent agent PE definition because contracts it signs are not binding on the foreign enterprise under civil law.<sup>91</sup> Tax authorities have challenged commissionaire schemes, but key cases were overturned by taxpayers through litigation. Thus, only the agent's commission is taxed in the host country; the foreign enterprise is not subject there to taxation on the profits from the sales.

**BEPS Action 7 amends the OECD Model Tax Convention so that commissionaire arrangements will satisfy the dependent agent PE definition.** As a matter of policy, if the aim of an agent is to negotiate contracts on regular basis in the host country but formally completed by a foreign enterprise, the enterprise should be considered to have a dependent agent PE and be subject to tax in the host country.

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<sup>89</sup> OECD/G20, BEPS *Preventing Artificial Avoidance of Permanent Establishment Status: Action 7-Final Report*.

<sup>90</sup> Zimmer (France), Dell (Norway). In contrast, in Dell (Spain) the Spanish Supreme Court held in 2016 that a Spanish commissionaire for Dell Ireland was a dependent agent under the Spain-Ireland tax treaty.

<sup>91</sup> Action 7 Report, p. 10. Other strategies are used to avoid meeting the dependent agent definition in the host country: agent negotiates the terms of the contract but without formally entering it because it is formally finalized by the foreign enterprise; or the agent claims it is an "independent agent."

**Two other common schemes to avoid PE status also will be prevented with the amendments to the OECD Model Tax Convention agreed under BEPS Action 7.** Many activities previously considered in the OECD Model to be preparatory or auxiliary, were expressly excluded from being PEs, are now core business activities.<sup>92</sup> Also, fragmented operations in the host country across several affiliates could be claimed, independently, as preparatory and auxiliary and similarly avoid meeting the PE threshold in the host country. The Action 7 Report contains rules to prevent these avoidance techniques.

### **Recommendation**

- Review with TA input Armenia's Model Tax Treaty to consider inclusion of Action 7 measures and implement them either through the MLI or through bilateral re-negotiation of tax treaties.

### **Additional BEPS measures: medium-term**

#### ***Indirect transfer of interests (Action 6)***

**Most jurisdictions impose tax on capital gains made by resident and non-residents from the disposal of immovable property.** To prevent avoidance of this taxing right, tax treaties provide that a contracting state can tax a resident of the other state that makes a capital gain from the sale of shares in a "land-rich" company in the first state (art 13(4) of the 2010 OECD Model). A "land rich" company is a company, which derives more than 50 percent of its value from immovable property located in that state. Many jurisdictions deem mineral rights to be of the immovable property class and therefore it has significance for Armenia.

**Art 13(4) of the OECD Model has been amended to prevent two avoidance schemes.** First, it extends taxing rights of the contracting state to tax capital gains arising from the alienation of interests in trusts and partnerships.<sup>93</sup> Another form of avoidance is the injection of assets other than immovable property into the tested party, such as cash, to dilute the relative value of the immovable property in a contracting state below 50 percent threshold. This avoidance is countered by making the valuation at any time in the 365 days preceding the alienation of shares (or interests in partnerships or trusts).<sup>94</sup> Does Armenia retain the right in its tax treaties to tax the shares of a company whose majority of assets consist of immovable property located in its territory? Armenia's treaties could be upgraded with the new wording agreed on Action 6 for article 13(4).

### **Recommendation**

- Consider reviewing treaties to ensure that the new Article 13(4) is included in Armenia's new and re-negotiated tax treaties—that domestic law exists to tax such indirect transfers.

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<sup>92</sup> Art 5(4)

<sup>93</sup> Ibid.

<sup>94</sup> Ibid., para. 44.

### ***Controlled Foreign Company (CFC) Rules (Action 3)***

**CFC rules are used to counter international tax deferral.** If a country's tax timing rules are based on resident's receipt of income from abroad, high wealth individuals or companies may avoid taxation by indefinitely deferring the receipt of foreign income using a CFC. CFC rules counter international tax deferral by attributing the income, on an accruals basis to resident controller of a CFC and are an effective anti-avoidance measure.<sup>95</sup> The *Action 3* Report contains a series of building blocks for countries that are intending to implement effective CFC rules.<sup>96</sup> It is very valuable guidance regarding best practices on CFC rules.

**Armenia has no CFC rules specifically set in legislation and it is expected that it may be susceptible to international tax deferral using CFCs.** Tax practitioners however advise that artificial deferral of tax by using low-tax offshore areas may qualify as tax evasion and lead to a criminal liability.<sup>97</sup> To make the TC more equitable, international tax deferral, using CFCs should be countered. Effective CFC legislation is likely to take some time to develop, and it is recommended that additional and specific technical assistance on this issue should be requested. In any case, a CFC regime will be difficult to apply without effective exchange of information mechanisms, which Armenia is about to strengthen.

### **Recommendation**

- Seek specific TA on the design of CFC rules to counter international tax deferrals.

### ***Tax policy considerations for entering, maintaining and terminating tax treaties***

**BEPS Action 6 also calls on countries to have certain tax policy considerations when entering tax treaties, though this does not amount to a minimum standard.**<sup>98</sup> These considerations are relevant as to whether existing treaties should be modified, or perhaps terminated. It is usually assumed that if a source country is giving up its taxing rights over certain income, that this income is taxed in the other country. If a state levies no income tax or low-income taxes, a country should consider whether a tax treaty is necessary with that state, since such treaty creates the risk of double non-taxation.<sup>99</sup> A country should consider also its treaty partners' ability (and willingness) to comply with the provisions dealing with administrative assistance, such as the exchange of tax information.<sup>100</sup>

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<sup>95</sup> See IMF, *Spillovers in International Corporate Taxation* (2014), p. 10, para. 10,

<sup>96</sup> Action 3 Report.

<sup>97</sup> Global Legal Group, 2018. "International Comparative Legal Guide to Corporate Tax 2018 (Armenia)", London.

<sup>98</sup> Ibid., p. 94, para. 75.

<sup>99</sup> Ibid.

<sup>100</sup> Ibid., Commentary, para. 15.6.

**Domestic law can deal with double taxation by providing either a credit or exemption for foreign income derived by residents.** However, such measures cannot deal with all forms of double taxation, especially if there are significant differences between the source rules of the two countries.<sup>101</sup> For example, double taxation arising from a transfer pricing adjustment cannot be resolved in the absence of a tax treaty. The value added of tax treaties is greater where they can deliver relief unavailable unilaterally, such as avoiding economic double taxation arising from transfer pricing.

**Net capital importers such as Armenia should be very conservative in entering new tax treaties and in maintaining existing treaties to preserve their domestic tax base.** Some of Armenia's tax treaties (Netherlands, Switzerland, United Arab Emirates) eliminate its taxing rights over certain income in some circumstances. The authorities are keenly aware of this, regarding them as unfavorable for a source country. Currently, Armenia is in the process of renegotiating the treaty with Switzerland (November 2018) as they attempt to change some of the provisions into their favor since these have created costly loopholes.

### **Recommendation**

- Review the tax treaty network to determine which treaties should be retained and others that it may wish to renegotiate in Armenia's favor because of the low withholding tax rates, the potential for treaty shopping and no significant bilateral economic activity.

### **International Standards in Automatic Exchange of Information (AEOI)**

#### ***Exchange of information on request (EOIR)***

**The Authorities requested background information from the mission with regard to the process of AEOI).** According to Armenia's Global Forum Road Map, working meetings are planned to evaluate with Global Forum experts Armenia's AEOI capacities, both legislatively and technically. This is scheduled for September 2018. After this process, the Armenian Authorities may come back with further requests for technical assistance after they have received recommendations from Global Forum experts. The Global Forum on Transparency and Exchange of Information for Tax Purposes is the largest international tax grouping, with 147 members, including all OECD members, financial centers and a growing number of developing countries. The Global Forum monitors the effective implementation of international standards on tax transparency by all Global Forum members, and any relevant non-members of exchange of information on request (EOIR) and AEOI, which together provide an effective suite of international tax compliance tools.

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<sup>101</sup> Ibid.

## ***EOIR Rating Round 1***

**Exchange of Information on Request (EOIR) is an important practical tool for jurisdictions and their tax administrations to combat international tax avoidance and tax evasion in cases that concern a specific taxpayer or a defined group of taxpayers.** The Global Forum has conducted peer reviews of its member jurisdictions' ability to co-operate with other tax administrations in accordance with the internationally agreed standard that requires information to be available (a) and obtainable by the tax authorities of the requested jurisdiction (b) and the existence of a treaty that allows the information to be exchanged (c). Each jurisdiction is evaluated for its compliance with each of 10 essential elements in the Global Forum's terms of reference and an overall rating is also assigned. Also, at the conclusion of the Round 1 reviews, the Global Forum undertook a lighter, accelerated procedure to recognize any further progress jurisdictions had made in implementing the EOIR standard. These so-called "fast-track" reviews assigned "provisional" ratings in advance of the jurisdictions' reviews in round 2. A jurisdiction's overall rating can be the following: *Compliant, Largely Compliant, Partially Compliant or Non-Compliant*. In certain cases, jurisdictions have been assigned ratings of *Provisionally Largely Compliant* or *Provisionally Partially Compliant*.

## ***EOIR Rating Round 2***

**The Global Forum completed its first round of peer reviews in 2017 and has already commenced its second Round of reviews, which will cover all Global Forum members and is scheduled to be completed in 2021.** As with the Round 1 reviews, jurisdictions are still expected to ensure information is available, that it can be obtained by the tax authorities and that there are mechanisms in place allowing for the exchange of that information. In addition, the Round 2 reviews are being conducted based on Terms of Reference strengthened in 2016, in particular, with the concept of beneficial owner, to strengthen transparency of relevant entities and arrangements.

## ***Convention on Mutual Administrative Assistance in Tax Matters***

**The Multilateral Convention on Mutual Administrative Assistance in Tax Matters ("the Convention") is a freestanding multilateral agreement designed to promote international co-operation between tax authorities, while respecting the fundamental rights of taxpayers.** The Convention provides for all possible forms of administrative co-operation between the parties in the assessment and collection of taxes, such as exchange of information on request, automatic exchange of information and spontaneous exchange of information, with a view to combating tax avoidance and evasion. The Convention was amended by a protocol which entered into force on June 1, 2011. To date over 110 jurisdictions participate in the Convention.

**The international standard in the AEOI, as adopted by the Global Forum, consists of a common requirement to exchange information on financial accounts and assets held offshore (largely consisting of the Common Reporting Standard or CRS).** Financial

institutions are required to carry out standardized due diligence requirements to identify their customers, both individuals and entities, and to report the information to the tax authorities, which then exchange it with their foreign counterparts on an annual basis. The exchange of the relevant information is based on an international agreement (either multilateral, like the Mutual Administrative Assistance Convention, or bilateral, e.g. a double tax treaty) and is usually also accompanied by an operational level agreement between the two jurisdictions (multilateral, like the MCAA, or bilateral between the jurisdictions). All Global Forum members were asked to commit to commence exchanges under the AEOI Standard in 2017 or 2018 at the latest, except for developing countries that do not host a financial center, as it was recognized that they may need a longer timeframe to implement the AEOI Standard due to capacity constraints and that they pose a reduced immediate risk to the level playing field. Some developing countries have since committed to implement AEOI and to begin exchanges by 2018, 2019 or 2020.

**To date over 100 jurisdictions have committed to implement AEOI with first exchanges by a specific date.** The Map displays jurisdictions' commitment to AEOI by indicating either: 2017, 2018, 2019 or 2020 - the year for which first exchanges are intended. Armenia has not indicated yet a date for first exchanges. However, Armenia is committed to AEOI in principle but was not asked to commit to exchange from a specific date and has not yet set a date for first exchanges.

### ***Common Reporting Standard under the MCAA signed***

**This is an administrative operational agreement between competent authorities of jurisdictions for the implementation of the AEOI Standard.** It is a multilateral agreement, but the exchange relationships are bilateral as they need to be mutually activated between the interested parties; the agreement comes into effect after the signatories file notifications including those relating to confidentiality and data safeguards as well as intended exchange partners.

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