TECHNICAL

NOTES & MANUALS

Managing Tax Incentives in Developing Countries

Miguel Pecho, Stoyan Markov, Philip Wood, Rachel Auclair,
and Fernando Velayos

TNM/2024/07

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This technical note addresses the following questions:

- What are the main compliance risks posed by tax incentives?
- What are the elements of an integrated compliance strategy to manage those compliance risks?
- Why should the most basic compliance obligations never be waived for recipients of tax incentives?
- What are the key governance and transparency conditions to effectively manage tax incentives?

This note was prepared under the supervision of Debra Adams and Andrea Lemgruber, and benefited from comments provided by Doris Akol, Katherine Baer, Brendan Crowley, Ruud De Mooij, Marco Borges De Siqueira, Shafik Hebous, Michael Keen, Li Liu, Tadatsugu Matsudaira, Andualem Mengistu, Gilles Montagnat-Rentier, Andrew Okello, Paulo Paz, Juan Redondo, Kriti Velji, and Graham Whyte.

Cover Design: IMF Creative Solutions

Cataloging-in-Publication Data
IMF Library

Names: Pecho, Miguel, author. | Markov, Stoyan, author. | Wood, Philip Richard, 1969-, author. | Auclair, Rachel, author. | Velayos, Fernando, author. | International Monetary Fund, publisher.
Title: Managing tax incentives in developing countries / Miguel Pecho, Stoyan Markov, Philip Wood, Rachel Auclair, and Fernando Velayos.
Other titles: Technical Notes and Manuals.
Description: Washington, DC : International Monetary Fund, 2024. | Nov. 2024. | Includes bibliographical references.
Identifiers: ISBN:
9798400289590 (paper)
9798400289613 (ePub)
9798400289675 (web PDF)
Subjects: LCSH: Tax incentives—Developing countries. | Tax incentives—Law and legislation.
Classification: LCC HJ2330.P6 2024

Recommended citation:
Pecho, Miguel, Stoyan Markov, Philip Richard Wood, Rachel Auclair, and Fernando Velayos. 2024. “Managing Tax Incentives in Developing Countries.” IMF Technical Notes and Manuals 2024/07. International Monetary Fund, Washington, DC.

Please send orders to:
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I. Introduction

This note aims to address the often-overlooked revenue administration aspects for managing tax incentives.[1] Much of the attention on tax incentives has focused on their design and effectiveness to attract domestic and foreign investment and promote economic growth. However, tax incentives pose potential risks of revenue leakages particularly in developing countries, as well as additional compliance and administrative costs, which add to the sizable revenue foregone they represent.

Tax incentives in developing countries intend to attract investment by reducing the tax burden of qualified investment projects and firms. They typically try to incentivize the economic development of certain sectors and regions, promote job creation (in labor-intensive industries), expand export-oriented activities,[2] and transfer cutting-edge technologies, among other objectives. They are made available either to all qualified domestic and foreign investors or to those specifically approved on a project basis by a granting authority at the executive branch.

In most cases, tax incentives in developing countries focus on corporate income tax, value-added tax, and excises and import tariffs and frequently take the following forms:

- Free zones (for example, free trade zones, export processing zones, special economic zones, development zones): free zones exempt business from some or all taxes and aim, in principle, at separating a qualified business activity from the domestic market.[3]
- Tax holidays: non-ring-fenced exemptions from some or all taxes for selected new firms or projects that might carry out activities inside or outside the domestic market.
- Lower-income taxation for small- to medium-sized enterprises.
- Full or partial exemption from income withholding taxes.
- Lower rates, and partial or full exemption from value-added tax and excises and import tariffs applicable to eligible goods purchased or imported by qualified firms or under qualified projects.
- Investment tax credits or equivalent allowances.
- Capital recovery schemes like accelerated depreciation or initial capital allowances.

Not all tax incentives in developing countries are well designed, and this has an impact on their administration. Some are well targeted and prescribed in a single law, whereas others are ill-designed (as it may be the case of some profit-based tax incentives) and scattered in various laws (not necessarily tax laws) or even approved by lower-rank instruments sometimes with nontransparent or discretionary clauses, which open opportunities for lobbying and rent seeking.

Reforms for streamlining tax incentives usually take time to receive political support, so revenue authorities in developing countries must manage tax incentives risks effectively to prevent abuses and revenue leakages. However, because revenue authorities are primarily focused on revenue collection,[4] they can often perceive that managing tax incentives risks takes up much of their time with limited revenue impact. As a result, they usually prioritize activities with immediate or sizable revenue results and actions visibly in line with priorities assigned by governments.

In addition, management of tax incentives in developing countries usually takes place in an operating environment characterized by weak governance and strategic management practices. Many times, public

1 Tax incentives, a subset of tax expenditures, refer in this note to investment tax incentives.

2 Export-oriented tax incentives might violate World Trade Organization agreements on subsidies and countervailing measures.

3 For instance, value-added tax exemption usually applies to goods supplied and services provided inside free zones. Similarly, import tariff relief includes all imported goods used inside the zone as input for the business activity.

4 In the case of custom administrations, also mandated with facilitation of legitimate trade and national security.

bodies involved in managing tax incentives lack an adequate governance framework (for example, a ruled-based decision making, modern transparency and accountability practices) to reduce vulnerabilities to abuse and corruption, or given their individual mandates and competences, they tend to work in silos, missing the opportunity to be more effective by working together.

This note is organized as follows: The second section presents some key enablers for effectively manage tax incentives, the third section develops a risk differentiation framework for managing tax incentives risks, the fourth outlines considerations for a compliance program focused on tax incentives, and the fifth section presents some conclusions.

II. Key Enablers

For an effective management of tax incentives, certain key enablers must be in place. This note highlights at least four enabling practices or approaches that allow the implementation of adequate responses for addressing tax incentives risks: an integrated work by all public bodies involved in managing tax incentives, public awareness about the existence of tax incentives and their social benefits and costs, clear and simple tax incentives policy design and legislation, and a modern compliance risk management (CRM) framework.

A. Institutional Arrangements and Governance

Management of tax incentives is facilitated by taking a whole-of-government approach. Individual mandates and competences assigned to public bodies involved in managing tax incentives—notably investment boards, the Ministry of Finance or equivalent, line ministries, and revenue authorities—often prevent them from adopting a more integrated approach for addressing tax incentives risks. Instead, they should promote dialogue platforms for identifying common challenges and propose collaborative responses because each party has relevant information or knowledge for managing tax incentives risks.

Moving from working in silos to networks requires strong leadership to establish appropriate collaboration platforms. Coordination is enabled when public bodies involved in managing tax incentives adopt formal or informal interministerial and interagency committees and working groups where staff can engage with their counterparts to exchange knowledge and information,[5] undertake process redesign to avoid redundancies (for instance, implementing a single-window service approach for investors such as the Rwanda's One Stop Centre[6]), and formulate holistic strategies for managing tax incentives risks.

It is key to have a clear understanding of the different roles and responsibilities of all public bodies involved in managing tax incentives. There must be a consensus about the benefits of working collaboratively for both promoting investment and ensuring compliance with tax and customs obligations. Investment boards and line ministries play an important role in managing tax incentives; however, it is an international good practice to give the leading role in introducing, amending, designing, and approving tax incentives to the Ministry of Finance because it is the body responsible for the country's fiscal framework. Revenue authorities must focus on enforcing compliance with tax and customs obligations.

Information sharing is enhanced when information technology (IT) systems of public bodies involved in managing tax incentives can communicate. The interoperability of IT systems (often developed using different technologies) ensures a proper flow of information between parties (for example, import and export data; taxes and social contributions withheld to employees; government certificates granting reliefs for qualified goods, either for domestic purchases or for imports) and the possibility of integrating information for having an end-to-end view of tax incentives.[7] For recipients of tax incentives, interoperability implies a reduction in burden because data can be potentially collected only once.

Regardless of their institutional setting, public bodies involved in managing tax incentives need to have in place a sound governance framework to reduce vulnerabilities to abuse and corruption. Some of the elements to promote good governance are as follows (IMF 2019):

- Minimum accountability and transparency practices.
- Nondiscretionary decision-making management structures.

[5] Information on tax incentives is not confidential, so it should be accessible to all parties, with safeguards to protect, retain, and dispose of private and commercial information.

[6] For more information, see the Rwanda's One Stop Centre website: https://osc.rdb.rw/en/

[7] Barriers for sharing information because of heterogeneous levels of digitalization should be overcome.

- Modern IT systems (for example, the Automated System for Customs Data (ASYCUDA) World Exemption Module) and processes, which translate into standardization initiatives.
- Effective internal controls.
- Independent external oversight.
- Professional civil service with high integrity standards and a code of conduct.
- Graduated sanctions for wrongdoings.

Adequate resourcing investments for public bodies involved in managing tax incentives are needed for staffing, training, and infrastructure. An appropriate and rational budget produces a return on investment for the government and a level-playing field for the business community. Public bodies need to develop institutional capacity to analyze tax incentives from the policy, legal, and administrative viewpoints. Staff are required to have both soft skills as well as technical, commercial, and investigative skills.

B. Transparency, Accountability, and Reporting

To obtain an accurate picture of public finances, the IMF Fiscal Transparency Code[8] advises to regularly disclose and manage revenue foregone from tax incentives. Tax incentives are a form of spending delivered through the tax system (a hidden spending instead of a direct spending), so they require the same level of scrutiny during budget discussions. Reporting on tax incentives and their fiscal cost helps enhance fiscal management and accountability. International good practices require reporting periodically (at least, annually) on tax incentives to the legislative branch.

A good practice is to publish a comprehensive report comprising a stocktaking of all tax incentives approved by laws and other instruments, with an estimation of the revenue foregone. Revenue foregone estimations are generally obtained by comparing tax incentives with a benchmark tax system, for example, a single-rate value-added tax or corporate income tax without reliefs, and an import tariff with a standard rate for a group of similar goods. This kind of estimation only takes into consideration static effects. If a sense of the potential revenue gains from streamlining tax incentives is desired, estimations must take into consideration behavioral response from taxpayers and the interdependence between different tax incentives.[9] In case the fiscal framework considers tax incentives caps, revenue foregone estimations help verify compliance with the thresholds.

Dissemination of more granular information, for instance, about policy objectives or targeted recipients is also recommended for additional public scrutiny. Redonda, von Haldenwang, and Aliu (2023) point that information on policy objectives and targeted recipients is frequently highly aggregated or missed from tax incentives reports produced by developing countries. Recipient-specific information is scarce because of the confidentiality of tax information. When available, it is frequently limited to tax incentives approved on a project basis. Information on targeted recipients (either their number or profile) is particularly relevant because it would bring to light data about the expected benefits of tax incentives.

Tailored to different levels of data availability and analytical capacity, systematic development of cost–benefit analysis is desirable for verifying that tax incentives accomplish their economic and social goals and are affordable. In a nutshell, these evaluations verify that tax incentives' social benefits (for example, net investment, employment creation, spillover effects, efficiency gains) outweigh social cost (for example, revenue losses, compliance and administrative cost, distortive resource allocation). Beer and others (2022) point that a small number of countries produce these evaluations regularly, though they are growing. Canada and Germany have a robust evaluation framework in place including, among others, transparent reporting on beneficiaries and dissemination of evaluations.

[8] For the IMF Fiscal Transparency Code, visit https://www.imf.org/external/np/fad/trans/Code2019.pdf

[9] For further discussion, see Heady and Mansour (2019).

When tax incentives are approved on a project basis, negotiations between investors and the granting authority must be conducted with the highest degree of transparency and accountability. Negotiations should be framed into a clear, standardized, and ruled-based procedure to avoid under-the-table negotiations between public officials and investors. It is advisable that revenue authorities be consulted about the tax implications of the negotiated terms and conditions. Once signed, the agreements and all the supporting documentation (project-specific information) should be disclosed for public scrutiny. When a robust transparency and accountability framework is not in place, countries should consider avoiding granting tax incentives on a project basis. Instead, tax incentives should be made available to all qualified domestic and foreign investors who comply with a clear and objective eligibility criterion (self-assessment principle). Ex post, revenue authorities can always exercise their powers to verify if eligibility criteria were met.

C. Policy Design and Legislation

Ill-designed tax incentives challenge tax principles, creating spaces for a more vulnerable revenue system. Sound policy design principles are needed to make an economic and social case for tax incentives, particularly in developing countries. For instance, previous IMF, World Bank, Organization for Economic Co-operation Development (OECD), and United Nations advice (IMF, OECD, UN, and WB 2015) has stressed the superiority of targeted cost-based tax incentives (for example, investment tax credits, accelerated depreciation) over activity or profit-based ones (for example, tax holidays, income tax exemptions). This is because tax incentives are wasteful when unexpected or unanticipated events, or location-specific or firm-specific factors (for example, natural resources, monopolistic powers) lead to excess profits (or economic rents).[10]

The OECD/G20 Base Erosion and Profit Shifting (BEPS) project emphasized the potential damaging role of tax incentives when they include features that facilitate base erosion and profit shifting, causing spillover effects on tax bases of other jurisdictions (OECD 2013). The historic agreement for introducing a minimum tax under the Pillar Two of the OECD/G20 Inclusive Framework Agreement calls for adjustments on tax incentive regimes. Because the minimum tax will reduce the overall benefit of tax incentives, the whole design of various very advantageous tax incentives in developing countries needs to be reviewed (see Hebous and Mengistu 2024; OECD 2015, 2022).

It is best to prescribe tax incentives in the national legal framework (preferably a single tax law), ensuring public scrutiny by parliaments. Tax incentives approved by lower-rank instruments (for example, decrees, executive orders) may escape public oversight and can become prone to rent seeking, abuse of power, and corruption. From an investor's point of view, it is best to have all provisions regarding tax incentives consolidated in a single legal instrument for tax certainty (uniformity and transparency generally enable a better business environment).

Sound legislation enables an effective management of tax incentives. In this regard, among others, the legislative framework should:

- Narrow/specify the purpose of tax incentives.
- Clearly establish eligibility criteria for granting tax incentives, that is, type of firms, scope of targeted activities/sectors (for example, using the International Standard Industrial Classification) or regions.
- Specify investment targets/commitments (for example, minimum capital investment, jobs to be created, technology to be transferred).
- Describe enrollment protocols (by application only, deemed) and requisites.[11]
- Define time limits for tax incentives either with sunset provisions (an expiration at a given date) or with limiting or ruling out renewal periods.

[10] See a taxonomy of excess profits in Hebous, Prihardini, and Vernon (2022).

[11] Details may be issued by regulations or administrative documents.

- Establish recapture provisions (that is, the obligation to repay the tax incentive) when the recipient fails to satisfy investment targets/commitments or when revenue authorities detect a misuse of the tax incentive.
- Use current customs tariff nomenclature—that is, the national classification coding based on harmonized system for value-added tax and excises and import tariff reliefs.
- Allow for exchange of information between all public bodies involved in managing tax incentives, and provide adequate information gathering powers to obtain information from third parties.
- Grant sufficient monitoring and enforcement powers to revenue authorities, for example, for undertaking reviews and audits, for accessing free zones' premises and traders' records, for conducting on-site examinations and inspections, for terminating or revoking a tax incentive when the recipient fails to satisfy investment targets/commitments or when revenue authorities detect a misuse of the tax incentive (including fraudulent schemes), and so on.
- Establish specific anti-avoidance rules in connection to tax incentives—such as limitations to tax deduction of certain payments made to firms operating with tax incentives (for example, excessive interest payments, excessive fees for management services) or even establish a general anti-avoidance rule.
- Establish clear administrative and criminal penalty regimes.[12]

Public bodies involved in managing tax incentives must work collaboratively to ensure the approval of secondary legislation. This includes regulation and other administrative instruments (circulars, directives, instructions, binding public rulings, and other subsidiary and ancillary legislation) needed for further clarifying the application of tax incentives. Voluntary compliance is encouraged, and administration facilitated, when the whole legal framework is clear and simple.

D. Compliance Risk Management

Tax authorities use various forms of CRM to systematically identify, assess, and prioritize compliance risks and determine how to treat them. Figure 1 illustrates the essential elements of a modern CRM framework. Apart from the CRM process itself, a robust CRM framework requires proper governance (for example, a Risk Management Committee), planning, and performance evaluation protocols, as well as a range of necessary inputs and resulting outputs, affecting virtually every part of a tax administration.[13]

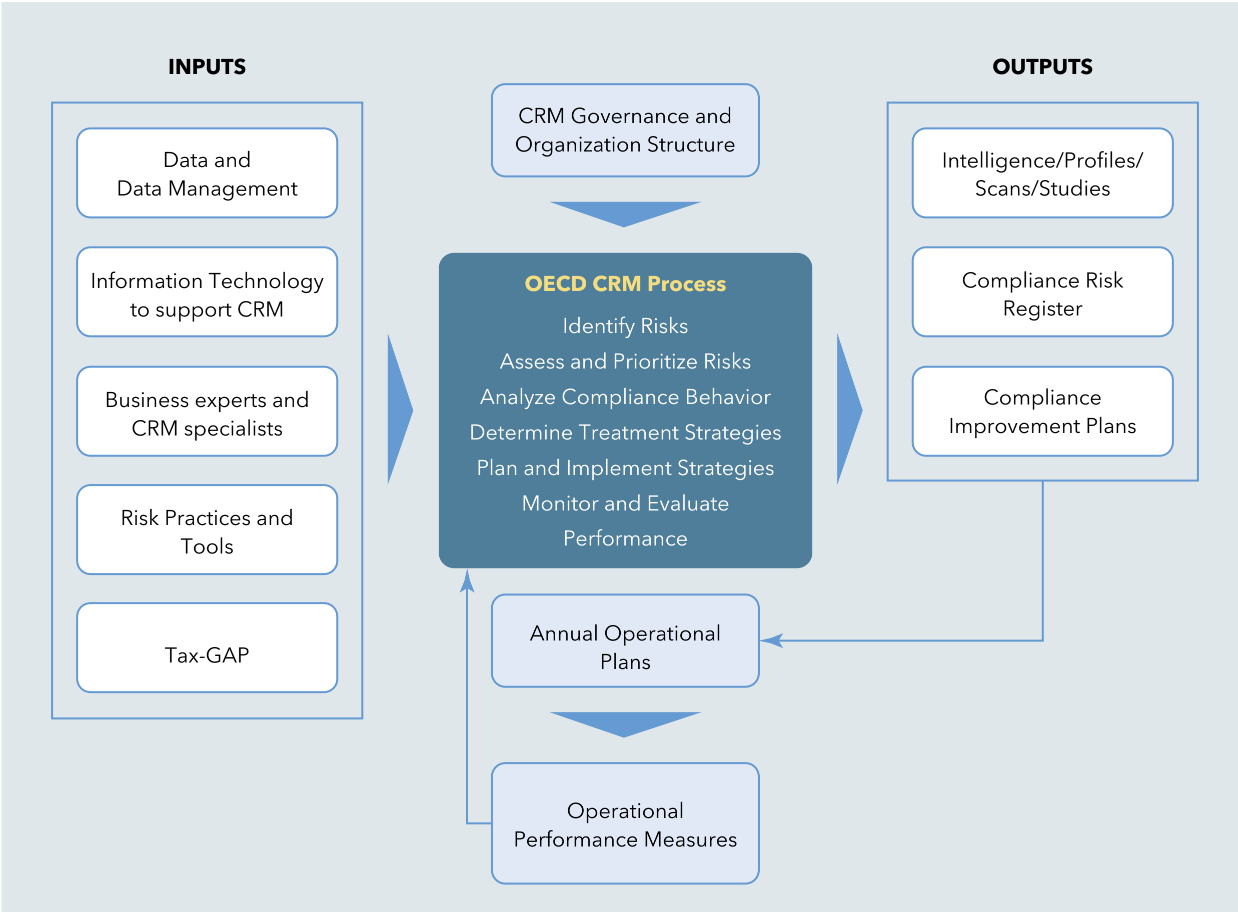
Function-based approaches followed by many tax authorities in developing countries, sometimes inhibit them from having an end-to-end view of taxpayers. This, in turn, prevents the development of integrated compliance strategies for addressing the root causes of noncompliant behaviors, a practice that CRM aims to overcome. Envisioning to maximize voluntary compliance, CRM helps tax authorities in adopting differentiated approaches (services, assurance, and enforcement) for managing taxpayers' populations according to their levels of risk. CRM can provide an end-to-end view of recipients of tax incentives and support the development of more holistic tax incentive compliance strategies, including formulation of legislative reform proposals and capacity development programs.

The cornerstone of CRM is the development of a risk differentiation framework (RDF). No tax authority is resourced sufficiently to look at all taxpayers in depth. The RDF may be viewed as an informed decision-making process to allocate available (scarce) resources to manage the most critical compliance risks. Assigning different treatments to manage risk populations (or scale them from less to more intrusive) is just

[12] See Waerzeggers, Hillier, and Aw (2019) for additional guidance.

[13] For more information, see the "Compliance Risk Management" module of Virtual Training to Advance Revenue Administration. Virtual Training to Advance Revenue Administration is a joint initiative of four international organizations: the Inter-American Center of Tax Administrations, the Intra-European Organization of Tax Administrations, the IMF, and the Organization for Economic Co-operation and Development.

Figure 1. Essential Elements of a Compliance Risk Management Framework



Source: Betts 2022.
Note: CRM = compliance risk management; OECD = organization for economic co-operation development.

the logical consequence of CRM. The basic idea is that not all taxpayers pose the same level of risk—"one-size-fits-all" approaches are rarely appropriate, so resources should be allocated accordingly to actions of different frequency and intensity. The next section presents elements for developing an RDF for managing tax incentives risks.

Customs authorities are also taking a similar approach for CRM. Apart from the traditional transactional risk analysis for the clearance of goods at importation, they have been performing more and more compliance risk analyses before the goods arrive and after the goods are released, particularly for tackling diversion risks from various special regimes and areas of duty relief vulnerable to abuse. Initial prioritization of risks first targets large importers that benefit from exemptions that represent high revenue foregone, as well as known offenders. The output from such analysis is used to determine the most appropriate preventative and corrective measures required to mitigate the risks identified (for example, monitoring programs, desk reviews, on-site checks including post-clearance audits). Chapter 5 of Perez Azcarraga and others (2022) discusses CRM for tax incentives at customs.

For a more systematic view, some revenue authorities have found it helpful to introduce dedicated units to oversee CRM work on tax incentives. These units usually centralize responsibility over the various functions, in coordination with the HQ unit responsible for the general CRM framework. They also administer key documentation, engage with the recipients' community as the main point of contact within the revenue authorities, and liaise with other public bodies involved in managing tax incentives, for instance, for the preparation of comprehensive reports about the revenue foregone. Examples of these units in developing countries include the Nigerian Federal Inland Revenue Service's Tax Incentives Management Department and the Dominican Republic Directorate General of Internal Taxes' Preferential Regimes Department.[14]

[14] Decisions should be made about the involvement of these segment-based units for field operations such as collection enforcement, reviews and audits, and investigation and prosecution, usually in the hands of other function-based units.

III. Developing a Risk Differentiation Framework for Managing Tax Incentives Risks

The journey starts with the systematic identification of tax incentives risks, that is, patterns of noncompliant behaviors resulting in potential revenue leakages. This involves knowledge-intensive processes with a need to draw on different forms of insights and intelligence, leverage on data and advanced analytics, perform or commission research to understand compliance gaps and its components, and, in general, use of accumulated knowledge and expertise.

Some of the usual tax incentives risks found by IMF missions are as follows:

- Granting tax incentives to projects or firms that are not eligible, fictitious business, or previously identified tax offenders.
- Recipients looking to disguise ineligible income or expenditure to qualify for tax incentives exacerbated when they run mixed operations, that is, some operating under tax incentives and others not.
- Harmful compliance risks arise when income incentive regimes are used for profit shifting at domestic or international levels, and other abusive tax planning schemes, particularly transfer pricing abuses. It is well known, for instance, how nonqualified firms shift profits into related parties operating with tax holidays or under free zones by inflating interest payments or by payments for service contracts (management fees) and reinsurance arrangements (premiums), reducing the overall tax burden of the economic group.
- Harmful compliance risks from indirect tax incentives occur when qualified goods from a free zone enter the domestic market without paying indirect taxes or are diverted to ineligible end users (for example, home consumption) or when local suppliers disguise domestic sales in the form of sales to free zones, usually treated as exports under the value-added tax law, and then claim value-added tax refunds.
- Indirect tax incentives pose risks at the time of importation. For instance, oftentimes imported goods are misclassified in order to obtain reliefs fraudulently.
- Importation of certain goods also poses risks of diversion to ineligible end users or private consumption like in the case of fuel, cement, and alcohol and tobacco products, which is exacerbated by smuggling practices.
- Purchasing of assets on behalf of nonqualifying firms that are part of the same economic group or frequent transfer of assets (for example, slump sale, repurchase of assets) between them.
- When a temporal incentive is ending, compliance risks arise because recipients may try to accelerate/anticipate income to include it into the incentive timeframe or transfer deductions that cannot be exhausted to nonqualifying firms.
- Continued grants of tax reliefs to recipients that continuously fail to qualify for the incentive when they miss investment targets/commitments attached.

For assessment and prioritization purposes, an objective mechanism is needed to quantify tax incentives risks identified and assess their relative size. As indicated by Brondolo and others (2022), this involves a combination of qualitative (expert-based) and quantitative (data-driven) approaches for developing noncompliance likelihood (the probability of occurrence) and consequence (impact) ratings, which combine to determine a relative rating of every risk, typically presented in the form of a risk matrix. Risks with higher overall ratings (higher likelihood, higher consequence) require priority actions (risk treatments) by revenue authorities. Other factors such as the institutional capability or the level of risk contagion may influence the prioritization criteria.

For those prioritized tax incentives risks, additional ranking and prioritization work must be conducted for identifying recipients of potential concern. Recipients of tax incentives must be ranked and prioritized according to a reasonable estimation of their level of risk. For this, an initial set of quantitative risk filters should be applied to recipients' data[15] aiming at grouping recipients into various risk categories (for example, lower-, medium-, key-, and higher-risk categories) for having an informed view of relative compliance risk. Risk filters must consider both consequence and likelihood of noncompliance. For instance:[16]

- For consequence of noncompliance, filters may look at the value that best represent recipients' business size (the higher the size, the higher the consequence) like total sales or purchases, gross income, profits, customs value of imports, total investment, and so on.
- For likelihood of noncompliance, filters may look at the ratio that best represent recipients' use of tax incentives (the higher the use, the higher the likelihood) like the ratio of corporate income tax revenue foregone to either investment, gross income, or profits; the ratio of value-added tax revenue foregone to total supplies; the ratios of import reliefs respect to customs value of imports; and so on.

More risk filters (and flags) should be added to further rank and prioritize recipients—particularly if the number of higher-risk or key recipients is larger than the revenue authorities' resource capacity. Among others, they can explore deviations from historical patterns and/or industry or economic group medians,[17] compliance history (filing and payment history, assessments from previous audits, penalties applied in the past, interpretation and litigation history), the level of disclosure, cooperation and engagement with revenue authorities (noncompliance with information reporting obligations), and specific revenue authorities' concerns (related party dealings, use of secrecy and low-tax jurisdictions, foreign-owned recipients, complex organizational structures, hot topics, quality of corporate governance).

The result of applying all risk filters is a risk differentiation framework that helps revenue authorities with forward-looking planning of risk treatments, allocating available (scarce) resources to manage the most critical compliance risks.[18]

- Recipients that show relatively higher consequences of noncompliance demand "one-to-one" approaches; however, those with relatively lower likelihood of noncompliance (key recipients) may require a service or assurance focus, whereas those with relatively higher likelihood of noncompliance (high-risk recipients) must require an enforcement focus.
- Recipients that show relatively lower consequences of noncompliance demand either "one-to-few" or "one-to-many" approaches; however, those with relatively higher likelihood of noncompliance (medium-risk recipients) could require an enforcement and assurance focus depending on the severity of risks, whereas those with relatively lower likelihood of noncompliance (low-risk recipients, the largest risk population) may require a service focus only.

15 Ideally gathered from multiple sources, but if it is not possible, a good start is relying on tax returns data.

16 Aslett and others (2024) developed an Excel-based template for supporting the work with risk filters. It can be downloaded from the IMF's Revenue Portal.

17 Being the deviation percentage: a proxy for likelihood of noncompliance (the higher the deviation, the higher the likelihood), and the deviation value: a proxy for consequence of noncompliance.

18 For further discussion, see Hamilton (2019).

IV. Considerations for a Compliance Program on Tax Incentives

A compliance program on tax incentives should be seen less as one that mobilizes additional resources and more as one that protects revenue bases. This focus would make revenue authorities, at least *prima facie*, more prone to allocate resources for managing tax incentives risks. A typical compliance program focused on tax incentives should cover the whole investment cycle (enrollment, operations, and closing) and combine supportive, preventative, and corrective actions to prioritized tax incentives risks.

A. Enrollment in Tax Incentives Must Be Subject to the Approval of Revenue Authorities

Regardless of any other registration obligation, applicants for tax incentives must register with revenue authorities following the standard procedures established for all taxpayers. A unique tax identification number must be assigned to all recipients of tax incentives. Under such a tax identification number, revenue authorities must record basic identification information in their registration databases such as name, addresses, and contact details; date of incorporation; nature of primary and secondary business activities; list of all representatives (for example, board of directors), associated entities, and related parties (for example, shareholders and subsidiary companies); full details of ultimate beneficial owners; information about the tax incentive (for example, revenue stream, duration, qualified projects, and associated investment targets/commitments); and so on.

Applicants should get final confirmation of their enrollment from the revenue authority before starting their commercial activities and potentially being eligible to tax incentives. Revenue authorities need to perform detailed pre- and post-registration checks on applicants (and their representatives, associated entities, and related parties) such as identity proofs and cross-sectional analysis—looking for associations with other registered taxpayers, information crosschecking against third-party data, on-site visits to premises, and so on—with the intention to verify that applicants qualify for tax incentives or do not pose relevant compliance risks. Failures to pre- and post-registration checks should lead automatically to the rejection of the application or the imposition of additional conditions. Appendix 1 presents a few considerations for enrolling applicants in special economic zones suggested by some IMF missions.

When tax incentives are approved on a project basis, at the time of application, applicants should be required to submit detailed and specific supporting documentation. This includes but not limited to the business plan or a feasibility study; detailed project's financial model specifying the expected internal rate of return—the rate of return that would make the net present value of a series of cash flows equal to the cost of investment; and the investment project profile, including implementation schedule, asset allocation, and investment targets/commitments. Investors should be required to update periodically financial results with actual revenues and expenses.

B. To Ensure Voluntary Compliance through Self-Assessment, Revenue Authorities Must Provide Support to Recipients of Tax Incentives and Ensure Tax Certainty

Modern revenue administration is based on the self-assessment principle. In this regard, the primary responsibility to comply with tax and customs obligations relies on the recipients of tax incentives. To support voluntary compliance through self-assessment, revenue authorities must make it easier to comply with low-cost, simple and user-friendly business processes, fully computerized operations, and extensive guidance, assistance, and information.

Making extensive guidance, assistance, and information easily accessible is fundamental. Recipients require specialized, customized, and targeted information; communication campaigns publicizing policies, guidelines, and procedures—sometimes revenue authorities need to work in tandem with the investors community, private sector's trade and sectoral organizations, and tax intermediaries; practical compliance instructions and guidelines—sometimes in multiple languages and accessible through a variety of channels (call centers, internet portals, information sessions, premium phone services); among others. For example, Fiji Revenue and Customs Service provides a summary of all the tax incentives, conditions to be met, details of tax benefit, and reference to the legislation for all the tax incentives provided in different sectors[19].

Increasing tax certainty is equally important for promoting voluntary compliance. Revenue authorities' interpretation and application of tax and customs rules must be unambiguous and widely communicated to recipients of tax incentives. For instance, administrative commentaries and circular letters may help clarify complex laws, clarifying how tax incentive rules interact with general tax and customs rules or other non-tax legislation, or when there is an overlap of provisions regarding tax incentives, if a tax incentive applies or not in addition to others. As a part of engagement programs, some revenue authorities attend to questions and look for prompt solutions to common misunderstandings.

Public and private rulings are equally important to make the recipients of tax incentives aware of how revenue authorities interpret the law. Rulings, even private rulings, should be published (maintaining the anonymity of the consultant). Moreover, where a private ruling may give rise to BEPS concerns, it might be exchanged with other jurisdictions under the new tax transparency standards (BEPS's Action 5). The World Trade Organization also included transparency requirements in the 2017 Trade Facilitation Agreement: Article 3 of the Trade Facilitation Agreement mandates that authorities publish the requirements for the application for an advance ruling, the time period by which it will issue an advance ruling, and the length of time for which the advance ruling is valid.

C. Filing and Reporting Obligations Should Never Be Waived for Recipients of Tax Incentives

Tax returns remain a critical means by which tax incentives are claimed. Preferably, all recipients should file tax returns (including tailored tax incentive supplementary forms) using electronic means, which enable revenue authorities to perform validations at front. For instance, when capital allowance incentives or other expense-based incentives are claimed through tax returns, revenue authorities can check the recipient's eligibility or flag inconsistent self-reporting based on previous tax returns or third-party information. They are particularly relevant if recipients operate mixed activities, that is, some operating under incentives and others not. From a recipient's perspective, tax returns (as is the case for customs declarations) are the basis for seeking administrative review of any revenue authorities' assessments or appeal of them to a court or tribunal.

The general transfer pricing reporting obligations are sufficient to assist in identifying abusive transactions in connection with tax incentives. The arm's length principle is typically self-assessed, that is, recipients must document that their internal transfer prices correspond to the arm's length principles. Depending on the country's legislation, documentation may include a transfer pricing return (insufficient for conducting an audit or making assessments), a local file (details of a local recipient's intragroup transactions), and a master file (a high-level overview to place the multinational enterprise group's transfer pricing practices in their global economic, legal, financial, and tax context). It is important to ensure that this obligation extends not only to cross-border transactions but also to domestic transactions.

[19] For more information, see the Fiji Revenue and Customs Service website: https://www.frcs.org.fj/wp-content/uploads/2023/08/Incentive-Brochures-10.08.23.pdf.

Access to invoicing and bookkeeping information may complement filing and reporting obligations, eventually enabling the pre-filling of tax incentives information in tax returns. Because invoices record economic transactions, revenue administrations must strengthen invoicing and bookkeeping requirements to ensure timely monitoring of taxable and tax-exempt transactions. Leveraging on emerging technologies, over 50 countries have already implemented e-invoicing mechanisms. Evidence suggests that the use of e-invoicing might have important deterrent effects (Bellon and others 2019). In addition, another group of countries has gained electronic access to recipients accounting by making mandatory electronic transmission of bookkeeping information or developing public accounting platforms. Appendix 2 describes the experience of Brazil launching a digital accounting platform for tax purposes.

Targeted and specialized reporting obligations can help verify compliance with investment targets/commitments. Among others, recipients of tax incentives must report periodically about: jobs created (for instance, by type of employment, region, and duration); net investment flows (for example, capital injections, businesses created); assets allocated to the business activity by type (for example, tangible, intangible); technology transfers; progress reports on transformation of products; and exports levels by volume, type, and countries. This is more relevant when recapture rules exist because the recipient must repay the tax incentive, in full or partially, if the firm fails to comply with investment targets/commitments.

D. It Is Important to Manage Import-Based Tax and Duty Relief Requests at the Time of the Clearance of Goods

Customs authorities often face difficulties managing tax and duty reliefs on imports at the time of the clearance of goods because of limited knowledge of the recipients, the nature and volume of qualified goods granted with reliefs, and the conditions of the reliefs approved by granting authorities to qualified goods. In this regard, clearance of goods should not be granted with duty exemption/reduction without a government authorization (for example, certificates, master lists) that specifies all this information. Customs authorities must work together with other public bodies involved in managing tax incentives to ensure government authorizations flow electronically and expeditiously at the time of the clearance of goods.

For certain import-based tax and duty reliefs, it is also a good practice to request compliance certificates from both the tax and customs authorities before clearing them. These certificates indicate whether or not traders have good compliance records in relation to their tax and customs obligations. If the applicant is a new firm with no compliance history, the requisite of presenting a compliance certificate may be extended to representatives, shareholders, or related parties if needed. For fairness reasons and to level the playing field for businesses, noncompliant traders, especially repeat offenders, should not get the privilege of tax and duty reliefs.

On-site examinations are sporadically required to verify that goods imported under exemption regimes are in fact used for the purpose they were approved for by the granting authorities. Customs authorities should assess the reasonability of imported quantities to the recipient's business size and the suitability of goods to the nature of their business activity or the tax incentive granted. Customs should pay particular attention to sensitive or suspicious goods (for example, cement, fuel oil, vehicles, alcohol, machinery, equipment, electronic devices). Physical goods inspection is ideal for detecting nonconformity issues such as misclassification of goods (sometimes requiring laboratory analysis) or volumetric imbalances.

E. Traceability Mechanisms of Transactions, Assets, and Inventories, and Collection of Third-Party Data Enhance the Effectiveness of Compliance Approaches

Revenue authorities should be able to trace assets and inventories that belong to recipients of tax incentives and monitor their transfers, transformations, valuations, and variations. For instance, end-to-end cargo traceability approaches by customs authorities enable monitoring inventories of goods (shrinkages and waste volumes) at ports of entry, warehouses, inward processing (to verify the quantity or percentage of processed products obtained from the processing of a given quantity of goods placed under the processing procedure), free zones, special regimes (such as exemptions and suspensive regimes), and temporary admissions (Perez Azcarraga and others 2022).

As indicated in Appendix 1, customs authorities, in particular, must have the power to mandate physical and intangible security standards at importers' premises, free zones, and ports of entry.[20] Standards may include fences, entry/exit gate control, closed-circuit television camera systems, and any other standard that allows full monitoring of entries and exits. Customs authorities should also be legally empowered to access and inspect the premises and records of free trade zone operators and other traders at any time. For effective monitoring, free zone activities should be conducted in customs-controlled designated areas. This is a good practice promoted by the World Customs Organization (see World Customs Organization 2021).

Apart from the information exchange with other public bodies involved in managing tax incentives, revenue authorities must have sufficient powers to collect relevant data from third parties. To ensure accurate reporting, revenue authorities must have the capability to systematically crossmatch self-assessed information reported by recipients of tax incentives against information from, for instance, law enforcement and security agencies, financial institutions, free zones administrators and operators, real estate property registers, service providers, external commercial databases (transfer pricing databases), and from other jurisdictions (regional and international partners) through active exchange of information, for which the adequate international agreements and conventions must be in place, for example, double tax agreements, Tax Information Exchange Agreements, the Convention on Mutual Administrative Assistance in Tax Matters, and Common Reporting Standard Multilateral Competent Authority Agreement.

F. Revenue Authorities Must Build Broad Knowledge on the Recipients of Tax Incentives Before Embarking on Reviews, Audits, and Investigations

Knowledge starts by scanning all available data of recipients of tax incentives. As indicated in section III, based on large-scale data matching and crossmatching activities, scanning activities (sometimes called monitoring programs) apply multiple risk filters (and flags) to tax returns data and other available data aiming to group recipients into various risk categories to have an informed view of relative compliance risk. Many times, scanning activities enable a first tier of engagement programs looking to encourage self-correction of anomalies or inconsistencies through telephone contact, reminder letters, or email.

There is a need to develop intelligence-driven recipients' profiles to further refine the risk hypothesis of those who show relatively higher consequences of noncompliance (key and higher-risk recipients). Profiling work must be conducted jointly, among others, by risk analysts, relationship managers, and subject matter experts (for example, industry-based specialists), drawing together risk information and tools (360-degree views). Practices vary, but several revenue authorities undertake profiling work based on the BISEP (Business, Industry, Sociological, Economic, Psychological) model.[21] Medium-risk recipients who show relatively lower consequences of noncompliance may also be subject to profiling work as a second-tier grouping, particularly if relevant transactions have been identified.

Apart from understanding recipients' context and environment, profiling work requires a deep exploration of tax incentives concerns. The BISEP model (and others) is used primarily to understand a taxpayer's

[20] Some intangible standards include financial security (business viability), personnel security, trading partners' security, as well as crisis management and incident recovery capacity (for example, appointment of a board member responsible for security, compliance, and staff training from this perspective).

[21] See Brondolo and others (2022) for a discussion about the BISEP (Business, Industry, Sociological, Economic, Psychological) model.

context and environment, but for tax incentives, experts need to also address, for instance, the following issues:

- Why is the size of the activity outside the sectors or geographical areas subject to tax incentives so high? Conversely, why is the activity level inside the areas so low?
- For recipients conducting part of their business without tax incentives, is the apportionment of their activities benefiting from the reliefs reasonable?
- Is the composition or nature of exempt purchases and imports in line with the tax incentives?
- Is the size of domestic or cross-border transactions of the recipient with related parties too high?
- Is the recipient associated with other businesses receiving tax incentives at the same time or with the same beneficial owner?
- Is there a history of recipients or shareholders receiving incentives in other countries and issues of noncompliance have been raised by other jurisdictions?
- Is the capacity to compete of the industry's qualified businesses affected considerably by tax incentive abuses?
- Is there a suspicion that entities using export promotion programs are diverting goods into the domestic market?

G. A Graduated Enforcement Approach Is Desirable when Planning Reviews, Audits, and Investigations on Tax Incentives

Risk reviews help revenue authorities gain clarity over the recipient's risk positions, circumstances, choices, and behaviors. Broad knowledge about recipients of tax incentives (see the previous section) enables more accurate case selection for comprehensive or specific risk reviews. They typically request additional disclosure of information from recipients of tax incentives to gain clarity over their affairs. Risk reviews enable an efficient use of resources because risk concerns are resolved or settled by revenue authorities without necessarily conducting an audit or investigation (most of the time, an in-person meeting is sufficient). Note that at any time a risk review can escalate into an audit or investigation if needed.

Audits and investigations must be initiated if risk concerns are not resolved with risk reviews. They are tools of last resort because they are labor-intensive, have a higher cost, and could be disruptive to recipients' operations. Therefore, whenever possible, their application should target recipients of tax incentives who are most likely to be noncompliant and with relatively higher consequences of noncompliance. Comprehensive (or full) audits should focus, for instance, on tax planning schemes or transfer pricing issues, and prosecutorial investigations whenever there is suspicion that a tax evasion or a tax fraud may have been committed. For other matters, it seems more appropriate to conduct less intrusive forms of audits and investigations like desk audits, issue-based audits, or industry-based audits, for instance, as a part of a project involving various recipients.

It is a good practice to disseminate results from reviews, audits, and investigations in a systematic way as a part of a broader deterrence strategy. For instance, countries like Australia (Taxpayer Alerts), UK (Tax Avoidance Schemes), or Chile (*Catálogo Esquemas Tributarios*) flag schemes and arrangements of concerns identified by revenue authorities, looking to increase the recipient's perception that they are aware of contrived or artificial arrangements and ready to apply a general anti-avoidance rule if it is available.[22] Similarly, prosecution of tax evasion or tax fraud cases should be highly publicized for showing credible enforcement capacity and deterring misconduct by others.

Post-clearance customs checks and audits are a key component of a compliance program focused on goods imported with reliefs. Although virtually all tax incentives are subject to restrictions regarding the use of goods imported with reliefs, customs authorities usually do not prioritize enforcement actions after

[22] See Waerzeggers and Hillier (2016) for additional guidance.

customs release (Montagnat-Rentier 2019). If they are not undertaken, all the good verification work done at prerelease or release stages may be undermined. In this regard, customs authorities should target higher-risk recipients continuously and key-risk recipients as needed with: on-site visits to importer's premises (factory, warehouse, place of business) to check inventory or confirm goods have not been sold and are used for the authorized purpose; desk reviews analyzing additional documentation; and post-clearance audits, some of them conducted jointly with the tax authority, oriented, for instance, to verify that goods imported with tariff reliefs were effectively processed and exported, were totally consumed without waste, or paid taxes in case they were sold in the domestic market.[23] Customs authorities should not pay attention only to quantity but also to the value of transactions under special regimes.

H. Weigh the Convenience of Adopting Assurance Approaches for Those Recipients That Demonstrate a Sound Level of Disclosure, Cooperation, and Engagement

Modern revenue authorities adopt assurance approaches as another element of their integrated compliance strategy. Also referred to as cooperative compliance approaches (or trusted trader programs in the context of customs administration), they offer earlier or additional tax certainty from the revenue authority in exchange for additional transparency and disclosure practices from taxpayers (or traders).

According to the tax administration diagnostic assessment tool,[24] assurance approaches are usually offered to taxpayers that demonstrate good governance of their tax affairs. They manage compliance risks of inaccurate reporting upfront (that is, before the tax return is filed or the customs declaration is submitted for release), increasing tax certainty, and reducing the possibility of tax litigations. Taxpayers commit to operate in an open and transparent manner and to make full disclosure of their tax risks as they occur (that is, closer to real time). In exchange, revenue authorities agree to provide tailored services, speed up clearance or resolution of technical and administrative issues, assign reduced risk ratings, and reduce the number of penalties. They may take the form of an agreement between the taxpayer and the revenue authority—as it is the practice in various OECD countries—or simply the form of an open forum. What is central is the possibility of a mutual understanding of risk positions.

A similar approach can be introduced while designing a compliance program on tax incentives. Assurance approaches may target primarily recipients of tax incentives who show relatively higher consequences of noncompliance but lower likelihood of noncompliance and who show a reasonable level of disclosure, cooperation, and engagement with the revenue authority. For instance, they are good candidates for Advance Pricing Agreements to determine upfront the acceptable transfer price of a transaction, for voluntary risk assessment and assurance programs like the OECD's International Compliance Assurance Programs focused on international tax risks, for less intense or frequent reviews and audits based on the level of confidence on how they manage their tax affairs, including settlement options before the end of the review/audit work to resolve potential litigations, or for alternative dispute resolution mechanisms.

On the customs front, trusted trader programs enable more robust pre-arrival controls of import-based tax and duty reliefs. This allows customs authorities to optimize their resources and concentrate their efforts on high-risk economic operators and goods (rather than trusted traders) at the time of arrival of goods at the border. These programs can evolve into authorized economic operator programs, which generally waive selectivity criteria during clearance of goods based on traders' compliance history. Appendix 3 presents

[23] Legislation should not prevent customs and tax authorities from visiting importer's premises; in fact, it should explicitly enable it.

[24] Tax administration diagnostic assessment tool provides a 360-degree diagnostic of the performance of a tax administration using 9 performance areas and 32 indicators. TADAT assessments focus on the administration of the following core taxes: value-added tax, corporate income tax, personal income tax, pay-as-you-earn amounts, and excise taxes. By assessing outcomes in relation to the administration of these core taxes, a picture can be developed of the relative strengths and weaknesses of a country's tax administration system.

an outline of the assurance approach to be implemented by Fiji Revenue and Customs Service for tackling customs risks.

I. Revenue Authorities Must Follow a Complete Recipients' Due Diligence Process when a Tax Incentive Comes to Its End

Regardless of any other deregistration obligation, deregistration of recipients of tax incentives from the taxpayer registration database must follow the standard procedures established by revenue authorities for all taxpayers. Deregistration should proceed only after completing a due diligence process that includes a documentation review, on-site inspections of business premises, verification that recipients are up to date with tax and customs obligations, and clearing of any outstanding tax and customs liability, among others (Nyanga 2023).

Revenue authorities should have the ability to deregister ex officio all recipients with expired tax incentives when they do not voluntarily initiate deregistration. Recipients must be automatically deregistered from the revenue authorities' registered taxpayer database and from the registration databases of all public bodies involved in managing tax incentives. When information technology systems interoperate, deregistration is quite a straightforward task. If this is not the case, timely communications would prevent the possibility of continuing to benefit recipients with the tax incentive after the expiration date. For instance, revenue authorities and Natural Resources Agencies that oversee extractive industries exemptions should work collaboratively to rigorously identify the differences in exemption rights and their timeframe according to the exploration, development, production, and decommissioning stages.

If needed, and within the limits prescribed by the law, revenue authorities must initiate collection actions over secondarily liable persons to improve the recoverability of tax and customs debts if they exist. Legislation should allow, for instance, the application of collection enforcement actions over those who are or have been managers of a business granted with tax incentives, irrespective of whether the business has ceased to exist.[25] Similarly, if the business is transferred, the transferee should be liable for prior tax debts unless the transferor obtained a tax clearance certificate prior to the transfer (Waerzeggers and others, forthcoming).

It is a good practice to condition any renewal of tax incentives to the presentation of evidence about their effectiveness. The cost–benefit analysis discussed earlier may bring to light the effectiveness and affordability of different tax incentives and be a key element when discussing their renewal. For instance, in Peru, any bill proposing a renewal of tax incentives must be accompanied by a cost–benefit analysis, demonstrating that tax breaks and reliefs were effective to achieve desired policy objectives. Similarly, when tax incentives are approved on a project basis, any negotiation for a renewal period should be conditioned to the presentation of project-specific evidence about their effectiveness during the original timeframe.

[25] It should not apply to a manager who has exercised a reasonably prudent degree of care and diligence in preventing the business from failing to pay taxes.

V. Conclusions

This note sets out the essential elements to effectively manage tax incentives risks. The majority of the elements are common to both tax and customs authorities, like the need for a strong governance arrangement and supporting procedures, and an integrated work by all public bodies involved in managing tax incentives. In this vein, transparency and accountability regarding tax incentives and the revenue foregone play an important role in maintaining public trust. Comprehensive and actionable legislative frameworks are crucial enablers for government. Both legislation and regulations need to be translated into tax and customs enforceable procedures that provide recipients with as much predictability and certainty as possible.

Key to the successful management of all tax incentives is to have an effective CRM framework in place. The note sets out a conceptual framework, particularly the development of a RDF for compliance planning. Key to the design and implementation of a CRM framework is a thorough understanding of the risks associated with each tax incentive. Understanding the different levels or segmentation of taxpayers according to their risk profile is also critical to identifying and mitigating the risks of any specific tax incentive. Because CRM is a continuous process, revenue authorities should routinely and systematically evaluate their compliance programs to verify their effectiveness in ensuring sound levels of voluntary compliance. This way they can evolve, adapt to new trends and risks, and build more robust and relevant compliance programs over time in a continuous improvement process.

The note also provides operational guidance on the concrete steps that need to be taken to improve tax incentive management. Guidance focuses on the following five key areas:

- Achievement of better enrollment underlining the role of revenue authorities in this particular procedure.
- Preventative actions, covering sound self-assessment support, filing and reporting obligations, and custom authority role in managing import-based tax and duty reliefs.
- Graduated enforcement approaches, which start building a broad knowledge of recipients of tax incentives before embarking into reviews, audits, and investigations, leveraging on robust traceability mechanisms and third-party information.
- Improvements to the closing phase, where due diligence and final deregistration of the recipients are needed.
- Considerations of assurance approaches for compliance improvement.

APPENDIX 1. Enrolling Applicants in Special Economic Zones

Revenue authorities should be consulted before the enrollment of investors and should be empowered to:

- Prevent authorization of applicants with a poor compliance history.
- Apply conditions to authorizations, including eligible commodities, financial guarantees, and expected production formulas to link inputs to outputs.
- Suspend authorizations of investors in case of tax debt through the territory.
- Revoke authorization of investors committing revenue offenses.

Investors should hold full computerized information on their economic activity within the zone, including imports, exports, supplies and purchases of goods and services, inventory log, and records of manufacturing process sufficient to reconcile inputs with outputs.

All zones should be within the customs territory of the country—these zones may suspend the application of taxes and duties but not control and enforcement powers exercised by revenue authorities.

Revenue authorities should have the power to:

- Impose conditions in terms of control resource availability and accessibility.
- Require construction/management security standards, including fences, board member responsibility for security and compliance, and entry/exit gate control and log record.
- Set the requirements for data and records to be held by zone operators and investors.
- Access and inspect premises and records of zone operators and investors at any time.

APPENDIX 2. Digital Accounting Platform in Brazil

Leveraging on emerging technologies, revenue authorities at the three levels of government launched in 2007 a public digital accounting platform (Sistema Público de Escrituração Digital, SPED) to receive, validate, store, and authenticate electronically financial, tax, logistic, transport, and labor information from firms.

SPED manages invoicing information of goods and services, bills of lading, bookkeeping information (including daybook, ledger, books comprising daily interim balance sheets, balance sheets, and entry forms), and payroll information, and it enables electronic filing and information reporting for taxes, withholding taxes and social contributions.

SPED allowed the Brazilian Revenue Authority to collect massive volumes of data, which in turn triggered innovative data-driven solutions to better support enforcement activities. For instance, access to electronic invoices at firm level enabled revenue authorities to monitor taxable and nontaxable transactions of goods and services (almost) in real time.

Combined with electronic bill of lading, SPED also enabled revenue authorities to trace merchandise across the country, by having a clearer view of the taxpayers' supply chain. Early access to firm's accounting information (invoices, bookkeeping, payroll) not only supports compliance enforcement strategies (for example, revamped tax compliance risk analysis, more targeted audit work) but also promotes voluntary compliance through a significant reduction of compliance costs.

In the context of Brazil, the latter point is of relevance given the existence of multiple taxes and duties levied at federal, state, and municipal government levels. SPED helped to standardize accounting documentation and tax procedures, and it even helped firms to improve accounting standards, strengthen internal controls, and enhance their digital relationship with clients and suppliers.

APPENDIX 3. Assurance Approaches Planned for Tackling Customs Risks in Fiji

To address the compliance risks associated with customs exports and imports in Fiji, Fiji Revenue and Customs Service (FRCS) will develop a multipronged approach to promote customs compliance and reduce the culture of noncompliance among brokers and traders. FRCS will create more awareness among customers regarding customs requirements for imports and exports. This will bridge the knowledge gap and raised awareness of relevant duties and taxes payable. For high-risk customers, FRCS will target profiling of noncompliant traders and brokers and strengthened its Customs Profiling Committee by reviewing profiles in ASYCUDA World System and Cargo Targeting System. FRCS will also invest in advanced data analytics software and cooperate with other agencies for data exchange to analyze patterns and behavior of traders for further analysis. This will determine whether customers need more awareness or need to be profiled. Continuous monitoring and spot checks of the bonded warehouses will be conducted to identify loopholes. Reminder letters will be issued to operators with warehouse goods nearing their expiry dates to clear them within six months. The advanced rulings will also be publicized to focus on the classification and valuation of goods, as well as the rules of origin. These measures will help FRCS promote customs compliance and reduce the culture of noncompliance among brokers and traders.

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PUBLICATIONS

Managing Tax Incentives in Developing Countries

TNM/2024/07

ISBN 9798400289590