



Tax Reform in Iraq

**USAID/Economic Governance II Project
Bearing point Co.**

Prepared by: Touhami Rhaiem



Preface



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- **Iraq Adopted the first income tax law no.52 in 1927 after the establishment of the modern Iraqi state in 1921. That Law was greatly influenced by the model income tax law prepared by Great Britain in 1922 used in the British colonies .**
- **Since 1927 till the adoption of the current income tax law No.113 of 1982 no significant developments happened on the tax legislation .**
- **No major amendments happened to law no.113 except for some laws with no apparent impact on the tax system in general .**



preface

- **After the fall of the former regime the coalition provisional authority , issued order no. 37 by which suspended the tax system starting from April /16/2003 till the end of that year .**
- **The tax system was reinstalled at April /1/2004 .**
- **The CPA issued order No. 49 reducing the tax price of the income tax and increased the legal allowances and subjected the governmental employees to income tax like the employees of the private sector.**
- **Order No. 49 kept the current laws in force. However, The tax reform is not the reduction of tax rate and increasing the legal allowances only, but also the structure and substance of the whole tax system .**



Evaluation of Current Tax System



The Evaluation of the Current Tax system

- **The current Iraqi tax system was designed for an internal highly centralized economy .**
- **The current tax administration laws does not provide enough guidance to the requirements of compliance and give the tax administration officers a wide discretion and inconsistence implementation.**
- **The current tax legislation suffers from many deficiencies that make its implementation and the compliance with a difficult thing if not impossible in some cases.**
- **The complexity of the current system.**
- **The scheduler nature of the system.**
- **Imprecision of the tax base.**
- **Lack of neutrality of the current system.**
- **Spread tax legislations.**
- **Inadequate supporting laws to ensure the accurate implementation.**
- **The lack of logical structure.**

This deficiency is due to a fragmented tax policies which led to a chain of random amendments during long period of time .



Why does Iraq Need Tax Reform?



Why does Iraq needs Tax Reform

General goals of tax reform

- **The necessity to abandon the old approaches for taxation and tax policy**
- **Article 25 of the new constitution compels the government to “reform the Iraqi Economy according to the modern economic principles “**
- **Also article 26 of the new constitution stated that the government shall encourage the investment. Taxes are essential instrument for the government to encourage local and foreign investments**
- **There can not be an economic reform and investment encouraging without a modern tax system**
- **Article 107 of the Iraqi constitution grants the central government a wide authority to set the fiscal and customs policies in order to make the reform**



Why Does Iraq Need Tax System Reform?

The Special goals of the Tax Reform :

- **Improve the competition capacity of local and foreign investors on the international market**
- **Stable and effective source of revenues for the government to reduce dependability on Oil resources and changes in the Oil market.**
- **Taxation in the modern economies is an essential tool to finance public expenses, and achieve social and economic objectives.**
- **The tax system is also an effective instrument for the government at the time of inflation and economic crises.**



The Principles of Tax Reform



The Principles of Tax Reform

- **A well-designed tax system should satisfy the criteria of equity, neutrality and simplicity.**
- **Details of the tax system may change but the basic rules of any tax system don't change because they reflect the equilibrium of those criteria.**
- **In a fiscal reform, the challenge for the government is to design an efficient, fair and simple tax system that is conducive to the above objectives.**
- **Reforming the tax system is a complex process and requires changes in several areas starting with the tax legislation and the tax administration.**



Principles of Tax Reform

The following actions must be adopted in designing a new tax system:

- **The reform should emphasize the neutrality of the tax system and the simplicity of its components.**
- **The reform should be oriented towards raising additional revenues, with essential questions being: What to tax? Who to tax? At what rate?**
- **It should not be left to the tax administration to decide what is taxable and what is not, this should be provided by law.**



Legal Basis of Tax Reform



Legal Basis For Tax Reform

- **The process of setting a tax system is subject to constitutional, administrative and legal conditions and rules and the political structure of the country as it was a federal or central system.**
- **The principle of legality is based on the principle of “no taxation without representation “ this means no tax can be imposed without law. This rule is stated in article 28 of the new Iraqi constitution.**
- **The other principle related to the authority to impose taxes, some constitutions allow the legislator the authority of impose taxes under certain criteria (federal or state taxes).**
- **Revenue raised by tax must be used only for lawful public purposes.**
- **These principles should be enforced by independent courts and other institutions (article 103 of the constitution).**



Legal basis for tax reform

- Tax reform should result in stable laws as much as possible by minimizing the frequent changes.
- Frequent changes in tax legislation upset the expectations of investors and make it difficult for them to understand and comply with the laws.
- In the republic of Kyrgyzstan, for example there were 600 amendments to the tax law at the first years of its adoption , that led the government to think of drafting a new law. While in Kazakhstan , the law of 1995 became incomprehensible because of the random amendments, so that the government decided to **set** a new tax law in 2001.



Individual Income Tax



Reasons for Individual Income Tax

- **Income tax is imposed on individuals in general mainly because it is taxing the rich and leaving the poor with the little they have. (Equity principle)**
- **Where there is corporate income tax then there should be income tax on individuals. Otherwise, the tax system would discourage the corporate form of business and would encourage other business forms that might not be undesirable for the economy. (Neutrality principle)**



Tax Base

The determination of the tax base lies on three elements:

- 1. The inclusion of taxable income**
- 2. The identification of exempt income**
- 3. The determination of net taxable income**



Tax Unit

- **The tax unit is the base for calculating the taxable income .**
- **the tax unit include either the individual or the family.**
- **The current Iraq tax system recognized the individual as a tax unit in principle, article 6(1) of law no.113**
- **But, the Iraqi law adopted the principle of aggregation of income of spouses without any procedures to reduce the tax burden.**
- **In case of aggregation of income the husband benefit from a legal allowance for his wife in an amount of 2000000 instead of 2500000 ID and the tax is imposed on the husband.**



Tax Unit

- **For children under 18 years old and unmarried, the law does not recognize them as taxpayers and their income is added to that of the father. The father is then granted an allowance of 200000 ID for each child.**
- **In this case the father's tax burden is heavier, which is unfair and violate the equity principle.**
- **We recommend using the individual as a tax unit with family tax relief for married couples and children on charge.**



Taxation Criteria

1. Residency

- **Countries adopt residency, or citizenship (or both as in USA) as criteria for imposing tax on individuals.**
- **Law # 113 adopted a mixed criteria based on citizenship and residency , as the foreigner resident is not subject to taxation for his foreign income.**
- **Tax on world wide income is imposed only on Iraqi citizens.**
- **There should be no discrimination in taxing taxpayers based on citizenship.**
- **The new income tax law should adopt a revised and simplified two-test residency for individuals. Under this test, a resident of Iraq would be:**
 1. **Any person domiciled in Iraq, or**
 2. **Any person physically present in Iraq for 183 days or more during the year.**



Taxation Criteria

- For legal person incorporated under Iraqi Laws or those having the central management and control in Iraq should be subject to income tax in Iraq.
- The purpose of this criteria is to prevent companies from establishing in low tax countries in order to avoid paying tax on foreign sourced income.
- The definition of residency for physical and legal persons should meet the international standard to encourage investments.



Taxation Criteria

- **Source country** : unlike residents , tax imposed on non-residents income for the income sourced in the country only.
- Thus, law shall provide rules for determining the income from foreign source and the income from local source according to the international implementation.
- **Final withholding** : Tax may be collected through a final withholding, the range of the withholding should be expanded to include most of the payments to non-residents like the interests and dividends.
- **Permanent establishment** : Most countries impose tax on the “*fixed place*” of the project which operated by the non-resident through “Permanent establishment” even if that place was not an independent domestic company but a branch of non-resident company. [See Section 5 the OECD Model Convention]
- Once this rule is adopted in Iraqi new tax system, Regulations no.4 becomes no longer relevant.



Legal Allowances

- **Article 28 of Iraqi constitution exempted the low income taxpayers from taxes.**
- **The methods of exempting low income taxpayers from taxes**
- **Foreign countries follow three methods for reducing tax burden on low income taxpayers:**
 1. **Tax exemption (zero rate).**
 2. **Personal tax allowances** (which is the most effective because it has effect on tax progressivity).
 3. **Tax credit.**
 - **The income on which a person starts paying tax defers from country to another because of the differences in the basic personal needs.**
 - **Determining the personal allowances should be take into consideration the allowances for wife and children and the tax structure.**



Legal Allowances

- **Order No. 49 granted personal allowance of 2500000 ID. about 1900 \$ with exchange rate 1300 ID per dollar.**
- **The income level in Iraq for 2002 was 2400 \$, so the legal allowance for 1900 is 80% of the annual income, which is very high.**



Tax rates

The following factors should be considered in determining the personal income tax rates:

1. **The progressivity: equity in tax system requires setting a structure of progressive tax rates.**
2. **Simplicity: high tax rates effect tax administration.**
3. **Business incentives: High tax rates create negative business incentives.**
4. **The prevention of tax evasion: High tax rates encourage tax avoidance.**
5. **Integration : personal income tax should be consistence with corporate tax and social tax system.**
 - **Before the war the income tax rates for individuals was ranging between 10% to 40%.**
 - **Order No. 49 reduced tax rates for individuals to 3% (lowest rate) and 15% (the highest)**



The Reasons for Corporate Income Tax



The Reasons for Corporate Income Tax

The current problems of Iraqi corporate income taxes:

- Weak legislative basis
- Weak administrative capacity
- Lack of accounting standards

The important reasons for imposing corporate income tax:

- Importance of foreign investment
- Foreign investments should be treated in a “neutral” manner
- Foreign corporate tax is based on worldwide income, with corporate income tax paid in foreign countries creating tax credits in another country.
- Should the Iraqi government not impose a corporate tax, then there is no tax credit generated in the foreign tax law, and the corporation must pay the whole amount of tax to the foreign country
- The result the tax impact is neutral for the foreign company, but Iraqi government lose an important tax revenue, and only the foreign government benefits from.
- So why let this money go to the government of the foreign investor when it could benefit Iraqi government without causing any disincentive to foreign investments.



Considerations for corporate income tax reform



When establishing the corporate income tax, it might be useful to take into consideration the following:

- **Harmonize the corporate and personal income tax provisions regardless of the form of organization**
- **There should be only one corporate tax rate**
- **There should be no zero income tax bracket for corporations**
- **The corporate tax rate should not exceed the top marginal tax on personal income tax.**
- **Corporations should be required to make anticipated payment of taxes. These anticipated payments should be a fixed percentage of gross monthly revenues**
- **All corporations should be subject to the same corporate tax. There should be no exemptions.**



Tax Accounting

- **Income tax shall be imposed on a periodic base for each tax year, this means that it should calculate the taxable income separately for each year**
- **Currently there is no accounting methods provided in law no.113 for determining taxable income**
- **There should be accounting methods in the new tax system income, or adopting the international accounting standards**
- **Adopting a depreciation system based on the pool of assets and not the kind of industries as it is currently.**



Encouraging the Investment



Encouraging investments

Factors affecting investors decisions:

- **Political stability**
- **The availability and cost of labor**
- **The infra-structure**
- **Corporate income tax**
- **Simplicity and stability of tax system.**



Encouraging Investments

Tax incentive to encourage Investments

1. Low tax rate

- **The most important element that encourage foreign investment is to maintain a simple fiscal system with a low tax rate for all corporations, domestic and foreign**
- **A low corporate tax rate is, in itself, an incentive. It allows investors to keep a larger portion of profits**
- **It indicates that the government is letting the market determine the most profitable investments without undue governmental influence**
- **The main disadvantage of low taxes, is that they benefit to existing companies as well as to new investments.**



Encouraging Investments

2. Tax Holidays:

- **Relatively easy to administer. This is likely one reason why they are widespread in developing countries**
- **Provides large benefits as soon as the company begins earning income, and thus will be more valuable than an incentive such as a lower corporate tax rate that accrues more slowly over a longer time**

Disadvantages of tax holidays :

- **Primarily benefit short-term investments, which often are undertaken in so-called “footloose industries” characterized by companies that can quickly disappear from one country to reappear in another country**
- **Rewards the founding of a new companies rather than an investment through existing companies**
- **Discriminates against investments that rely on long-term depreciable assets, like the oil sector.**



Encouraging investment

3. Investment allowances.

- Many countries, especially in the industrial world, allow fast write-offs through accelerated depreciation or give tax allowances or credits for investment expenditures
- Either all investments, or those they especially want to induce through tax allowances or credits.

Investment allowances advantages:

- The incentive is targeted at the desired activity since a company receives the benefit of lower corporate taxes only if it makes capital investments
- It encourages companies to take a long-term view when planning investments
- By targeting current capital spending, the allowance causes less revenue leakage than would a tax holiday
- It promotes new investment
- Accelerated depreciation is generally viewed as the least costly, as the lost revenue from accelerated depreciation in the early years is partially recovered in later years of an asset's life.



Income tax and the social Contributions

- **Most countries reformed their tax system and the social insurance systems to adopt one base for calculating the individual income tax social contributions, retirement and unemployment**
- **Adopting the same rules for tax and social contributions is a matter of achieving good economic policy and good administrative efficiency**
- **Achieving the unified base can be fulfilled easily by referring in the retirement and social insurance law to the same tax base of the income tax law.**



Recommendations



Recommendations

- **These recommendations flow from a comprehensive review of the current income tax legislation in Law # 113 introduced in 1982 as well as related regulations and other laws which impact the tax system**
- **Tax reform is not limited to the reduction of tax rates and expanding the tax base only, but also Iraq need major changes in the tax system to remove the random policies of the former regime to prepare the way to total economic reform**
- **Draft an entirely new Income Tax Law with a view to developing a Tax Code**
- **Setting a unified tax system to unify all direct and indirect taxes together**
- **Develop a new Tax Administration Law applicable to all tax laws**
- **The new income tax law should translate tax policy into action by the tax administration and taxpayers and reduce unwanted results**



Recommendations

- **To design a coherent tax structure that operates properly, the new Iraqi tax law should clearly identify the procedures of determining the total income, net income, and the taxable income**
- **The new income tax law should be simple and its principles consistent**
- **Equitable treatment for all taxpayers whether individuals or corporations**
- **Income tax should include a wide tax base and a large legal allowances in order to exclude low income taxpayers from submitting tax returns**
- **The wider the tax base is, the lower tax rates are**



Highlights of the proposed approach

- **Adopting self-assessment system for individuals provided that withholding tax shall be the final tax, in this case employees shall not submit a tax return unless they have another source of income**
- **Developing the tax system transparency by merging the real estate tax and other income tax in one unified income tax law**
- **The corporate law should be reformed according to modern principles to encourage and stabilize foreign investment**
- **The individual shall be the tax unit with tax relief for the family, married persons and children related to them**
- **The corporate tax rate should be flat rate**
- **Introduce capital gains tax with transitional rules to deal with the accumulated profits**



Tax Administration



Tax Administration

- Tax policy determines the contents of tax law and their methods, and tax administration is in charge with implementing those policies
- The Tax administration translates the tax laws into revenues
- The tax administration assume that the tax base and the tax rates were made correctly and should implement them with effectiveness and efficiency
- Currently, each tax in Iraq includes special tax administration rules, some laws of them do not include any administrative rule (sales tax)
- Generally, administrative rules are the same in most taxes, for this reasons instead of repeating them in every law which lead to confusion, it is better to draft a unified a tax administration law that unifies provisions for tax administration, and make their implementation more consistent
- The unified tax administration law should be organized around the different functions necessary for the tax administration (registration, record keeping, tax returns, audits, appeal...)



How to achieve the tax reform

- **Tax Policy should be the duty of the ministry of finance, while the implementation should be attributed to the tax commission**
- **Establishment of a new unit for proposing stable tax policy to implement the tax and economic reform of the country and prepare tax legislation for that purpose**
- **USAID has assisted the ministry of Finance of Iraq in establishing a Tax Policy Unit. The Unit is now staffed and functional**