



**USAID/Iraq Economic
Governance II**



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Tax Administration Reform

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Preface

While tax policy defines the tax laws and methodologies, it is tax administration that puts those policies into effect. Tax administration seeks to translate tax laws efficiently and effectively into tax revenue. Tax administration performance is evaluated with respect to the three requirements of effectiveness, efficiency and equity. The more complex it becomes to administer taxes because of complexity of the tax rules, the less effectively will the tax administration collect the potential taxes. At the same time its efficiency will be diminished because the cost of tax collection will be high.

An essential precondition for the reform of tax administration is to simplify the tax system to ensure that it can be applied effectively in the generally "low compliance" contexts of Iraq. The reform should focus on reducing the complexity of the tax system, encouraging taxpayers' voluntary compliance, differentiating the treatment of taxpayers by their revenue potential, and ensuring the effective management of the reform.

To design a tax administration reform strategy it is important to identify the problems that disrupt tax administration operations: taxpayer registration, returns and payment processing, computer operations, arrears collection, delinquent taxpayers, audit, sanctions and penalties, taxpayer services and publicity, management and organization.

Tax administration reform should be part of a broader fiscal reform effort aimed at restoring macroeconomic stability and at restructuring tax systems so that taxes are more efficient, less distortionary of market forces, and easier to administer. It seldom makes sense to try to reform tax administration without simultaneously reforming the tax structure into something that is both sensible and administrable.

The analysis of the Iraqi tax administration functioning shows that the current laws authorizing the activities of the tax administration do not clearly and sufficiently describe the compliance requirements, permitting too much discretion to tax administration officials and inconsistent application. The current tax administration provisions in Law # 113 are confusing, inadequate and arbitrary.

Iraq has ineffective tax administrations weak management of the organization, inappropriate use of available technology, ineffective use of available information to control non-compliance, weak collection enforcement, poor coordination between the tax administration and other agencies involved in tax administration, unclear priorities, in addition to the existence of corrupt practices.

Iraq tax administration operations are not fully based on generally-accepted principles recognized by most tax administrations today, such as voluntary compliance, self-assessment of tax obligations by taxpayers, and clearly defined rights and obligations of the tax authorities and the taxpayer.

Basis for tax administration reform

The principles of administering a particular tax are those that are broadly applicable throughout much or all of the different taxes. Therefore, rather than repeating each, it is easier to put them in one place and make clear that they refer to more than one aspect of the administration law. Placing the common rules into unified tax administration law makes it more likely that its application will be more uniform. However specific rules to a particular tax may be stated in the law creating the specific tax.

Administration of a tax system covers diverse number of rules unlike the substantive laws of taxation. The substantive laws like income tax law, the property tax law, or a VAT law have unifying themes and principles, typically related, around which the law can be structured and to which both policy analysts can return when creating the law.

The tax administration legislation should be primarily organized around the different functions necessary for the tax administration. This form of organization is called "functional."¹ The functional categories should be organized in a way so that they follow in logical, temporal sequence division in tax administration law, and should correspond to functional categories: registration, record keeping, returns, audits, appeal.... This makes the law easier to understand for the taxpayer as well as for the tax administration.

One goal of tax administration reform should be to place more responsibility on the taxpayer. Moving from a system of official assessment of all taxpayers by the tax authorities to a system of self-assessment is one way to further that goal.

However, a tax administration with limited resources cannot effectively monitor tax system with various deductions and exemptions. The costs of assessing, collecting, and controlling taxes should be kept to the lowest level consistent with other goals of taxation. Therefore the tax administration reform strategy should take into account the environment in which it has to function, the laws it is supposed to administer, and the institutional infrastructure with which it has been equipped.

This is why the reform should aim at simplifying the tax system to facilitate its administration and enhance the effectiveness and efficiency of the tax administration. That is a tax system with few taxes, a limited number of rates for each tax, limited exemptions, and a broad base has proven, in the context of many developing countries to

¹ The opposite of functional organization is organization according to substantive taxes. While Iraqi tax administration is organized in this way, the general trend is toward a functional organization.

be much easier to administer and to result in higher compliance levels than a complex system.

Reforming the tax administration is a complex process, which generally requires changes in many related areas, beginning with the tax laws. As a first step, reformers should determine what new tax and accounting laws and regulations are needed, then the timing and appropriate channels for introducing the legislation. Introducing new procedures may require the drafting and legislative approval of a new tax administration law and regulations. Legal changes frequently required to introduce modern accounting standards and invoicing requirements as well as complementary measures related to the rights and obligations of taxpayers and tax officials. A tax administration reform cannot be achieved without the reform of the whole tax system. Short-term measures rarely bring about substantial improvement.

The first step in tax administration reform is to diagnose existing problems and to develop an appropriate strategy based on the key tasks of tax administration activities — tax collection, collection procedures, tax compliance, tax return, penalties and interest appeal procedures, book keeping, and audit.

Tax Collection

Decisions must be made regarding which of many payment methods, such as withholding, advance payments, and payment at the time of filing, will be adopted for both legal entities and physical persons. Advance payments require the taxpayer to make preliminary payments throughout the year. Payment by withholding requires designated persons to collect (or withhold) tax from payments, which the designated persons make to taxpayers.

It is generally recognized that tax withholding significantly increases the efficiency of tax collection. Withholding may be either final, in which case the income recipient need not file a return to report the income or pay further tax, or preliminary, in which case the income recipient files a return to report the income and reconciles the withholding with the final assessed tax.

Many countries do not require an employee to file a return if he or she has no other income other than the wages on which tax is withheld. It is the employer's responsibility to correct for any under- or over-withholding of tax. Other countries require these employees to file a return, report their wages income, and reconcile the final tax assessment with the withheld tax.

A similar difference in treatment among countries exists with respect to withholding and reporting of interest and dividends. Because most tax administrations face difficulties in taxing interest or dividend income at the individual level, withholding tax schemes for

that type of income are commonly used. Withholding on this type of income should expand the tax base and increase tax collections. Typically, withholding rates on this income are flat, applying a uniform tax rate to gross payments. As with wages, the withheld tax may be either a final tax (*i.e.*, a schedular tax) or a preliminary tax, in which case the individual includes the income with his or her other income, computes the assessed tax on the combined tax, and reconciles the withheld tax with the total final assessed tax. In most cases, the tax withheld from interest or dividends paid to non-residents is a final tax. This eliminates the requirement for non-residents to file a return, thereby simplifying the tax administration.

Similarly, many countries require individuals and corporations, whose income is not subject to withholding or only to partial withholding, to make advance payments of income tax. Invariably, in these situations, the withheld tax and the advance payments of tax are not final taxes. The taxpayer is allowed to file a return and reconcile the final assessed tax with these withheld and advance payment amounts. Most countries provide for a refund of the overpaid amounts. If refunds are not allowed, then the overpayment is credited to the taxpayer's future tax liability.

In many countries, taxes due are collected through the banking system. It is not appropriate for tax administration itself to handle any money directly.

The current Iraqi laws and instructions set forth several withholding and prepayment requirements. There is no provision in Law # 113 regarding the installments payments by taxpayers. Under Section 17(1) of Law #113 and WWT Instruction, an employer is required to withhold income taxes on salaries, wages, bonuses, and allowances paid to employees. Under WWT Instruction, the employer is required to remit to the government the withheld tax on monthly basis, subject to a penalty for late payment. An interest charge is also imposed on late payments. In the past the Tax Commission accepted annual payments of the withheld taxes without imposing the penalty. Under WWT Instruction, the employee's withholding tax is determined deductions for allowances, pension and social security contributions, and insurance. If the employer is withholding tax on a monthly basis as required by the Instruction, then at the end of the year the employer reconciles the final assessment with the amounts withheld. If the employee does not have any other income other than the wages the employee is not required to file a return unless directed to do so by the Tax Commission, section 17(5) of Law #113.

Section 27(4) of Law #113 provides that if the employee has income other than wages paid by the employer that the employee is required to complete a return and give the return to the employer. Then the employer is required to file the return with the Tax Commission on behalf of the employee. However, this provision of the Law is not enforced by the Tax Commission.

Section 2(1)-(3) of Law #113 sets forth a list of items of income that are subject to tax (paragraph 1 refers to business profits; paragraph 2 refers to interest; paragraph 5 refers to wages). Section 2(6) states that tax will be imposed on any other source not exempted by law. Section 3(2) provides that income referred to in Section 2(5) is taxed during the

year. This seems to indicate some sort of advance payment requirement. Section 3(4) provides that the Tax Commission may assess provisionally the business profits before the beginning of the assessment year (i.e., year the return is filed) and collect the tax as a deposit on account of the related assessment year. This is not an automatic advance payment requirement imposed on all business profits but rather it requires an affirmative act on behalf of the Tax Commission.

With respect to income earned by non-residents, Section 3(5) provides that tax will be imposed in the year of its receipt or its registration in his account. Section 19(1) provides that a 15% withholding tax will be imposed on interest on debentures, mortgages, loans, deposits, and advances and annual allowances or pension salaries or other yearly payments. Rate reduced to 15% by CPA Order #84. However, interest paid by Iraqi banks and savings funds is exempt from tax (Section 7(15)) and accordingly, is not subject to withholding. Dividends are also not subject to withholding if tax already paid by the company under the integration.

Sections 20-22 of Law #113 sets forth various situations, involving both non-residents earning income in Iraq, where an authorized person, factor, agent, receiver, head of a branch, or company manager is required to pay tax on behalf of the non-resident. Section 23 provides that any such person responsible for paying tax on behalf of another person may deduct from money received on behalf of that other persons, sufficient amounts to pay the tax.

Section 28(4) of Law #113, provides that the Tax Commission may require any government office, socialist and mixed sector enterprise or establishment or any other person, to deduct a percentage not exceeding 10% of the amount due to contractors or other persons connected with them. The amounts withheld may not be released unless a certificate of clearance that the income tax has been paid has been received from the Tax Commission. The Tax Commission may request the transfer of the withheld amounts to it. The contractor or other person claims this withheld amount as a credit when he files his tax declaration.

The timing and method of collecting taxes is very important for both the government and taxpayers. For the government, timing and methods of collection obviously determine when revenues will be received. If the proper approach is taken, collections by the Tax Commission may be simplified, and the stability of the budget increased because the government will be able to better plan its cash flows; and for taxpayers, timing and methods of collection may simplify or complicate compliance with the tax laws.

To be effective, the tax administration reform strategy should have as a guiding principle an integrated approach to the tax collection process, and consider each of its elements—registration, collection, collection enforcement, audit, legal affairs, taxpayer services. To achieve a significant improvement in the overall effectiveness of the tax administration each element of the tax collection process needs to be reviewed and improved.

Collection Procedures

In order to have an efficient tax administration, the Tax Commission must be able to collect unpaid taxes, interest, and penalties. In some countries, the tax authority may garnish wages, and seize and sell property to satisfy outstanding tax liabilities, interest, and penalties. In some countries, the tax authority must apply to the courts to secure a judgment against the taxpayer and before it can take these actions.

In order to protect taxpayers' rights, the collection authority of the Tax Commission must be clearly defined while at the same time the Tax Commission must have sufficient powers to accomplish its duties.

Section 47 of Law #113 provides that tax, interest, and penalties are to be collected under the Law of Collection of Debts Owed to the Government, Law #56 (1977). Section 23 of Law #162 includes a similar provision. Section 47 of Law #113 provides that tax, interest, and penalties are to be collected under the Law of Collection of Debts Owed the Government, Law #56 (1977). Law #56 authorizes the Tax Commission to seize and sell debtor's movable property to satisfy the debt; and seize and sell debtor's immovable property if movable property is inadequate to satisfy the debt.

Section 23 of Law #162, Law on Real Estate Rental Tax (1959), provides that Law #56 will apply to collection of the tax due under Law #162. This tax is considered a secured debt on the subject real estate.

The current Iraqi legislation provides other measures related to collection enforcement:

- *Provisional attachment.* Section 52 of Law #113 allows the Tax Commission to attach properties if the owner attempts to conceal income or evade payment of tax.
- *Enjoin transactions.* Section 28(3) of Law #113 authorizes the Tax Commission to enjoin transactions and prevent their completion by government offices until tax is paid or until a deposit is made. Section 24 of Law #162 provides for enjoining real estate transactions under the same circumstances.
- *Contingent payments.* Section 28(4) of Law #113 and Instruction #4(?) require that up to 10% of payments to be made under supply contracts are to be withheld unless a certificate of clearance from income tax is received from the Tax Commission. The Tax Commission may request that the contingent payment be remitted to it.

The Tax Commission may ask the person renting property to withhold the tax from the rent to be paid, Law #162, Section 25.

- *Installment payments.* Section 46 of Law #113 authorizes the Tax Commission to allow a taxpayer, upon application, to pay the tax debt in installments. Under Resolution #307 (1984), interest will be imposed on the unpaid tax. Section 22(2)

of Law #162, Law on Real Estate Rental Tax (1959), allows the Tax Commission to permit payment of tax due in monthly installments.

- *Satisfaction of tax debt.* Section 48 of Law #113 provides that:
 1. The unpaid tax shall be first collected from the property of the husband even if the tax is imposed on the income of the wife or children;
 2. If the spouses are separated or if the husband is incapable of paying, the tax shall be collected from the property of the wife or children in proportion to their income;
 3. If the husband is incapacitated and has no income the tax debt shall be collected from the wife's property;
 4. The tax shall be collected from the widow' or divorcee's property if the tax is on her or her children's income; and
 5. If the children are considered separate taxpayers because of the death of their father, tax due on their income will be collected from their property.

- *Guarantee of tax payment on departure from Iraq.* Section 51 of Law #113 provides that the Tax Authority may request that border control delay the departure of any person who is suspected of attempting to leave Iraq to avoid paying tax. That person will be allowed to leave Iraq only after paying the tax or receiving a certificate from the Tax Commission lifting the ban on departure.

Restricting the provisional attachment of Section 52 of Law #113 to only the Director General is too restrictive. With proper guidelines and restrictions, the authority to make these provisional attachments should be devolved to managers of branch offices of the Tax Commission.

Not providing for garnishment of wages limits the effectiveness of collection actions against physical persons. The Tax Commission should be given the authority to garnish wages of physical persons to satisfy their outstanding tax debts. With wage tax withholding under Instruction #3, these outstanding tax debts will likely form other sources of income.

Guidelines should be developed to allow devolution of provisional attachment under Section 52 to managers of branch offices of the Tax Commission.

Tax compliance

One goal of tax reform should be to place more responsibility on the taxpayer. Moving from a system of official assessment of the income tax of all taxpayers by the tax authorities to a system of self-assessment is one way to further that goal.

Under a self-assessment system, taxpayers are required to file an income tax return on which the tax owed is determined and to pay the amount of tax owed with the return. Official assessments are issued only if a taxpayer fails to file a return, if an audit

concludes that tax was underpaid or a refund wrongly given, or if the taxpayer does not keep books and records that are adequate for calculating the amount of tax due.

Self-assessment system will reduce the number of cases that tax officials must address each year. However, implementing a self-assessment system requires a significant investment in taxpayer education to make them aware of their responsibilities and how to follow the rules.

High penalties imposed when wrongdoing is found will have a stronger deterrent effect on other taxpayers.

Self-assessment reduces the opportunity for collusion between taxpayers and tax authority employees by reducing the number of contacts. The possibility of bargaining exists only if the taxpayer is chosen for audit.

The success of a self-assessment system depends upon a well-managed audit system, as well as a strong taxpayer assistance component to educate taxpayers, and to resolve problems.

Tax return

A schedular final withholding tax on property income would avoid the necessity for the investor filing a return; a taxpayer whose income consists of wages subject to withholding taxation would satisfy his tax through that withholding. There is no need to burden persons whose incomes are not high, with income tax reports and filings. Nor should the tax administration be involved in auditing or processing a large number of tax returns for them. This makes the system more efficient.

The current legislation requires that every person with taxable income must submit a return by June 1 of the assessment year, section 27(1) of Law #113. The Tax Commission may extend the period to file a return if lawful excuse, Section 27(3) of Law #113. The Tax Commission assesses income tax after it has studied the return filed by the taxpayer, Section 30 of Law #113. An employee with income other than wages is required to submit a return through his or her employer, Section 27(4). Although this is included in Law #113, the Tax Commission does not require employers to accept these returns.

Law #162 is an official assessment system. Tax Commission notifies the taxpayer of the amount of tax owed, Section 21.

The current official assessment system set forth in Section 30 of Law #113 and Section 21 of Law #162 should be replaced by self-assessment systems. Adopting a self-assessment system will require totally new individual and corporate income tax returns so that those returns provide complete information about the taxpayer's income, exemptions from income, and deductions and the taxpayer's tax liability.

All taxpayers, other than those with rental income that exceeds ID 750,000 under current Law #162, could be required to report their rental income. The taxpayer could be required to compute the tax owed on the rents from the property. The declaration could be subject to audit to determine if the rental price is at arms length, or the claimed expenses are allowable. This audit could be selected based on information as to the average rents and costs for the area where the property is located, which will be known to the tax authority.

Taxpayers should be required to pay the amount of tax owed with the return.

The requirement that employees file their return to report income other than wages with his or her employer under Section 27(4) of Law #113 should be eliminated. The employee should be required to file his or her return directly with the Tax Commission.

Penalties and interest

A good system of sanctions and penalties is an indispensable tool for enforcing compliance. As part of the of the tax administration reform, an effective sanctions and penalty system is necessary to encourage taxpayers to voluntarily comply with their tax obligations. A guiding principle in the design of a good system of penalties and sanctions should be to encourage taxpayers to settle their tax arrears quickly and to discourage them from using legal challenges to delay the payment of taxes, which have been correctly assessed. To achieve these objectives, the sanctions and penalties: (1) should be levied promptly once a liability has been established; (2) should not be excessive; (3) should, however, be higher than the prevailing market interest rates

Improving compliance with tax laws depends in part on the ability of the Tax Commission to undertake efficient and effective enforcement mechanisms. The first step of enforcement is the imposition of interest and civil or monetary penalties. If the first step of enforcement is not effective then various collection activities, such as seizure of the taxpayer's property, or penal penalties may have to be resorted to increase compliance.

Setting monetary penalties can be difficult; they need to be large enough to provide deterrence but not so large that tax officials would hesitate to apply them in practice.

There are two types of penalties—civil (or monetary) penalties and penal (or imprisonment) penalties.

The most common civil penalties are:

- Failure to file or late filing of tax returns;
- Failure to pay taxes in a timely manner;
- Negligence in performing actions required by the tax laws and regulations;
- Failure to produce records; and
- Civil Fraud.

The most common penal penalties are:

- Evasion of tax;
- Willful failure to file returns;
- Knowingly submitting false statements;
- Failure to obey a summons;
- Knowingly interfering with the administration of tax laws; and
- Willful failure to pay over tax.

Although there is considerable variance among countries in the type of penalties imposed, most countries apply all or most of the penalties listed above.

As for interest, it is charged on unpaid tax liabilities but is not considered a penalty. Rather, interest is a charge for the use of money. Most countries impose interest on unpaid tax liabilities since the taxpayer had use of the money that actually belonged to the government. Interest is generally imposed at a rate slightly above the market rate from the date that the liability is due. Interest rate is set at slightly above market rate to avoid having the taxpayer view the government as a lending institution.

Similarly, interest is generally paid to taxpayers on refunds. Some countries require the government to pay interest on refunds only after a predetermined length of time, such as 30 or 60 days. This gives the tax authority the opportunity to determine the correct amount of refund. In this case, the government had use of the money that actually belonged to the taxpayer.

The following issues are important in establishing a workable penalty and interest system:

1. Whether the penalty and interest provisions encourage voluntary compliance (i.e., whether they are effective deterrents to non-compliance, tax avoidance, or fraud);
2. Whether administration of these provisions by the tax authority encourages voluntary compliance;
3. Whether the penalty and interest provisions are designed in a manner that promotes efficient and effective tax administration;
5. Whether the penalty and interest provisions are designed to operate, and are administered by the tax authority fairly such that similarly situated taxpayers are treated alike;
6. Whether taxpayers have adequate information about why penalties and interest are imposed so that taxpayers can avoid penalties and interest; and whether taxpayers can easily learn and understand the rules so as to avoid making mistakes.
7. Whether there are any established standards that the tax authority must follow when waiving penalties;
8. Whether the current penalty and interest provisions allow taxpayers to generate overpayments or underpayments in order to take advantage of disparities between commercial borrowing rates and the rates imposed in the law; and

10. Whether interest may be abated or waived and under what circumstances.
11. Whether appeals mechanisms are adequate for both parties.

Law #113 imposes several civil penalties:

- *Late payment penalty:*
 - If tax is not paid within 21 days from the date of notification, 5% of the amount of tax is added. If tax is not paid within 42 days of notification, 10% of the amount of the tax due is added to the tax, Section 45 of Law #113.
 - Instruction #3 (1983) imposes on the employer the requirement that it remit the tax withheld from employees on the first day following the end of each quarter. Section 17(4) of Law #113 and WWT Instruction, apply the late payment penalty of Section 45 if the employer fails to remit the withheld tax on a timely basis.
 - The Minister of Finance or a delegated person may waive the penalty on the excuse of force majeure, Section 45;
- *Failure to file return/statement penalty.* A penalty of not less than ID 100 and not more than ID 500 for failure or delay in filing return or statement, Section 56(1)(a);
- *Failure to perform penalty.* A penalty of not less than ID 100 and not more than ID 500 for failure to perform duties imposed by Law #113 or instructions, Section 56(1)(a);
- *Disclosure penalty.* A penalty of not less than ID 100 and not more than ID 500 for unauthorized disclosure of taxpayer information that is not to be disclosed under Section 53, Section 56(2). Tax Commission more often asserts penal penalty under Sections 57 or 58;
- *Failure to keep books and records penalty.* Section 56(1)(c) of Law #113 imposes a penalty of 10% to 25% of the assessed income, before deducting personal allowances, if fail to follow requirements of Instruction #2. The penalty will not be less than ID 500.
- *Failure to file return/statement penalty.* A penalty of 10% of tax, not to exceed ID 50,000, on failure to file a return by May 31. Applicable regardless of how late in filing. May be abated if lawful excuse, Section 56(1)(d).
- *Failure to submit accounts by foreign branch.* A penalty of ID 10,000 on each branch of foreign company that fails to submit its final accounts, unless delay due to lawful excuse, Section 56(2); and

- *Knowing submission or evasion of tax civil penalty.* If criminal offense of sections 57 and 58 proved in competent court, civil penalty of twice the amount of tax due, Section 59.

Law #113 includes several penal penalties that may be imposed by competent court as follows:

- *False statements/concealment of information.* Imprisonment of up to one year for knowingly submitting false statements or returns or concealing information, Section 57(1);
- *False statements/concealment of information prepares.* Imprisonment of up to one year for knowingly prepares false statements or returns or assisted another person to do so, Section 57(2);
- *Evasion of tax.* Imprisonment of not less than 3 months and not more than 2 years for committing fraud for the purpose of evading tax, Section 58.

The penal action may be terminated, regardless of the stage of the action, provided the taxpayer agrees to pay tax as determined by the Tax Commission, section 59.

Law #162 imposes the following civil penalties:

- *Late payment penalty.* Late payment penalties of 10% on both the basic and additional tax if not paid within a period that exceeds one-half the year. Tax Commission may waive the penalties if late payment due to legitimate cause, section 22;
- *Failure to report change in status of property penalty.* Section 7(c) imposes a penalty of 10% (or 20% if repeat violation) if taxpayer fails to inform Tax Commission of change in status of the property, such as change in rent charged or change from exempt use; and
- *Submission of incorrect information penalty.* A 10% penalty is imposed if incorrect information submitted, Section 29(4). Taxpayer may object to the Real Estate Tax Center.

Law #162, Section 30, imposes the following penal penalties, which may result in imprisonment of up to 6 months, and also include a civil penalty of ID 100:

- *Late submission of information.* Submitting late or refusing to submit required information without legitimate excuse, Section 30(1);
- *Refusal to permit entrance onto property.* Refusing to let authorized individual to enter property, Section 30(2);
- *Knowingly submitting incorrect information.* Knowingly submitting incorrect information to tribunals or Tax Commission, Section 30(3); and

- *Late submission of report.* Submitting late or refusing to submit report without legitimate excuse, Section 30(4).

Resolution #307 (1984) imposes interest on tax debts from the due dates set in Law #113 equal to current interest imposed by Rafidain Bank on overdraft facilities. Interest is imposed on tax amount due if tax is paid in installments.

The penalty provisions of Law #113 are not clear and do not give enough guidance to both the tax administration and taxpayers regarding consequences of not complying with the law and instructions. To the extent possible, the amount of the penalty should be expressed as a percentage of the tax liability to provide a benchmark for the seriousness of the offense and eliminate arbitrary judgments. Minimum and Maximum Penalties can and should be considered.

The penalty system should include only penalties needed to operate as an effective deterrence to non-compliance. The tax Commission should be authorized to abate a penalty if reasonable cause is shown.

Interest should be set at rates slightly above the market rate to avoid taxpayers taking advantage of disparities between loan rates and rates on government debt. Interest should be paid on refunds.

Sections 56 and 59 of Law #113 need to be clarified that Tax Commission may impose civil penalties without court approval, including specifically imposition by automated mechanisms, such as computer generated notices.

Penalties under Section 56(1)(a) of Law #113 for failure to file return/statement/information and failure to perform required activities penalty needs to be clarified and converted to a general negligence penalty. Penalty should be stated as a percentage of tax due, such as 5%, and not in absolute Iraqi dinar amounts. Civil penalty of section 56(1)(c) of Law #113 for unlawful disclosure of taxpayer information must be increased so that it will be a true deterrence of this behaviour.

Failure to file penalty of Section 56(1)(d) should be retained but the Iraqi dinar limit should be eliminated. At the least, if the limit is retained, it should be increased.

Law #113 should be revised to include a civil penalty on third parties who fail to produce required information. Civil fraud penalty of section 59 needs to be revised to remove the requirement that criminal fraud be proven first. The Tax Commission should be authorized to impose civil fraud penalty without also asserting criminal fraud. Civil fraud penalty in section 59, of twice the tax liability, is excessive. A rate of 75% of the tax understated due to fraud is more appropriate. All civil penalties should be included in one section so that a complete picture is available of the civil penalties.

The scope of penal penalties in sections 57 and 58 should be expanded to include: Willful failure to file tax returns; attempts to interfere with the administration of tax laws by

force or threat of force; willful failure to collect or pay over tax; and failure to obey summons. Length of imprisonment set for penal offenses in sections 57 and 58 of Law #113 should be increased so that the penalties operate as true deterrents.

Penal penalties under Law #162 need to be revised to make it clear that these penalties may only be imposed by a court and then only if the taxpayer knowingly committed the offenses. Late submission of information under Section 30(1) of Law #162 and late submission of report under Section 30(4) of Law #162 should not be penal offenses.

Law #113 needs to be revised to make it clear that interest under Resolution #307 will be imposed on tax debts. Law #113 should be revised to allow payment of interest on refunds to the extent the refund is not paid within 30 days of the time the amount of refund is finalized. Resolution #307 needs to be expanded and clarified to give more detail regarding computation of interest on tax debts in general and with regard to installment payments. Section 49 of Law #113 and Section 28 of Law #162, which authorize the Tax Commission to pay refunds, should be revised to authorize payment of interest on the refund not paid within 30 days of the date the amount of refund is determined.

Appeal Procedures

When a taxpayer does not agree with the decisions of the tax inspectors, it is essential for the integrity of the tax system, that the taxpayer be able to have the decision reviewed by neutral evaluators either within the tax authority, outside the tax authority and, ultimately through the judicial system. This review process provides a mechanism to monitor the application of the law and protects taxpayers from abusive application.

Provisions must be made to redress this kind of situation. Two sub-systems are required for this purpose - one to redress taxpayer grievances (appeals, administrative remedies, ombudsmen), and one to identify and correct (or prevent) errors by the tax administration (internal reviews, inspection and anti-corruption).

The organizational structure of many tax administrations includes an administrative appeals division, headed by a Director who provides functional direction for the disposition of notices of objection and appeal at all stages of the appeals process except appeals to the courts. Once an appeal has reached the courts the legal division of the tax authority should assume responsibility.

The administrative appeals division provides taxpayers with an independent and objective consideration of their notices of objection and appeal.

Many countries have a multi-stage appeal process under which the taxpayer appeals first internally within the tax authority, and then to the courts. Given the complexity of many tax issues, many countries have specialized courts to hear tax appeals. The decisions of the courts are published in many countries. Decisions made internally within the tax authority are rarely made public.

Law #113 provides three-stage appeal process:

1st Stage-Objection to assessment within Tax Commission, Section 33 of Law #113:

- Submit a written objection, showing reasons for objection and position on correct tax, to Tax Commission within 21 days of notification of assessment;
- 21-day objection period may be extended if force majeure events; and
- Taxpayer must pay entire amount due, or receive approval to pay the amount in installments under the procedures set forth in Section 46 of Law #113 and Instruction #16 (1996). The Instruction #16 provides that the taxpayer must pay at least 25% of the amount due and the rest may be paid in not more than 12 monthly installments. The Minister of Finance may approve more than 12 installments.

2nd Stage-Appeal Committee, Sections 35-40 of Law #113:

- Appeal to the Appeal Committee of denial of the objection in the 1st Stage must be submitted within 21 days of notification of denial, Section 35(1) of Law #113;
- 21-day appeal period may be extended if force majeure events;
- No appeal unless taxpayer has paid the entire amount due or is current on installment payments;
- Appeal Committee is composed of a judge of at least grade 2 (*i.e.*, administrative law judge) and two additional members specializing in financial matters, Section 37(1). These two additional members cannot be employees of the Tax Commission.
- Judge employed by the Ministry of Justice receives a salary from the Tax Commission; and
- Decision of Appeal Committee is final if the tax amount due was ID 10,000 or less, Section 40(1).

3rd Stage-Cassation Panel, Sections 40 of Law #113:

- Appeal of decision by Appeal Committee to Cassation Panel within 15 days of notification of decision, Section 40(2);
- To appeal, the amount of tax due must be more than ID 10,000;
- Either the taxpayer or Tax Commission may appeal decision of Appeal Committee, Section 40(2) of Law #113;
- On appeal to the Cassation Panel the taxpayer must pay a fee equal to 1% of the tax amount due, not to exceed ID 1,000, Section 40(4) of Law #113;
- Cassation Panel composed of a judge from the Cassation Court, two General Directors of the Ministry of Finance, one member from the Iraqi Commercial Chambers Union, and one member from the Iraqi Industries Union, Section 40(2) of Law #113.
- Cassation Panel may cancel, confirm, or modify the decision of the Appeal Committee;
- Cassation Panel's decision is final, Section 40(3) of Law #113.

Section 55 of Law #113 provided that the courts were prohibited from hearing any cases related to the assessment, imposition, and collection of tax. Law #10 (2003) cancelled Section 55 without canceling Sections 37 through 40 of Law #113.

Appeal of real estate rental estimation under Law #162 (1959) three-stage process:

1st stage-re-estimation by Estimation Panel:

- Re-estimation may occur because of change in status, such as change in rent or end of exempt use, or change in physical nature of property, such as damage to property, reduction or increase of at least 15% in revenue from property, Section 9; and
- Estimation Panel is composed of three members, Section 12.

2nd Stage- Review Panel:

- Written appeal of decision of Estimation Tribunal must be filed with the Review Panel within 30 days of date of notification of estimated income, Section 14 of Law #162;
- Either the taxpayer or the Tax Commission may appeal, Section 15 of Law #162;
- Composition of the Review Panel depends upon its location, Section 15 of Law #162. In all cases, the Review Panel will consist of 4 members.

- One-half of the tax must be paid in order to file an appeal to the Review Panel, Section 26 of Law #162. However, the tax does not have to be paid when the appeal is based on the real estate being vacant.

3^d Stage-Real Estate Tax Center:

- Established by the Ministry of Finance;
- A written appeal of decision of Review Panel must be filed with the Tax Center within 30 days of date of decision of Review Panel, Section 20(3) of Law #162;
- Either the taxpayer or the Tax Commission may appeal to the Tax Center, Section 20 of Law #162; and
- Taxpayer filing an appeal to the Tax Center must pay a fee of ID 2,500.

Section 20(7) provides that decisions of the Tax Center may not be appealed to the courts. Law #10 (2003) did not cancel this provision like it cancelled Section #55, the similar provision in Law #113.

The new Tax Administration law should provide the following:

- An Administrative Appeals Division, headed by a director, be established within the Tax Commission to handle all notices of objection filed by taxpayers.

- The judges that are appointed to the Cassation Panel should be specialized to hear tax cases. The newly proposed revisions to the Bankruptcy Law (Code of Commerce (Law #149(1970))) has such a provision providing for specialized judges, as designated by the Council of Judges, to hear petitions for bankruptcy.
- The decision of the Appeal division should be appealed to an independent court. Decisions of the courts should be published.
- Section 49 of Law #113, which authorizes the Tax Commission to pay refunds, should be revised to authorize payment of interest on the refund not paid within 30 days of the date the amount of refund is determined.
- The fees imposed on the appealing taxpayers in both Law #113 and Law #162 need to be adjusted to reflect inflation.
- Taxpayers should not be required to pay the entire amount due in order to appeal tax assessment. Justice that is too expensive, is justice denied. Either reduce the required payment amount to 50% or less or make installment payments a matter of right, or allow the taxpayer to post a performance bond.
- Consideration should be given to moving many of the technical details, such as composition, quorum, and voting, to instructions.

Integrity of the appeal process will be preserved only if each level of review is subject to limits, if cases are handled honestly, and if the government must pay interest on refunds due to taxpayers. Integrity of the appeal process will be improved if the decisions of the Cassation Panel and the courts are published.

Perception of impartiality of the Appeal Committee will be improved if the judge who is the chief of the Committee receives compensation not from the Tax Commission but from the Ministry of Justice. Same for the Chief of the Cassation Panel and the members from the Commercial Chambers and Iraqi Industries.

Book Keeping

The requirement that taxpayers maintain books and records in order to clearly and accurately determine income subject to tax is fundamental in tax law. Without adequate books and records tax reforms in law and procedure will be of only limited value.

Although most taxpayers should be required to maintain books and records, a limited number of taxpayers operating small business operations should be permitted to determine income and pay tax on a “presumptive” basis under which books and records are not required.

Required books and records include complete books of account, including records of cash and bank transactions, accounts receivable and payable, and inventory, as well as balance

sheets and income statements. Most countries specify the form of the records and the information that must be reported in those books and records.

Many countries provide that if the taxpayer has not maintained adequate books and records to determine taxable income the tax authority is allowed to determine that income under any other method that clearly reflects income. Some of the methods of reconstructing a taxpayer's income are: Bank deposits and expenditures method or other application of funds method; net worth method; and percentage or unit mark-up method.

In Iraq Instruction #2 (1985) was issued under the authority of Section 60(1) of Law #113, which provides that regulations will be issued specifying what books and records must be kept, who must maintain those records, and the manner of preparation. Instruction #2 provides in part that only certain companies must have their books audited, and certified by Ministry of Justice Registration Office:

- Companies to which the Companies Law applies if capital in excess of ID 30,000;
- Branches of foreign companies;
- Importers/exporters with goods in excess of 50,000 ID;
- Contractors/subcontractors as classified by Ministry of Planning;
- Owners of entertainment houses;
- Owners of private hospitals and pharmacies; and
- Owners of 1st class hotels and restaurants.

Section 56(1)(c) of Law #113 imposes a penalty of 10% to 25% of the assessed income, before deducting personal allowances, if the company fails to follow requirements of Instruction #2. The penalty will be not less than ID 500.

Section 39(2) of Law #113 provides that the Appeal Committee may hear cases on violations of Instruction #2 and may impose penalties.

Section 26(6) of Law #113 provides that if a partnership fails to keep adequate books and records, the Financial Authority has the right to assess the senior partner or the partner with the largest share of income for the tax owed on the net income of the partnership.

If the taxpayer has not maintained adequate books and records to determine taxable income, the Tax Commission should be allowed to determine that income under any other method that clearly reflects income. The new tax administration law must clearly state this authority, and perhaps might even describe the several methods. It is critical that the courts understand this provision and that they properly rule when the tax authority comes forth with a case and it is appealed by the taxpayer.

Instruction #2 must be analysed to determine whether sufficient to achieve goal of providing adequate information to Tax Commission to determine taxpayer's taxable income. Instruction #2 must be more thoroughly analysed to determine whether it is adequate for the stated purpose.

Instruction #2 gives taxpayers the flexibility to design their record keeping system to satisfy the needs of their particular businesses. However, the systems adopted must provide sufficient information to allow the proper determination of income and tax.

If the taxpayer has not maintained adequate books and records to determine taxable income the Tax Commission should be allowed to determine that income under any other method that clearly reflects income.

Audit

In order to increase compliance and facilitate verification of tax liabilities, the tax Commission should have the authority to examine books and records and other data which may be relevant or material to the determination of tax due and person liability for that tax. The tax authority should also have the authority to require testimony under oath where relevant or material to the inquiry.

The new tax administration law should require persons to appear, to testify, and to produce books, papers, records, and other data if required to do so by the tax authorities. The sanctions provided by law for failure to provide the information requested by the tax authorities include civil penalties and imprisonment.

Section 28 of Law #113 includes the following relevant provisions:

Officials of government offices, municipality governments, state owned enterprises, and the mixed sector are required to submit to the Tax Commission statements and information that the Tax Commission considers necessary for the implementation of Law #113, Section 28(1).

Tax Commission may require that any person supply information that it determines to be useful for the assessment of tax of any taxpayer, Section 28(2).

Tax Commission may investigate the income of the taxpayer and ascertain its sources where the income is earned. This gives the Tax Commission the authority to enter on the premises of the taxpayer to examine the taxpayer's income. Section 28(2)

Sections 18 and 20(6) of Law #162 authorize the Review Tribunal and Real Estate Tax Center, respectively, to examine the real estate when considering the appeal. In addition, the Tax Center may call the taxpayer to supply information.

Law #113's requirement in Section 28(2) that anyone must submit relevant information should give the Tax Commission the needed authority to obtain information from third parties (i.e., non-taxpayers). There is some concern whether some limitations should be placed on the Tax Commission's authority.

There is no requirement in Law #113 to summon someone to testify. This authority may be contained in another law. The new tax administration law should clearly define this authority and how it is exercised (notice requirements, enforcement requirements, etc).

The civil penalty under Section 56(1)(a) is too lenient; the amounts need to be raised or replaced with a penalty as a percentage of the tax due, the preferable approach. Also, unclear whether this penalty may be imposed on third parties for failure to produce the information requested. An alternative is to provide for a rather stiff penalty that is waivable if the information is produced. Another means that has been used is that once the taxpayer or his agent has failed or refused to provide the information, the tax authority can assess on the basis of its best information and the taxpayer cannot later come in with documents or information to support a lower tax.

The civil penalty for failure to produce information needs to be increased and clarified as to what the penalty applies. The penalty also needs to be adjusted to reflect inflation.

The new tax administration law should include a civil penalty on third parties who fail to produce required information.

Conclusion

The analysis of the Iraqi tax administration functioning shows that the current laws authorizing the activities of the tax administration do not clearly and sufficiently describe the compliance requirements, permitting too much discretion to tax administration officials, inconsistent application, and widespread corruption. The current tax administration provisions are confusing, inadequate and arbitrary.

Iraq has ineffective tax administrations, weak management of the organization, inappropriate use of available technology, ineffective use of available information to control non-compliance, design of computer systems without taking into account the real needs of the Tax Commission, weak collection enforcement, poor coordination between the tax administration and other agencies involved in tax system, unclear priorities.

Tax Administration reform must aim at keeping the tax laws as simple as possible; giving the Tax Commission simpler, and hence potentially, enforceable laws to administer taking full account of taxpayers' rights, accountability and responsibility, and provide a legal basis for a modern and efficient tax administration.

However, tax administration reform should be part of a broader fiscal reform effort aimed at restructuring the whole tax system so that taxes are more efficient, less distortionary of market forces, and easier to administer. It rarely makes sense to try to reform tax administration without simultaneously reforming the tax system into something that is both sensible and administrable. Short-term measures rarely bring about substantial improvements.

Drafting a tax administration law and other related regulations must ensure its future operability. A legal framework to ensure a proper administration and enforcement of the tax legislation should be provided sufficient powers to the Tax Commission to efficiently assess and collect taxes and to enforce tax legislation when necessary, thus leading to improved tax compliance.

As for “*which country(ies) provide the best examples as models for the development of tax administration law in Iraq.*”, each tax administration faces a varied environment within which it administers its taxation system. Jurisdictions differ in respect of their policy and legislative environment and their administrative practices and culture. As such, a standard approach to tax administration may be neither practical nor desirable in a particular instance, specifically in Iraq. Therefore care should be taken when considering other Country’s practices to copy one particular approach.

