Tax Policy Recommendations Income Tax for Iraq

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Implemented by BearingPoint Inc.

Prepared by Touhami Rhaiem

Preface

- Taxation is the only practical means of raising the revenue to finance government spending on the goods and services offered to its citizens.
- The ideal tax system should raise essential revenue without excessive government borrowing, without distorting the economic activity, and without deviating too much from tax systems in other countries.
- Setting up an efficient and fair tax system is necessary for integrating the international economy.
- Tax policy should be guided by the general principles of neutrality, equity, and simplicity.
- Create an efficient tax administration with a well-educated and well-trained staff.

Executive Summary

Deficiencies in the Current Income Tax System

A thorough analysis of the current income legislation shows the following:

- The complexity of the current system
- The schedular nature of the system
- Imprecision of the tax base
- Lack of neutrality of the current system
- Inequitable treatment of taxpayers for non-economic reasons
- Economic distortions created by the current system
- Spread tax legislative texts
- Inconsistent definitions
- Inadequate supporting laws (enforcement) and regulations
- Does not recognize complexities of modern economy
- Difficult, if not impossible, to administer

Deficiencies in the Current Income Tax System

- Inadequate principles, outdate concepts, and un satisfactory policies
- The lack of logical structure resulting in undue complexity witch causes uncertainty to both tax administration and taxpayers and results in inefficiency of the administration

Other reasons for a new law:

- Bad earlier drafts.
- The need to break from past actions in taxation and economic policy.
- Remove the opportunity for discretion on the part of tax officials and reduces errors associated with compliance, and consequently remove opportunities for corruption.

Why a personal income tax

- A personal income tax mainly because it gives the appearance of being progressive, taxing the rich and leaving the poor with the little they have.
- If there is going to be a corporate income tax then there must be a personal income tax. Otherwise, the tax system would discourage the corporate form of business and would encourage other business forms that might not be as desirable. (Neutrality)

Why a corporate income tax

Number of aspects of current Iraqi corporate income taxes are difficult to enforce because :

- Rule of law is weak
- Accounting standards are not established
- Information is hard to come by
- Weak administrative capacity

There is one very important reason for imposing the corporate income tax:

- Foreign investment is likely to be important
- Foreign tax laws treat overseas investment in a “tax neutral” manner
- Foreign corporate tax is based on worldwide income, with corporate income tax paid in foreign countries creating tax credits (up to a certain limit)
- Should the host government not impose any corporate tax, then there is no tax credit generated in the foreign tax law, and the firm must pay the amount to foreign country

Why a corporate income tax

- Foreign firm would not be worse off or better off, but the foreign government would be richer
- So why let this money go to the home government of the foreign investor when it could go to the local government without providing any disincentives to foreign investment.

consideration for establishing corporate income tax

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
- The corporate tax rate should not exceed the top marginal tax on personal income tax. In order for taxpayers not to choose the corporate form of doing business for purely tax reasons.
- Corporations should be required to report on and withhold personal income tax from dividends paid
- Depreciation rates should be uniform by asset class rather than be based on specific industry
- 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

Economic efficiency and administrative feasibility

To make sure that the tax is well designed from the point of view of economic efficiency and administrative feasibility, we make the following recommendations:

- There should be few rates.
- There should be few exemptions.
- The zero rate should be high enough to ensure that not too many people are caught in the net.
- Withholding on salaries, interest earnings and dividends should be instituted.
- It might make sense to make dividend earnings deductible, or even a credit, from personal income tax to avoid double taxation.
- Personal income tax should be paid by all residents of Iraq.
- Income derived in Iraq or from outside Iraq should be subject to the personal income tax.
- All income should be taxed the same, regardless of its source.

Proposed Approach

- Draft an entirely new Income Tax Law with a view to the development of a Tax Code longer-term
- Treat all taxpayers – whether individual or corporation, similarly
- Include all income sources in one income tax law
- Provide some special rules (allowance, exemption, lower rates) for some types of income
- Repeal (upon enactment of the new law) the 1983 law and the law on real property tax and any special laws dealing with related issues
- Develop a new Tax Administration Law
- Coordinate the new laws with the other current and proposed Tax Laws with a view to the development of a Tax Code in the longer-term

Highlights of Proposed Approach

- A global tax system based on schedular elements, where income from different sources are determined separately then aggregated and taxed at unified progressive rates.
- Introducing a capital gains tax with transition rules to deal with the accumulated profits.
- Liability to tax for legal persons should should be based on the “place of incorporation” test or the “central management and control” test.
- Liability to tax for individuals would apply to all persons domiciled in Iraq, or physically present in Iraq for 183 days or more during the year.
- The individual would be the tax unit, with family tax relief for married couples and children on charge.
- There should be a progressive tax rate structure for individuals with less marginal rate bands applicable to resident and non-resident alike.
- The flat corporate income tax rate should be retained.

Highlights of Proposed Approach

- A 'tax year' should be based on the following:
  - Individuals- the calendar year
  - Unincorporated small businesses- the calendar year
  - Corporations- the fiscal period for which its accounts are prepared for the purposes of the tax law.
- For income from employment:
  - All remuneration includible including 'in-kind'
  - Subject to withholding of tax at source
  - Allowances claimed on notice to employer
  - No deductions for expenses
  - No tax declaration required absent income from other sources, or taxpayer has overpaid through withholding
  - If declaration required, taxes withheld are credited against the tax due

Background

Background

- These recommendations flow from a comprehensive review of the current income tax legislation in Law #113 introduced in 1982 as well as associated regulations and other laws which impact tax on income.
- The 1982 law, and those changes made in the past two decades were designed for an inward looking economy that was highly centralized and controlled.
- 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 on a national basis.
- The current tax legislation suffers deficiencies and inadequacy making its application and compliance difficult, if not impossible, in some cases.

Principles Underlying Tax Reform

Goals of Tax Reform

Governments use income tax legislation as a fiscal policy instrument to:

- Achieve governmental goals
- Finance public spending
- Stabilize the economy
- Increase economic growth
- Achieve an efficient allocation of resources
- Perform a redistribution of income

Principles Underlying Tax Reform

- Reforming the tax system is a complex process, which generally requires changes in many related areas, beginning with the tax administration.
- Legal changes are required to introduce modern accounting standards.
- Tax reform should emphasize the neutrality of the tax system, simplify the structures of the income tax system by:
    - Reducing the number of rates,
    - Broadening the tax base,
    - Eliminating preferential treatment of particular economic activities, and introducing a new and simple income tax to replace the old one.
- Low rates applied to virtually all economic income will increase efficiency by minimizing the tax deterrent to additional income producing effort (from labor or investment) at the margin.
- A broad base will help assure the market to be the determinant of economic decisions and will assure fairness.

Principles Underlying Tax Reform

- Tax legislation should ensure that there is consistency in the use of terminology and provide coherent structure provisions.
- Tax reform should eliminate low-income taxpayers from the tax application and ensure a degree of progressivity in the tax law.
- Tax reform should keep the tax laws as stable as possible by minimizing the frequency of change.
- Frequent changes in tax legislation upset the expectations of investors and make it difficult for taxpayers to understand and comply with the laws.

Legal Basis for Tax Reform

- The basic legal foundation for taxation according to the rule of law is that a tax can be levied only if a statute lawfully enacted is so provided
- Tax must be applied impartially
- Retroactivity, if any, should have the least possible incidence on taxpayers rights and expectations
- Revenue raised by tax must be used only for lawful public purposes
- These principles should be enforced by independent courts in accordance with the rule of law

Principles Underlying Tax System

- The tax system should specify central concepts. A well-designed tax system should satisfy the criteria of equity, neutrality and simplicity.
- 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

Simplicity

Objectives:

- **Encourage compliance**
- Facilitate administration
- Increase taxpayer understanding
- Remove as many taxpayers as possible from the tax rolls
- Minimize record keeping, paperwork, and computations by taxpayers
- Minimize need for filing of many or complex returns
- Minimize burdens and lessen possibility of errors

Measurable Elements:

- Relatively simple tax structure with few rates, exemptions, deductions, and exclusions
- No burdensome methods of collection
- Structure that often includes wage withholding closely matching final tax liability for wage earners
- Structure that does not require returns to be filed by those with only wage or interest income

Equity

Objectives:

- **Tax imposed in accordance with ability to pay**
- **Horizontal equity (equal tax on equal incomes)**
- **Vertical Equity (higher rates on higher incomes)**

Measurable Elements:

1. Benefit Principle :
   - **The benefit principle reflects a link between benefits and contributions, e.g. social security, highways user fees etc.**
   - **The benefit principle ties tax policy exclusively to expenditure policy**
   - **The principle is consistent with both horizontal and vertical equities**
   - **However, it is difficult to implement for most public services and is of limited relevance in practice**
2. Ability-to-pay Principle:
   - **Individuals are taxed according to their capacity to pay tax**
   - **The reasonable indicator of ability to pay is the income**
   - **Taxpayers with similar incomes pay similar taxes**
   - **A progressive rate structure whereby the tax rate rises as income rises**
   - **Assessing tax based on a taxpayer's net, rather than gross, income**
   - **The integration of corporate and personal income tax to avoid double taxation**

Neutrality and Efficiency

Objectives:

- Minimal interference with business decisions.
- Limited deviations,
- Taxpayer decisions made on the basis of economic merit and not tax benefits
- No inhibition of economic growth

Measurable Elements:

- Few or no incentives encourage tax-induced transactions with little or no economic rationale
- The same tax rates applicable to essentially the same business transactions
- A structure that is neutral between different businesses
- Business income taxed once
- Average rates high enough to generate revenue but low marginal rates
- Carryback and carryover provisions and prompt payment of refunds

Stability

Objectives:

- Consistent system over time to permit business planning with certainty
- Less frequent changes to allow development of administrative and control systems by taxpayers and the government

Measurable Elements:

- Comprehensive tax code, requiring little or no annual "fine tuning"or further clarification
- Carefully developed system that is less likely to produce unintended results

Ease of Administration

Objectives:

- Minimal paperwork burdens
- Clear rules for determining taxable incomes
- Ease of calculation of tax liability
- Ease of audit
- Objectivity in auditing returns
- System operable by the available administrative resources

Measurable Elements:

- Estimated tax system
- Self assessment of taxes with selective audit
- Presumptive taxation where necessary
- Effective penalty and appeals system

Models of Income Tax Systems

Models of Income Tax Systems

- An optimal income tax system examines the trade-off between efficiency, equity, and simplicity.
- Major structural changes are preferred over marginal changes, the latter perpetuates inefficient tax structures.
- These recommendations should be reflected in the design of the income tax system.
- Four theoretical models exist for the design of an income tax system: schedular, global, composite, and dualistic.

Models of Income Tax System

Schedular System

A schedular income tax is one in which separate taxes are imposed on different categories of income

- Schedular tax systems divide income into different categories, each category being subject to its own computation rules and tax rates
- In a schedular system, gross income and deductible expenses are determined separately for each types of income
- Under this system, most taxes are collected by withholding so that the number of taxpayers who must file a tax returns is significantly reduced

The advantages of the Schedular System are:

- It is easy to administer in countries without a developed tax administration.
- Progressive tax rates may not be applied to all categories of income.
- Personal tax relief may not be applied against the total income.
- This leads to inequity between taxpayers and ineffectiveness of the system and for these reasons we don't recommend the schedular system to be adopted in Iraq.

Models of Income Tax System

Global System

- A global income tax is one in which a single tax is imposed on all income, whatever its nature.
- Global tax systems aggregate income from all sources at the individual or family unit level.
- Under the global system, incomes from different categories are combined together and progressive tax rates are imposed on the total income.
- This has the advantage of making the tax system more equitable as all sources of income are taxed in a similar way.
- The global system achieves another element of equity in that progressive taxation is the most effective way imposing taxes on the ability-to-pay basis.
- It also has an administrative advantage by simplifying tax administration and compliance in that only one tax return is filed for multiple sources of income.
- However, the determination of global income by the taxpayer represents a major problem in developing countries.

Models of Income Tax System

Composite System

- The composite system is a global system with schedular elements.
- Under the composite system, schedular incomes are aggregated and their sum subjected to a single progressive rate scheme.
- Amounts of income are defined by category such as employment, property, and business income.
- Each category of income has its own rules.
- A unified progressive tax rate is applied on the aggregated categories of income.
- Most countries have adopted a composite system.
- The composite system has some advantages like:
  - Eliminating timing differences and the deduction of expenses and other losses against other positive property income reducing thereby the tax base.
- The composite system is also useful for quarantining deductions.
- It is also recognized that this is generally the manner in which accounting records are kept

Models of Income Tax System

Dual System

- The dual income tax system has been introduced in Scandinavian countries.
- Under this system incomes are divided into either capital income or labor income.
- Capital income includes dividends, capital gain, interest,and rents
- Capital income is taxed at flat rate, a moderate rate.
- Labor income consists of wages and salaries, fringe benefits, pension income, and social security benefits
- Labor income is taxed at a progressive rate and allowances are allowed against labor income only.
- Negative capital income can be offset against positive labor income.

Models of Income Tax System

Dual System

- Alternatively the two forms of income may be taxed jointly at the Corporate Tax rate.
- While gross labor income would subsequently be taxed at additional progressive rates.
- Joint taxation permits the offset of negative income from capital income sources against positive labor income, as well as the application of a joint basic allowance.
- Single taxation of capital income is ensured through withholding or source taxes.
- Heavy tax burden is placed on the immobile factor labor.

Assessment of current Iraqi Tax System

- Iraqi income tax law enumerates different types of income, section 2 of Law #113.
- The law specifies expenses to be deductible from income without relating these deductions to a particular type of income, section 8 of Law #113.
- The Iraqi tax system also imposes various taxes on various sources of incomes separately, (e.g. real estate rental income which is subject to the Real Estate Tax Law #162)
- The current Iraqi income system is a schedular one.
- The lack of consistency of the current tax legislation and the failure to provide a coherent structure has led to a confused application of the tax law and has made the law unworkable.
- We recommend the new income system to be a global one based on a schedular approach (composite system).

Structure of Income Tax

The Structure of Income Tax

- Having decided on which tax reform principles are to be applied, the tax model to be implemented, and the legal aspects of the new system, the following actions must be adopted:
  - Action should be oriented towards revenue raising, with essential questions being: What to tax? Who to tax? What rate to use?
  - Decisions must be made about the rates of tax, about a comprehensive tax base (what should be included as income), about the tax unit and the treatment of income earned through entities (corporation, partnership etc.)
  - The concept of taxable income, the treatment of particular types of income, allowable deductions, exemptions, credits, and the rate structure and the number of brackets.

The Structure of Income Tax

Tax Base

The determination of the tax base lies on three elements:

1. **The inclusion of amounts in taxable income,**
2. **The identification of exempt income, and**
3. **The determination of the net taxable income.**

Taxable Income

There are two main theories to determine the taxable income:

1. **The source theory, and**
2. **The net accretion theory.**

The Structure of Income Tax

The Source Theory

- Receipts that arise from a source are a component of taxable income
- A source means the traditional category of income, capital, employment, and business
- Income that cannot be linked to a traditional source of income is not taxable (e.g. lottery etc.)
- A residual category is to extend the reach of gross taxable income beyond the confines of the source theory and implement a broader concept of income.
- The source concept of income is important for the taxation of capital gain, which is not considered income under this theory.

The Structure of Income Tax

The Net Accretion Theory

- All net proceeds and benefits, gifts, inheritances, lottery gains, and other gains and no *quid pro quo* receipts should be included in income
- Under the accretion theory, gross income is a comprehensive concept; it includes capital gain and irregular receipts
- This definition of “comprehensive “ income equals consumption plus net wealth accumulated during the tax period
- There is a consensus that the net accretion theory provides adequate tax criteria
- However, no country has succeeded in the full implementation of the net accretion theory

The Structure of Income Tax

Taxation of Capital Gain

- The main difference between the source and the net accretion theories relates to the taxability of capital gain.
- Capital gain does not flow from a permanent source, it should not be subject to income according to the source theory.
- Whereas, capital gain is part of taxable income under the net accretion theory.
- The consideration of equity provides a strong case for taxing capital gains
- The capital gain taxation is a sophisticated and complex piece of fiscal legislation.
- Introducing a capital gains tax property requires transition rules to deal with pre-tax accrued profit.

Law #113 replaced Law #59, which had a specific provision that subjected capital gains to tax. The Tax Commission explained that since Law #113 does not contain this provision that, by implication, capital gains are not subject to tax.

- We recommend introducing a capital gain tax with transition rules to deal with the accumulated profits.

The Structure of Income Tax

Structuring Taxable Income

There are two methods to structure taxable income:

1. **Itemization approach: a loose enumeration of taxable items, comprising a residual clause (USA).**
2. **Listed categories: the inclusion of amounts in gross income is specified by reference to particular categories of income, capital, employment, and business (Canada).**

The Structure of Income Tax

Net Taxable Income

- A tax system, whether global or schedular, imposes taxation on a net amount because this amount properly reflects a person's increase in economic capacity for the tax period.
- Net income from each category should be determined according to proper rules applied to each category (employment, business, and investment).
- Horizontal Loss deduction allows the offset of losses in one category of income against other positive income from another category within the same taxable year.
- Vertical loss deduction allows the "carry-over" of aggregate losses, to offset profits of subsequent or preceding years.

The Structure of Income Tax

Tax Liability:

- Some countries adopt residence, others citizenship as a criterion for determining an individual's tax liability.
- For legal entities, the criteria are either the place of incorporation or the "*central management and control*".
- Law # 113 adopted a mixed criteria based on citizenship and residency. Legal entities that are incorporated under Iraqi laws <u>and</u> that have its central management and control in Iraq are subject to income tax.
- The new income tax law should adopt a revised and simplified two-test residency for an individual. Under this test, a resident of Iraq would be:
    1. All persons domiciled in Iraq, or
    2. All persons physically present in Iraq for 183 days or more during the year.
- For legal persons, the new provision should be based on the "*place of incorporation*" test or the "*central management and control*" test.

The Structure of Income Tax

Tax Unit

- Tax law provides charging provisions to impose tax on taxable income derived during the tax year by taxpayers
- The charging provision identifies the person liable for tax, namely any person who has taxable income for the tax period
- In the case of individuals, the issue of what the tax unit comprises will be either the individual tax unit or the family tax unit
- The tax unit is the basis on which a person’s taxable income is calculated
- The current Iraqi system is inconsistent in this regard, and discriminatory against women in addition to being difficult to administer
- We recommend using the individual as the tax unit with family tax relief for married couples and children on charge

The Structure of Income Tax

Tax rates

- The ability-to-pay principle requires that direct personal taxes have a progressive rate structure
- A progressive rate is appropriate for two reasons:
  1. First, it recognizes that the ability to pay tax without incurring undue hardship depends upon income.
  2. A progressive rate addresses the issue between those who earn higher incomes and those who earn lower incomes.

  Recommendations:

  - Progressive tax rate structure for individuals.
  - One rate structure with less marginal rate bands applicable to resident and non-resident alike.
  - The flat corporate income tax rate should be retained.

The Structure of Income Tax

Tax credits

- Tax credits are designed to provide tax relief to a particular category of taxpayer.
- Tax credits can be refundable or non-refundable.
- Tax credits are reductions in the amount of tax otherwise payable.

The Structure of Income Tax

Tax Period

- The charging provision imposes income tax by reference to the tax period.
- The taxable income must be calculated separately for each year.
- The tax year for the purposes of income tax is, generally, a period of 12 months.
- Most countries use the calendar year or the financial year.

The Structure of Income Tax

Tax Assessment

- The new Iraqi Income Tax Law should set up a “comprehensive income” and appropriate procedures for determining the amount subject to assessment.
- The new taxable income should provide accounting rules to allocate income and expenses to a particular tax year, called accounting methods.
- The new income system should set up a definition of a “tax year” based on the following:
  1. In the case of an individuals, the calendar year.
  2. Unincorporated small business activities, the calendar year.
  3. In the case of corporations, the fiscal period of which its accounts are made up for the purposes of the tax law.