Discussion document on further reform of the income tax law and administrative procedures of Country X.

Kieran Holmes
www.kieranholmes.com

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PREFACE

The purpose of this document is to examine the current income tax law of Country X, including the Presidential Decree passed early this year. The document discusses perceived difficulties with the current income tax law and proposes recommendations for improvement.

If adopted these recommendations will lead to an enhancement of revenue as the tax base is broadened. Those taxpayers complying with the law will find it easier to file their returns and pay their taxes as procedures are simplified. Those taxpayers not complying with the law will face a wider range of penalties and sanctions that will dramatically increase the costs of non-compliance.

It is hoped that this document will lead to a full and frank discussion of the income tax law and procedures amongst all stakeholders, particularly tax administrators and tax professionals in the private sector and will lead ultimately to improved legislation.

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1. TAX BASE

1.1 Employment income

Discussion of current law

The main Articles in this area are 17, 18, 26 (d, e, and g), 50 and 53b of Law No 31 of 1991 (the income tax law).

Articles 17 and 18 are the primary Articles dealing with employment income. Article 17 includes within the charge to taxation all salaries, wages, etc including benefits in kind. Article 18 states that taxes shall be imposed on the net income received by the taxpayer after deduction of pension contributions, other work-related expenses and stamp taxes.

Article 26 (d, e, and g)

This Article was to be deleted in the recent income tax amendment law in order to bring within the charge to taxation compensation allowances, wages of agricultural workers and the income of day labourers. The deletion is necessary in order to arrive at a more equitable treatment of employment income. The parliament failed to delete the Article.

Article 50

This Article imposes a ceiling tax rate of 20% for wages and salaries. This is an improvement on previous law where the limit was 16%.

Article 53 b.

This Article attempts to impose a 15% tax on incentive payments with no deductions allowed.

The law on the taxation of employment income should be drafted with tax administration objectives very much in mind. The primary objective should be to facilitate the easy withholding of tax by employers and to make the tax withheld a final tax for the vast majority of employees.

As a first step Articles 26 (d, e, and g), 50 and 53b should be deleted.

The items of income contemplated in Article 26 are normally taxed. Compensation payments are compensation for employment income foregone and should be taxed in the same way as the employment income would have been taxed. The protection of very low incomes such as those paid to farm workers or day labourers should be left to the exempt amount.

The effect of Article 50 is to erode the corporate tax base as director/shareholders can take as much as they like in directors' remuneration that will be taxed at 20%, rather than at 35% if retained in the company. Article 53 b is bad law as it creates opportunities for tax avoidance and also lends itself to administrative confusion. Both Articles 50 and 53 b are attempting to limit the average rate of tax on employment income. It is better if both Articles are deleted and the limitation of the average tax rate be addressed through the use of a small number of relatively wide

personal tax bands. It should be remembered that progressivity in the personal tax system can be provided by the use of as few as two or three tax bands. It is not necessary to have 6 bands proceeding evenly in steps of 5 percentage points to achieve a progressive system.

The next step is to provide rules for the valuation of benefits in kind in the tax law. To a large extent we have already done this in the new Employer's Guide to withholding tax from employees. However it would be better if these rules were enshrined in regulations so as to clarify their legal status.

The third step is to establish a realistic exempt amount and personal tax bands in relation to typical incomes paid in Country X. There is no point in having 6 tax bands as set out in Article 48 when the vast majority of taxpayers use only 3 bands because of the limitation set out in Article 50. Why not combine the two Articles with a realistic exempt amount set close to GDP/capita and just three relatively wide tax bands of, say, 15%, 25% and 35%? Keeping the tax bands as wide as possible will ease tax administration, assist employers in deducting the correct tax and prevent employees from being dragged into higher marginal tax rates due to receipt of occasional extra payments like overtime, bonuses or gratuities.

On the administration front we must continue with the efforts to improve the efficiency of employee withholding. Currently the tax on employment income is paid haphazardly and often well after the end of the tax year when the Tax Authority has raised an assessment. This situation must be changed and the target must be to receive 100% of the tax due on wages and salaries evenly ***within*** the year of assessment. This will involve strengthening the employee withholding function, revising the procedures and processes in use within the T.A. in this area and drafting employee withholding regulations for employers.

Recommendations

Delete Articles 26 (d, e, and g), 50 and 53b.

Draft specific rules for the valuation and taxation of benefits in kind.

Amend Articles 48 and 50 to arrive at one set of tax rates and bands for all personal income.

1.2 Interest income

Discussion of current law

Article 15h exempts from tax the interest income of individuals arising from deposits in banks and savings funds. Presumably individuals in receipt of interest arising from loans to companies are liable to taxation on this interest. The exemption does not specify banks and savings funds resident in Country X, so presumably individuals are also exempt on their foreign-source interest income.

Companies are liable for tax on interest received from banks and savings funds.

Presumably the logic for exempting the interest income of individuals is that other countries in the region exempt income from this source and Country Xi banks need to remain regionally competitive. There is probably a certain attraction for the Tax Authority in this also in that exempting interest income eliminates the administrative

problem of individuals having to report this income, which again presumably, is not large overall although some individuals may have substantial interest income. However, there are a number of disadvantages to the wholesale exemption of interest income. First of all the holders of bank deposits are amongst the richer individuals in society and exempting their interest income means that a certain amount of equity is lost from the tax system. Secondly, not having a taxing point on interest income means that information on the existence of bank deposits does not come readily to the attention of the Tax Authority. This is a vital loss of information that can have a major impact on compliance with other taxes, mainly business income. Thirdly, if the aim of the exemption is to encourage individuals to deposit monies in banks in Country X then this aim is undermined due to the application of the exemption to foreign interest as well. Fourthly, the existence of an exemption for interest income accruing to individuals serves to encourage the private sector to seek the same treatment for companies.

Recommendations

It is recommended that interest income be taxed at a uniform low rate of 10% and that this tax be collected from the banks by withholding at source. It is also recommended that the tax withheld by the banks be treated as a final tax with the result that individuals (not companies) in receipt of interest income from which tax has been withheld would face no filing or further payment obligation with respect to this income. A low tax rate of 10% would be unlikely to undermine the attractiveness of banks in Country X vis-à-vis banks in regional countries where interest is exempt from tax. Assuming an interest rate of 8% p.a., depositors would receive a net 7.2% after deduction of tax.

The banks should be obliged to report all payments of interest made to taxpayers on a quarterly basis.

1.3 Dividend income

Discussion of current law

Article 15h exempts the income of individuals from shares in public and joint-stock companies.

Article 15h(2) inserted by the recent presidential decree exempts 90% of dividend income earned by public companies from their shares in other companies provided that the other companies have paid the taxes due on their earnings or are exempted from such taxes. In practice it appears that the Tax Authority will grant this exemption only to “holding companies” which own more than one subsidiary. Since the exemption only applies to 90% of dividend income and only to those dividends received by holding companies it is not a full exemption of inter-corporate dividends.

Recommendation

It is recommended that 100% of inter-corporate dividends be exempted from tax. The Tax Authority could consider the imposition of a 10% tax on dividends paid to individuals similar to the tax suggested for interest i.e. a final withholding tax with no further reporting requirements. This would compensate for any fall in revenue that might occur from the full inter-corporate exemption as well as lead to greater equity in the tax system since the recipients of dividends are in the main higher income taxpayers.

1.4 Rental income

Discussion of current law

Article 32 charges rental income to tax. The Article brings within the charge to tax income from developed real estate and vacant land. However this Article has been amended by the recent Presidential Decree which limits the tax on income from the rental of real estate to the equivalent of one month's rental or 8.33% per annum.

The Tax Authority faces a real problem with regard to the collection of tax on rental income. There are many residential properties let to Embassies, NGOs and international companies. There is also a flourishing market in commercial properties. The rental contracts are big by income standards in Country X and are usually expressed in US dollars. The owners of these properties are powerful people, often senior Government officials, politicians and military personnel who blithely ignore their tax obligations. The reduction in the tax on rental income to the equivalent of one month's rent is an effort at encouraging compliance in this area and securing more revenue. It is felt that the owners of let properties will be willing to pay one month's rent as a tax whereas they are currently unwilling to be taxed at marginal rates on this income.

It is submitted that the reduction in the rate of tax on rental income to the equivalent of one month's rent is misguided. The previous draft of Article 50 limited the tax rate applicable to rental income to 16% (two months gross rent) in any event. If the owners of let property were unwilling to be taxed at 16%, which is a very low rate of tax, what guarantees are there that they will pay up at 8%? If they don't pay up will there be a proposal to go as low as 4%?

Presumably everyone agrees that there is no logic to a lower tax rate for rental income than from other sources of income on revenue and equity grounds, so that the reason for the lower tax rate on rental income is purely compliance enhancement. Therefore the government should come out strongly and firmly and insist that all officials, politicians, military officers and others on the government payroll make a fair and accurate return of their rental income. Failure to do so should result in dismissal from government service. The Tax Authority must be given full political support in its mission to tax rental income and to prosecute offenders.

Recommendations

It is recommended that Article 32 be amended to ensure that all rental income is brought within the charge to tax including rents from undeveloped real estate or land utilised for whatever purpose. The limitation of tax on rental income equal to one month's rent should be deleted.

It is also recommended that the Tax Authority's information gathering powers be enhanced in this area. Payers of rent should be specifically required to report rental payments and Real Estate Agents should be obliged to file information returns. (Some powers do exist in Articles 58 to 60 and these should be strengthened). Stiff penalties for non-compliance or for providing false information should be introduced.

Furthermore, in addition to taking strong action against the recipients of rental income who are in receipt of government income, the government should take steps to ensure that those entities normally outside the tax net e.g. embassies, international organisations, NGOs, etc are circularised and formally requested to provide the names and addresses of landlords to the Tax Authority as well as full details of rents paid.

1.5 Capital gains

Discussion of current law

Assets can be generally divided into three broad groups, business assets, investment assets and personal assets. Business assets are those held by businesses, usually for the purposes of the trade of the business. Examples are buildings, vehicles, plant and equipment, shares in subsidiaries, etc. Investment assets are usually shares, let property, treasury bills, etc. Personal assets are always held by individuals and are usually the family home, a personal vehicle, jewellery, etc.

Where the tax law demands the taxation of capital gains, it is normal to allow a deduction for enhancement expenditure and costs of disposal. Capital losses are usually quarantined and carried forward as a deduction against future capital gains. In some tax systems capital gains are assessed separately at a special rate and in others the gains are charged to income tax.

Article 5 of the income tax law states that: -

"Taxes shall be assessed on the earnings of individuals, partnerships, and corporations regardless of their purpose and whether they engage in commercial, industrial, financial or real estate activities."

While it is accepted that the Article may have lost something in the translation, this provision would not normally allow for the taxation of capital gains. Nevertheless the Tax Authority has taken the view that since the disposal of assets can produce capital gains which is income for the owners of businesses then those gains amount to taxable income. This view appears to have been accepted by the private sector, if grudgingly.

Article 51 states that a tax shall be levied on the disposal of land or real estate at the rate of 3%. The tax is paid by the disposer of the property and falls due within 15 days of the date of disposal (Articles 40 – 46). From an income tax point of view this is bad law since the tax is payable regardless of whether a gain or a loss was made on the disposal.

Recommendation

It is recommended that the de facto situation in the current law be recognised and formally incorporated into the law. This would involve explicitly stating in the law that gains on the disposal of business assets are taxable while losses are allowable. Consideration should also be given towards the taxation of investment assets.

Gains/losses should be assessed to income tax at normal rates of tax.

The 3% tax on the disposal of land and real estate should be abolished.

1.6 Exempt income

Discussion of current law

The draft law agreed between the MED Fund mission and the Tax Authority in late February/early March '98 proposed the deletion of Articles 15 (a, b, c, and e). Briefly the reason for the deletion of these Articles was the abolition of the exemption from tax of: -

- cooperatives and agricultural associations,
- land exploited for agricultural production,
- the income of educational institutes, and
- earnings from the export of Country Xi agricultural products

Instead the Article was amended under the Presidential Decree as follows: -

- Charitable institutions which are not for profit and whose income is solely aid financed are exempt from tax.
- The exemption from tax of co-operatives has been retained provided they are in the field of agriculture or fisheries and provided their activities are restricted to the needs of their members and provided they do not import or export.
- Income from the use of land from agriculture, gardening, forestry, livestock, poultry fish or bees is exempt from tax.
- Technical institutes are exempt from tax.
- Profits derived from the export of agricultural, industrial, fishing, or artisinal products of Country Xi origin are exempt from tax.

The latter exemption is particularly pernicious in that it widens the tax exemption from applying only to agricultural exports under current law to include industrial, fishing and artisinal exports as well. Clearly this amounts to a substantial further erosion of the tax base.

The Tax Authority has succeeded in adding a restriction to this exemption to the effect that the exemption is limited to the extent stipulated in the implementation order for this law.

The implementation order has not yet been drafted but the Tax Authority intends to insert conditions such as: -

a) 100% of the raw materials used in the production of the goods exported are from Country X,
b) The taxpayer must provide documentary proof of the export, and
c) The taxpayer must transfer the proceeds of the exports back to Country X.

While the T.A. is trying to minimise the erosion of the tax base through the application of stringent conditions in the implementation order this is very much a second best option. There is no guarantee that they will succeed in having these conditions adopted. Furthermore even if they are adopted the effect will be additional administrative burdens and a consequent reduction in efficiency.

Recommendations

It is better to delete Articles 15 a, b, c, and especially e, as originally agreed. Low-income farmers should be protected through the application of the exempt amount as set out in Article 52. Consideration should be given to increasing the exempt amount if its effect is to bring subsistence farmers within the tax net.

There is no economic justification for exempting income from the export of agricultural, fisheries and industrial production. To do so will erode the tax base to an unacceptable level and in the areas from which more tax revenue is needed to compensate for the fall in oil prices. Furthermore this provision will cause administrative chaos, as the Tax Authority will find it almost impossible to separate out domestic and export income and expenditure.

1.7 Depreciation

Article 9 b provides a deduction in respect of the depreciation of assets calculated according to the rates and methods established by regulations issued by the Council of Ministers. The current depreciation schedule is overly long and detailed and runs to about 40 pages.

It is suggested that consideration be given to drafting a much simpler depreciation schedule based on the expected useful lives of assets with assets grouped into 4 categories. It is suggested that the current practice of calculating depreciation according to the straight-line method be retained. An example of a revised depreciation schedule (currently under discussion within the Tax Authority) is set out below.

Group	Assets included	Depreciation rate
1	Computer hardware and data handling equipment, including printers, scanners, peripherals etc., surgical instruments, laser equipment and any other computer operated equipment used for drawings, mapping or other purposes.	25%
2	Automobiles, Taxis, Light General purpose trucks, tractors, special tools and devices, office furniture, fixtures and equipment, buses, heavy general purpose trucks, trailers and trailer mounted containers, construction equipment.	20%
3	Any depreciable asset not included in another group.	10%
4	Aircraft, railroad cars, locomotives, railroad equipment, ships, boats, barges, tugs, trawlers, and similar water transportation equipment, industrial buildings, engines and turbines, public utility plant, oil and gas pipelines.	5%

Recommendation

Simplify the depreciation schedule.

1.8 Bad debts

Discussion of current law

The draft Income Tax Amendment law agreed with the MED Fund mission and the Tax Authority in late February/early March '98 proposed the insertion of Article 9 m which would allow banks and other financial institutions to create provisions against bad debts. The draft law proposed that the provision for bad debts claimed in a previous year would be added back in the current year. The Presidential Decree published earlier this year did not contain the requirement of adding back the previous year's provision to profits.

If we accept that bad debts provisions should be deductible for banks we then have to consider what abuses may occur. If there is no limitation placed upon the deduction allowed, the bank could theoretically choose any figure it wants as the provision each year and claim a deduction accordingly. Since a provision for bad debts is created in respect of anticipated bad debts in any one year (and the bank will do this year after year), it is reasonable to add back in any one year the deduction claimed for the provision in the previous year. This protects the Tax Authority from the creation of excessive provisions since the bank will know that whatever is claimed this year is added back next year.

Essentially from a tax point of view the bank is gaining a timing advantage equal to the tax on the value of the provision for a year. From the bank's point of view it is able to provide against the anticipated bad debts in any one year as well as claim a deduction for the bad debts actually incurred.

Recommendation

Allow banks to claim a deduction for bad debts provisions but add back deduction claimed in previous year.

2. INTERNATIONAL

2.1 Income of residents

Discussion of current law

Article 6 h appears to bring within the charge to taxation the global income of resident companies and resident individuals. This Article has been modified by the recent Presidential Decree so as to limit the taxation of companies to those companies whose headquarters are in Country X and to give due consideration to the prevention of double taxation.

It is necessary to explore the meaning of and the reason behind this amendment. Does it mean for example that a company that has its headquarters in Dubai and which trades in Country X through a branch office is not taxable in Country X on the income of the branch? If so, then the amendment has clearly introduced an easy means of avoiding tax in Country X into the law. Companies merely have to migrate their headquarters outside the geographical jurisdiction of Country X in order to avoid taxation.

What is meant by having “due consideration to the prevention of double taxation”? Are foreign taxes creditable or just deductible? Does the expression mean that the full value of all foreign taxes paid are creditable against Country Xi tax or is only so much of the foreign tax that satisfies the Country Xi tax on the foreign-source income creditable? Can a foreign tax credit arising on, say, business income be set against tax on, say, rental income of a Country Xi company? Are all foreign taxes creditable or only those from countries with which Country X has negotiated double taxation agreements? What is the status of double taxation agreements within the law and what rules apply if there is a conflict between the provisions of a double taxation agreement and the domestic law?

Recommendations

Amend Article 6h to delete unintentional error.

Draft specific rules for the avoidance of double taxation, the granting of foreign tax credits and the status of double taxation agreements and other international tax agreements such as bilateral and multilateral aid agreements and agreements with oil companies etc.

2.2 Income of non-residents

Discussion of current law

Article 6i brings within the charge to tax the income earned in Country X by non-residents in carrying out an activity, profession or individual transaction regardless of the time period involved. This is a very general provision that will likely need to be drafted in greater detail so as to provide clarity and certainty to investors and tax officials alike.

Some of the items of Country Xi source income that the Tax Authority may wish to consider for a specific listing in addition to what is already in Article 6i are: -

- profits from services performed under contracts with the government of Country X or public sector companies,
- services performed on ships, aircraft or vehicles operated between Country X and other countries,
- profits made from real property in Country X including gains made on the disposal of shares in companies whose assets are mainly real property in Country X,
- gains made on the sale of shares in a Country X based company,
- gains from the rental of movable property in Country X,
- royalties, dividends, management fees, directors’ fees, payments for natural resources, etc paid by resident companies.

It is recognised that the Tax Authority may consider that some or all of the items in this list (which is not comprehensive) are taxable under current law. However even if this is the case it is better to list the items for the purpose of providing greater certainty to investors and tax administrators alike.

Recommendation

Draft clear and comprehensive source of income rules.

2.3 International withholding

Discussion of current law

International investors can siphon profits out of a domestic company through the payment of interest, royalties, management fees, services payments, etc. to a non-resident parent company. The items mentioned are fully deductible against profits and, since parents and subsidiaries are connected persons, may be adjusted relatively easily to depress local taxable income.

Currently the only means of recovering tax on these items is to raise an assessment on the non-resident recipient of such payments. This however is a slow and cumbersome procedure which may result in no tax at all if the non-resident can show that it has substantial deductions available for set-off against the Country X-source income e.g. headquarters' research and development expenses available for set-off against an assessment on Country X-source royalties.

On the other hand there are advantages to the imposition of a final withholding tax on such income.

For the Tax Authority the advantages are: -

- Ease of collection of tax,
- Payment of tax is made much earlier than through the assessment process,
- No arguments with taxpayers regarding deduction of expenses,
- Cash flow advantage in that a tax payment is made at the same time as the payment is made to the non-resident.

Companies are likely to prefer a withholding tax to the assessment procedure because: -

- It is easier and cheaper to comply with a withholding tax than to become embroiled in long and protracted arguments with tax officials over assessments.
- Tax credits are generally available in the home country.
- A low rate of withholding is applied and this may become lower under bilateral double taxation agreements.

Recommendations

Consider the introduction of a final withholding tax on payments to non-residents of Country X-source dividends, interest, royalties, management fees, re-insurance payments (?).

3. PROCEDURE AND ADMINISTRATION

Discussion of current law

3.1 Returns

Article 66 of the income tax law covers the filing of tax returns. Returns must be filed within 4 months of the end of the year of assessment. Taxes are assessed on the basis of the return submitted after a review and, if necessary, an audit.

Article 67 was supposed to have been amended under the income tax amendment law agreed in March '98. The draft amendment extended the period during which the Tax Authority could notify the taxpayer that the return is unacceptable to three years (currently one year). It also deleted the requirement for the taxpayer to be summoned to a meeting to discuss the findings of the review. This Article however was deleted from the Presidential Decree.

The returns procedure is cumbersome and acts to delay the collection of tax. First of all the period within which a return may be filed could be shortened to three months. Secondly, and more importantly, the entire assessment and collection procedure acts to delay the payment of tax cumbersome. There is little point in taxpayers, especially corporate taxpayers, filing returns and then having to wait for the Tax Authority to review the return, prepare an assessment, issue the assessment and then seek to collect the tax. Corporate taxpayers can easily file the return (which should include a calculation of the tax due) along with a cheque for the payment of the tax. These taxpayers may be audited at a later stage but at least the tax according to their calculations will have been remitted.

Article 69 deals with assessments and objections. Assessments may be made after the end of the fourth month if returns have not been filed. After the assessment is issued a taxpayer has one month to lodge an appeal. A taxpayer also may be entitled to a further extension of 15 days. The contesting taxpayer shall then be called to a meeting to discuss the objection submitted. If agreement is not reached the Tax Authority shall issue an explanatory order which itself is subject to appeal within 30 days. At this stage up to 7 or 8 months may have elapsed from the year of income and the tax may still not have been paid. The taxpayer can continue to drag the procedure out for several more months if he so desires.

The law and procedures must be amended to minimise the opportunities for taxpayers to delay the payment of tax by stringing out the appeals process at each step of the way. In the medium term the Tax Authority should only consider self-assessment for companies. Therefore procedures should be changed so that all other business and property income taxpayers receive an estimated assessment within 4 months of the end of the year of income. Appeals against these assessments will only be valid if accompanied by payment of the amount of tax not in dispute, which itself shall not be less than 80% of the eventual liability. There should be no legal requirement for face to face meetings with taxpayers to discuss objections submitted. Taxpayers in receipt of estimated assessments should either pay the tax on the assessment or appeal the assessment and pay the tax not in dispute. Taxpayers ignoring estimated assessments would then face the recovery of tax provisions suggested in 3.3 below.

Article 70

Article 70 in the draft amendment law as agreed in March '98 was originally intended to give power to the Tax Authority to assess and collect tax from taxpayers who do not maintain complete or accurate accounting records. Under the Presidential Decree recently passed the Article has been amended to a means of collecting lump-sum taxes from taxpayers, those who do not have data on the size of their turnover and those who do have data on the size of their turnover.

Article 70 as it appears in the Presidential Decree is bad law in that it rewards taxpayers who do not keep accurate books and records by calculating their taxes at comfortably low percentages of turnover (or such turnover as they actually report) or by taking an arbitrary percentage growth escalator over the previous year's tax. Meanwhile taxpayers that do keep proper books and records receive the full application of the law as their compliance reward.

Many taxpayers have genuine reasons for filing returns late. A return may not have been filed due to the illness or death of the taxpayer or a member of the taxpayer's immediate family. A company may have been unable to have its accounts audited in time to meet the filing deadline. In these circumstances it is not unreasonable for the Tax Authority to grant an extension of time to file a return. However granting an extension of time to file a return in exceptional circumstances is not a good reason to delay payment of the tax. Therefore while it is recommended that the Tax Authority have the power to grant time extensions for filing returns in certain circumstances, this power should only be exercised where the taxpayer requesting the extension has provided an estimate of the tax payable. Where the taxpayer fails to pay the estimated tax or where it emerges that the estimated tax paid is less than the eventual tax liability additional tax as set out in 3.6 below should be levied.

Recommendations

Reduce the filing period from 4 months to 3 months.

Amend Article 67 as originally agreed.

Introduce self-assessment for companies. Companies will be expected to calculate the tax due and make payment at the time the return is filed. A corporate return will be treated as invalid if it is not accompanied by payment of the tax due. For invalid returns or returns filed late, interest should run from the date the return was due.

Appeals to be valid only if accompanied by payment of the amount of tax not in dispute. The amount of tax paid on appeal should equal at least 80% of the final liability as determined when the return is filed. If the amount of tax paid at the time of appeal does not equal 80% of the final liability, interest should be charged on the amount unpaid from the date the return was originally due.

Delete Article 70 as it appears in the Presidential Decree.

Permit extensions of time for filing returns in exceptional circumstances but only if estimated tax is paid.

3.2 Payment of tax, instalments

Business taxpayers are generally obliged to make their accounts up to 31 December, file returns within the period January to April and pay the tax due by that date based on the returns filed. Article 102 appears to allow the Tax Authority the power to withhold tax at the point of importation. Importers must pay 3% of the cost of the goods imported by air and 2% of the cost of goods imported by land or sea as an advance payment of income tax. This advance payment of income tax is greatly resented by the private sector. However the Tax Authority has consistently refused to delete this provision in view of the very large proportion of business income tax collected by this method.

Many countries oblige business taxpayers to pay their taxes on a quarterly basis, rather than in a lump sum after the end of the year of assessment. The advantage for the Tax Authority is that tax comes in earlier and the advantage for business is that tax payments are spread evenly throughout the year which for many businesses can make cash flow planning easier. The introduction of payment of tax on a quarterly basis can have a significant impact on revenue in the first couple of years, depending on how it is phased in. It will in fact have a permanent impact on revenue as the interval between the time profits are generated and the time tax is paid on those profits is shortened considerably.

It is not necessary to oblige companies to file quarterly returns nor should companies be asked to do so. It is sufficient to oblige them to pay tax on a quarterly basis. A simple rule of thumb can be legislated for such as obliging the payment of 3 quarterly instalments with the final payment accompanying the return. Each instalment could be say 30% of the previous year's total tax liability to allow for inflation and income growth, with penalties for non-compliance.

Recommendations

Consider obliging companies to pay their taxes on a quarterly basis.

Consider exempting companies that pay their taxes on a quarterly basis from the obligation to make a down payment of their income tax liabilities at the point of importation.

3.3 Recovery of tax

Discussion of current law

The law dealing with the collection of tax and the seizure of assets is contained in Articles 94 to 103 of the income tax law.

Article 99 allows the Tax Authority to apply to the Public Prosecutor for a writ of attachment on assets equal to the amount of tax owing but there does not appear to be an automatic right of a preferential claim in this Article.

Article 100 allows the Tax Authority to apply to the Public Prosecutor to issue a writ of execution on a tax debtor's assets including cash or securities or on other assets he has in the custody of others. This power however is only in respect of definite tax debts i.e. when the taxpayer has exhausted the appeals process.

Article 100 appears to allow the recovery of tax from persons having the custody of assets of the taxpayer. Again this power is upon application to the Public Prosecutor and is only in respect of definite tax debts.

There is no power of closure (either temporary or permanent) of businesses for non-compliance, despite the recommendation to this effect made by the IMF in the August 1997 red cover report.

There appears to be no Article dealing with the obligation of receivers to advise the Tax Authority of their appointment or no provision preventing receivers from disposing of assets without the prior written consent of the Tax Authority. Such provisions are necessary to enforce the Tax Authority's preferential claim on the assets of companies in receivership.

Recommendations

Consideration should be given to amending Article 99 so that the Tax Authority has an automatic preferential claim on all assets of the taxpayer where tax is owing.

Consideration should also be given to granting the Tax Authority power to recover tax from the assets or income of the spouse of the taxpayer.

The obligation to make applications to the Public Prosecutor is an unnecessary bureaucratic hurdle, which prevents the Tax Authority from acting quickly to recover taxes owing. Article 100 should be amended to allow the seizure of assets by written order of the Tax Authority and in respect of all tax debts, not just where tax owing is 'definite'. For the purposes of carrying out such distress proceedings tax officers should be empowered to enter any premises at any time, accompanied by a police officer if necessary. To protect taxpayers there should be an obligation on the Tax Authority to hold assets for a certain period (say 3 weeks) before disposing of the assets. Distressed assets could be held at special premises of the Tax Authority or indeed at the premises where the distress was levied. If the taxpayer does not pay the taxes owing within the period the assets should be sold and the tax recovered from the value of the assets sold, less the costs of disposal and any surplus returned to the taxpayer.

Article 100 could also be amended to generally allow for the recovery of tax from persons who owe or who may owe monies to the taxpayer. The Tax Authority should be given the power by notice in writing to require a person: -

- who owes money to the taxpayer or
- who holds money on account for the taxpayer or
- who has authority from some other person to pay money to the taxpayer,

to pay this money to the Tax Authority up to the amount of tax owing.

The Tax Authority should give consideration to the introduction of a power of closure of businesses for non-compliance.

Consideration should be given to the introduction of the power of compelling receivers to notify the Tax Authority of their appointment and the prevention of the disposal of assets of a company in receivership without the written permission of the Tax Authority.

3.4 Records and investigation powers

Discussion of current law

There is no specific Article in the Income Tax law dealing with the requirement to keep books and records, although this requirement does exist in an Implementing Order[1]. The provision in the Implementing Order does seem to be unnecessarily long in that various categories of taxpayers are specified and there is an attempt to allow small businesses (now overtaken by inflation and currency depreciation) to keep less than adequate records. In contrast the TPCS law[2] does have a provision requiring the maintenance of proper books and records with detailed rules contained in the implementing regulations.

The Presidential Decree inserted an amendment (Article 9k) to the effect that a deduction for certain expenses such as “facilitation expenses” of up to 1% of net income may be claimed without evidence of payment. In many cases 1% of net income could be a substantial deduction to allow without evidence.

Many taxpayers in Country X keep their records in the English language. This practice is common not only with overseas companies but also with many Country Xi businesses.

Recommendation

The law should explicitly state that taxpayers are obliged to keep those records that are necessary for the accurate determination of their income.

There should be a provision that any deduction may be disallowed where the taxpayer is unable to produce a receipt or other record of the transaction.

Heavy penalties should be introduced for failure to keep proper books and records.

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[1] Implementing Order No 203 of 1992 (Article 27).
[2] Article 25, law 70 of 1991

The law should also recognise the de facto situation and make provision for records to be kept in the English language. The Tax Authority should seek to provide taxpayer information booklets and major return forms in both the Arabic and English languages.

3.5 Offences and penalties

Discussion of current law

The law relating to infractions and penalties is contained in Section 7 (Articles 90 to 93 inclusive) of the income tax law.

Article 90 imposes a fine on conviction of not less than 50% and not more than 150% of the proceeds derived from a list of infractions. A period of imprisonment of up to one year may be imposed instead of the fine. While a fine linked to the value of the offence is a good idea for certain offences, it is not recommended as a general penalty for tax offences. It is submitted that a monetary fine up to a significant limit is more comprehensible to taxpayers with the addition of a fine linked to the amount of tax foregone in certain circumstances. A prison sentence is also a useful deterrent and for very serious offences the Courts should have the option of imposing a fine and a prison sentence.

The perceived disadvantage of a monetary fine is that the value of the fine is eroded over time by inflation. It is suggested therefore that the Courts be given the discretion to impose a fine up to a ceiling amount and that the ceiling amount be set relatively high and reviewed every couple of years so that it does not become eroded in value over time.

To be effective every tax law must specify a wide range of offences with significant penalties for infractions. It appears that the offences listed in the current income tax law are not comprehensive and the penalties are not strong enough. For example the offence of filing a false return is listed but there seems to be no reference to the more common offence of failure to file a return. Article 91 imposes a fine for failure to comply with any notice or request issued by the Tax Authority or failure to appear when instructed to do so by notice. However the penalty for these infractions is a paltry ** 2,000 at the maximum.

It is suggested that offences be divided into two categories of more serious and less serious. The more serious offences relate to fraud or the failure to comply with withholding obligations. These should incur a maximum fine of **5,000,000 and/or a maximum prison sentence of 2 years. The less serious offences such as failure to file a return should carry a maximum fine of ** 250,000 and a maximum prison sentence of 6 months.

The original agreed amendment law called for the appointment of nominated officers who shall be personally liable for the tax obligations of companies. The purpose of this provision was to identify an individual against whom the Tax Authority may proceed in respect of tax defaults by companies. The provision was deleted from the Presidential Decree but a revised provision is under discussion with the Tax Authority.

Recommendation

It is recommended that the Tax Authority considers the following table of offences and suggested penalties for inclusion in the law.

It is also recommended that company officers be made personally liable for corporate offences.

Offence	Suggested penalty (on conviction)
Failure to file a return[3]	Up to ** 250,000 or imprisonment of up to 6 months, or both fine and imprisonment
Failure to keep proper records	Up to ** 250,000 or imprisonment of up to 6 months, or both fine and imprisonment
Knowingly keeping false records	Up to ** 5,000,000 or imprisonment of up to 2 years, or both fine and imprisonment
Failure to obey notice from Tax Authority requiring person owing money to taxpayer to pay that money to Tax Authority to be set against taxpayer's tax debt.	Up to ** 5,000,000 or imprisonment of up to 2 years, or both fine and imprisonment. Upon conviction the courts should also force compliance with the original notice.
Failure to withhold tax, either employee withholding tax or tax due from international payments as suggested.	Up to ** 5,000,000 or imprisonment of up to 2 years, or both fine and imprisonment
Failure to pay tax withheld.	Up to ** 5,000,000 or imprisonment of up to 2 years, or both fine and imprisonment
Providing false withholding tax certificates	Up to ** 5,000,000 or imprisonment of up to 2 years, or both fine and imprisonment
Failure to provide reasonable facilities and assistance to auditors in the examination of books or records at taxpayer's premises	Up to ** 250,000 or imprisonment of up to 6 months, or both fine and imprisonment
Failure to comply with request for information from Tax Authority[4]	Up to ** 250,000 or imprisonment of up to 6 months, or both fine and imprisonment
Knowingly using a false Taxpayer Identification Number	Up to ** 5,000,000 or imprisonment of up to 2 years, or both fine and imprisonment
Making false or misleading statements to a tax officer or omitting items from a statement that are material to that statement	Up to ** 5,000,000 or imprisonment of up to 2 years, or both fine and imprisonment
Obstructing tax officers in the course of their duties	Up to ** 5,000,000 or imprisonment of up to 2 years, or both fine and imprisonment
Failure to advise Tax Authority of appointment as receiver	Up to ** 5,000,000 or imprisonment of up to 2 years, or both fine and imprisonment.

3.6 Additional tax

Without an effective sanction taxpayers will seek to delay the filing of returns and the payment of taxes. Delays in compliance whether arising from the failure to file returns, pay taxes or delay payments by spurious appeals contribute to a real loss of revenue. To combat this practice, tax administrations impose a charge for the

[3] Consideration should also be given to the imposition of a daily penalty for each day the offence continues after conviction. This may be considered as an alternative to the additional tax charge suggested in 3.6 below.
[4] Replaces Article 62 of current law where penalty is 1% of the estimated value of the information withheld. Income Tax amendment law proposed a figure of 3%.

revenue lost as a result of the delay in payment of tax. It is suggested that in Country X an additional tax be imposed to compensate for the loss of revenue arising from delays by taxpayers.

The additional tax could be linked to an interest charge well known to taxpayers such as the prime rate or the Central Bank Discount Rate. To effectively discourage taxpayers from delaying their tax payments the additional tax rate should be set several percentage points higher than prime, say prime plus 2-3 percentage points.

The table below sets out a minimum list of offences to which additional tax should apply. The additional tax should be imposed ***in addition*** to the penalties suggested in section 3.5 above. This is because the penalties in 3.5 above are imposed in respect of the offences listed. The additional tax is imposed in respect of the revenue lost as a result of delays by the taxpayer.

For the first four offences the additional tax is similar to an interest charge. For the last two offences the additional tax is set at double the amount of tax lost as a result of the offence, reflecting the relative seriousness of these particular offences.

Offence	Additional Tax
Failure to file a return	Additional tax at the specified rate calculated on the tax payable from the date the return was due.
Failure to pay tax on time	Additional tax at the specified rate calculated on the tax unpaid from the date on which the payment was due.
Failure to pay over tax withheld on time	Additional tax at the specified rate imposed on the withholding agent in respect of tax not withheld from the date that the tax should have been withheld. Additional tax may also be imposed where tax has been withheld but not paid over.
Failure to pay estimated tax upon receipt of extension of time to file return or underestimation of tax upon extension of time to file return	Additional tax at the specified rate calculated on the deficiency of tax from the date the payment was due.
Failure to maintain proper records as required by law.	Additional tax of double the amount of tax payable for the year of assessment in which proper records are not maintained.
Making false or misleading statements to a tax officer or omitting items from a statement that are material to that statement	Additional tax of double the amount of tax lost as a result of the false or misleading statement or from the item omitted.

4. SUMMARY OF RECOMMENDATIONS

The following is a summary of the recommendations made in this paper.

Recommendation	Included in '98 draft law agreed with IMF
Delete Articles 26 (d,e, and g), 50 and 53b	Yes
Prepare rules for the valuation of benefits in kind	No but new draft Employer's Guide anticipates such rules
Amend articles 48 and 50 to arrive at uniform tax rates and bands for all personal income	Yes
Improve efficiency of employee withholding	Additional regulations will be necessary
Impose final withholding tax of 10% on interest payments	No
Impose final withholding tax of 10% on payment of dividends	No
Exempt 100% of inter-corporate dividends	No
Amend Article 32 to tax all rental income and abolish limitation on rental income equal to one month's rent	Yes
Improve information gathering powers of tax authority in the area of rental income	No
Take steps to recover information on rental incomes from embassies, NGOs, International Organisations, etc	No
Consider regularising taxation of capital gains	No
Abolish 3% tax on disposal of land and real estate	No
Delete Articles 15 a, b, c,	Yes
Delete tax exemption on export of agricultural, fisheries and industrial production	Yes
Simplify depreciation schedule	No
Allow banks to claim a deduction for bad debts provisions but add back deduction claimed in previous year.	Yes
Amend Article 6h to ensure that companies do not gain a tax advantage by moving their headquarters out of Country X	Yes
Draft specific rules for the avoidance of double taxation, granting credits for foreign taxes paid and for the recognition of double taxation and other international agreements	No
Draft clear and comprehensive source of income rules	No
Consider the introduction of a final withholding tax on payments of Country X-source income to non-residents (e.g. dividends, interest, royalties, management fees, services income, re-insurance payments)	No
Reduce the filing period from 4 months to 3 months	No
Amend Article 67 as originally agreed	Yes
Consider introduction of self-assessment for companies	No
Appeals to be valid only if accompanied by payment of tax not in dispute	No
Delete Article 70 as it appears in the Presidential	Significant departure from agreed

Recommendation	Included in ’98 draft law agreed with IMF
Decree	draft law
Permit extensions of time for filing returns in exceptional circumstances but only if estimated tax is paid	No
Consider obliging companies to pay tax in quarterly instalments	No
Consider exempting companies that pay tax on a quarterly basis from tax withheld on imports	No
Amend Article 99 to grant automatic preferential claim to Tax Authority on all assets of taxpayer	No
Consider granting Tax Authority power to recover tax from assets of spouses	No
Allow the Tax Authority to enter premises and seize assets by written authority without the necessity of seeking the approval of the Public Prosecutor	No
Allow Tax Authority to dispose of seized assets	No
Allow recovery of tax from persons who owe money to tax debtors	No
Consider the possibility of closing the business premises of non-complying taxpayers	No
Compel receivers to notify Tax Authority of their appointment. Prevent disposal of assets without agreement of Tax Authority	No
Improve provision regarding the keeping of proper books and records	No
Allow for books and records to be kept in Arabic and English languages	No
Consider introduction of comprehensive penalties provisions as set out in paragraph 3.5 above	No
Make company officers personally liable for corporate offences	Yes
Consider introduction of additional tax provisions as set out in paragraph 3.6 above	Some