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Tax on Shipments to Iraq

Iraqi customs offices at entry points to Iraq have recently been asking for a 3.3% income tax on shipment value of some imports directed to ministries as well as to companies in Iraq. As there seems to be no specific rule relating to this new practice and the selection of taxable and non taxable imports, it is worth investigating on the legal basis and qualification of this new approach.

At present, there are no new provisions of Iraqi income tax relating to taxation of supplies to Iraqi Ministries and companies. The law and its executive regulations still distinguish between business *with* Iraq, which is not taxable, and business *in* Iraq, which is subject to income tax. However, the practice to request payment of a certain percentage of the supply value by the carrier or freight forwarder of the supplies at the point of entry into Iraq is new.

It seems that this payment request is based on Art. 28 (4) of Law No. 113 of 1982 – the Income Tax Law (“ITL”) – which authorizes the Tax Department “...to require from any person to deduct a percentage not exceeding 10% of the amount due to contactors or other persons connected to them...”. As a result, it seems that the request to pay 3.3% of the supply value to the customs authorities should be regarded as a kind of guarantee deposit that will be released once the supplier as tax payer has proven, by submitting a tax clearance letter, that he has settled his tax obligation with respect to the contract concerned.

Legal Background of Taxation of Supplies to Iraq

Under Art. 2 (1) ITL, all profits from commercial activity are subject to income tax. Art. 21 (7) ITL explains in more detail that non residents are not chargeable to tax “...unless trade, commercial business, vocations or any other transaction of a commercial nature, from which the gains and profits have arisen, are carried on in Iraq. The financial

authority shall differentiate between trading in and with Iraq, and their decision shall be subject to appeal.”

Under this tax law, all business activities performed in Iraq are subject to tax. With respect to supply contracts or contracts combining supplies and erection services to be performed in Iraq, it is also necessary to differentiate between business in Iraq and business with Iraq. It is administrative practice that all contracts which have at least some parts to be performed in Iraq will completely be handled as business in Iraq and will be subject to income tax.

Only last year, with Instructions No. 2/2008, the Iraqi tax administration provided for a clearer distinction between business in Iraq and business with Iraq. Article 1 of the First Chapter of Instructions No. 2/2008 enumerates cases and activities which are considered to create trading in Iraq. This article applies to supply and mixed supply/service contracts of a foreign contractor with public as well as with private customers and is independent from the place of delivery or the place of business of the foreign contractor. Trading in Iraq will be assumed if

- the non-resident foreign contractor has a branch or a representative office in Iraq, and any representative or employee of the branch or representative office signs the contract;
- the contract was signed outside Iraq by representatives or employees from the head office of the supplier and the supplier has taken over all legal and handling activities like L/C, customs and import handling, irrespective if operated through branch or head office personnel;
- the contract value was paid partially or totally inside Iraq;
- the compensation for the supplies have been paid to the supplier in context of a barter deal;
- the contract has been signed by a resident of Iraq or a local agent according to the instructions of the supplier; then the supplier and the agent, the latter for his commission, shall be subject to tax;
- the complementary services to any supply including installation, supervision, maintenance and engineering works shall be subject to tax irrespective if performed under the same or a separate contract;
- the compensation is paid for any services of experts or any other employee's or Iraqi or foreign experts' or labourer's activities, even if paid outside Iraq.

Article 2 of the Instructions defines the cases which are considered as trading with Iraq and, therefore, do not result in any Iraqi income tax liability. Trading with Iraq will be assumed if

- the supplier has its place of business outside Iraq, the contract was signed outside Iraq and all legal and handling activities like L/C or shipping paper handling, customs and similar processes and paperwork were done by the Iraqi party;
- the supplier has a branch or representative office in Iraq but the contract was signed outside Iraq without involvement of the branch or representative office in which case the branch, representative office or agent shall be taxed only for commissions attributable to them;
- services or expert activities are performed and paid outside Iraq.

Although these instructions provide for more clarification, they still do not answer all open questions. In any case it is recommended to have separate contracts for imported supplies to be separated from any on shore services. Furthermore, it is recommended to avoid signing a contract characterized as business with Iraq as an Iraq branch of a foreign company or to stamp the contract with a branch stamp.

The Influence of Supply Clauses on Taxation

For the time being, it is not entirely clear in which cases the above guarantee deposit of 3.3% of the supply value is requested by the customs authorities and, in particular, whether they follow the above distinction between trading *in* and trading *with* Iraq. In any event, it might be worthwhile to check if the supplies are connected with any kind of service performed in the territory of Iraq; in that case, the contract value would, according to the above, be subject to tax, and the custom authority's request of a guarantee might be understandable. In this respect, the following would apply:

- A contract providing for supplies and subject to the delivery clause FOB or CIF under the Incoterms does not contain any obligation to be performed in the territory of Iraq and, therefore, should not be made subject to income tax. In this case, any request by the customs authorities of the guarantee deposit would seem unjustified and should probably be challenged.
- On the other hand, it is common practice to add to the CIF clause a remark "on site", requesting the assistance of the supplier during customs clearance procedure and the supply of the goods to customers site in the country of Iraq. In this case, the tax authorities might have arguments to claim that part of the supplier's obligation has been performed in Iraq and, therefore, the request of taxing of the entire supply contract is justified.

- The same would probably apply to contracts subject to “D-clauses” of the Incoterms because, under these clauses, the supplier incurs responsibilities to be performed in the country of the customer (e.g. supply to destination in Iraq and taking all responsibility up to this point).
- In case of a combined supply and on-shore service contract, the tax authorities of Iraq have always been of the opinion that the entire contract should be subject to income tax. In the past, the withholding tax deduction has been requested from the customer/buyer. However the wording of Art. 28 (4) ITA might also cover the request to withhold amounts from any other person – arguably even customs authorities.

The tax deduction practice by the Customs Authorities is new, hence only little information on their approach and the background of differentiation between various supply cases has been collected. The interpretation of different supply cases as described above is only meant as a first attempt to explain the legal basis for the new practice and to sharpen the view for the tax aspects of different supply clauses. In any case it is worthwhile to check if any “*in* Iraq business elements” are included in the contractual agreement or if any local services have actually been performed on Iraqi territory. Any practice which would request tax on any supply not differentiating between business *in* Iraq and business *with* Iraq would not have a legal basis and should therefore be considered to be made subject to appeal.

Further information on tax matters can be obtained by

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