

## Oil and gas taxation in Iraq



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Oil and Gas Tax Guide

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# 1.0 Summary

The principal taxes and rates applicable to companies in the oil and gas extraction industry are:

- Corporate income tax – applicable to upstream oil and gas activity, and supporting industries 35%
- Corporate income tax – applicable to activities not falling within the scope of the Oil and Gas Tax Law 15%
- Withholding tax\*
  - Dividends N/A
  - Interest 15%
  - Rents and royalties 15%

\*Please refer to our comments in Section 7 below.

## 2.0 Corporate income tax

### 2.1 In general

The main source of tax law in Iraq is the Federal Income Tax Law, Law Number (“No.”) 113 of 22 November 1982, as amended in 2003 (the “Federal Income Tax Law”). There are no state level or municipal taxes imposed in Iraq.

The Federal Income Tax Law broadly provides that entities resident in Iraq should be subject to corporate income tax in respect of their worldwide income. Entities which are not resident in Iraq should be subject to tax on income arising in Iraq.

As a semi-autonomous region in Northern Iraq, the Kurdistan Region has introduced certain laws and practices which differ from the position in Federal Iraq. Throughout this guide, we have provided our comments with respect to Federal Iraq only, unless otherwise noted.

### 2.2 Rates

Under Federal Income Tax Law the headline corporate income tax rate is a flat rate of 15%.

A separate tax law was passed in March 2010, Law No. 19 (the “Oil and Gas Tax Law”), which applies to upstream oil and gas companies and supporting industries operating in Federal Iraq. The Oil and Gas Tax Law provides for an increased corporate income tax rate of 35% on contracts concluded with foreign oil companies and their subcontractors operating in Iraq in the field of oil and gas production and associated industries.

At the time of writing, it is not expected that the Oil and Gas Tax Law will be enforced in the Kurdistan Region of Iraq, however this position should be monitored closely.

### 2.3 Taxable income

Taxable income is broadly total income less allowable deductions. Total income is generally all income from whatever source. The Federal Income Tax Law provides that expenses incurred in generating taxable income during a period should be deductible in calculating taxable income.

In practice, it is common for the tax authority to seek to assess an entity to tax on a ‘deemed profits’ basis where they consider that there is insufficient documentation to support expenses disclosed in the financial statements.

## 2.4 Revenue

Article 2 of the Federal Income Tax Law broadly defines types of income which are subject to tax in Iraq. According to Article 2, the following types of income should be treated as taxable:

- profits from commercial activity or from activity having a commercial nature, vocations and professions, including contracts, undertakings and compensation for non-fulfillment thereof if not for making good a loss sustained by the taxpayer;
- interest, commissions, discount and profit arising from trading in bonds and securities; and
- any other source not exempted by law and not liable to any tax in Iraq.

Article 5 of the Federal Income Tax Law provides that “tax shall be imposed on income of the Iraqi person resident which arises inside or outside Iraq, regardless of the place of receipt.” “Person” in this context refers to both natural persons and legal persons (i.e. companies, branches of foreign companies etc).

Tax is also imposed on the income of a non-resident which arises in Iraq, even if it is not received in Iraq.

## 2.5 Deductions and allowances

Article 8 of the Federal Income Tax Law sets out certain expenses which are allowed as deductions in calculating taxable income. As a general principle, it is stated that all expenses incurred by the taxpayer in order to produce income during the year shall be deducted in calculating taxable profits. Any deductions which are claimed should be supportable by appropriate documentation.

Items which are specifically listed as deductible for corporate tax purposes include (but are not limited to):

- interest paid on money borrowed and invested in the production of income;
- rental expenses in connection with premises occupied for earning income;
- depreciation of the building owned by the taxpayer and used by the taxpayer to earn income;
- amounts incurred for the maintenance of machinery and equipment or for the replacement of tools and parts;
- depreciation expenses, in accordance with specific depreciation rates provided by the tax authority (see below);
- bad debts, provided that any bad debts which are recovered should become taxable in the year of recovery;
- pensions, salaries and contributions decided by Pension and Social Security Laws; and
- amortization of intangible assets, in accordance with the limits specified in the depreciation regulation.

### Depreciation

Instructions No. 9 of 1994 set out applicable depreciation rates. For selected machinery and equipment specific to the oil and gas industry the depreciation rates are as follows:

Pure butane production plant	6.5%
Gas drying and cooling units	5%
Electrical technology systems	5%
Electrical compressors	8%
High pressure containers	8%
Maintenance workshops	5%
Service activity equipment	20%
Hydraulic lifts	10%
Cranes	7.5%

The Oil and Gas Tax Law does not explicitly provide for any additional deductible or non-deductible items which are specific to the oil and gas industry (e.g. decommissioning costs, drilling and development costs etc), and accordingly the general provisions as per the Federal Income Tax Law should prevail.

## **2.6 Losses**

According to the Federal Income Tax Law, losses incurred during the year may be offset against any other source of income arising in that year.

Tax losses may be carried forward for a maximum of five consecutive years, to be offset against profits generated from the same source as the original loss. Up to 50% of taxable income in a year may be sheltered by brought forward tax losses.

To the extent that an entity is loss making, the tax authority may seek to assess the entity on a deemed profits basis, which would effectively disregard any losses incurred in the current year and deny the entity of tax relief for carried forward losses in future periods.

## **2.7 Foreign entity taxation**

The Federal Income Tax Law does not recognise a concept of permanent establishment. From a tax perspective, contracts with non-Iraqi residents are also specifically covered by Instructions No.2 of 2008 which broadly sets out tests to define whether the non-resident is “trading with” or “trading in” Iraq. In summary, “trading with” Iraq should not result in an Iraq tax liability, whereas “trading in” Iraq will.

Broadly, a non-resident would be considered to be “trading in” Iraq where contracts are concluded in Iraq, payments for the services are made into an Iraq bank account, or services are physically provided in Iraq.

A contractor “trading in” Iraq will need to register a legal entity in Iraq, register for tax purposes and obtain a tax clearance from the Iraq authorities.

As Instructions No.2 of 2008 is currently drafted, there is no de minimis time limit for provision of services in Iraq – therefore strictly as little as one day spent working in Iraq should be considered to be “trading in” Iraq, and thus give rise to a requirement to register a legal entity and register with the tax authorities.

# 3.0 Other corporate income tax

## **3.1 Additional profits tax**

There is no additional profits tax in Iraqi tax law.

## **3.2 State**

There is no state tax in Iraqi tax law.

## **3.3 Municipal**

There is no municipal tax in Iraqi tax law.

## 4.0 Tax incentives

### 4.1 Research and development (“R&D”)

There are no R&D tax incentives in Iraqi tax law.

### 4.2 Manufacturing

There are no manufacturing tax incentives in Iraqi tax law.

### 4.3 State

There are no state tax incentives in Iraqi tax law.

## 5.0 Payments to related parties

### 5.1 Transfer pricing

There are no formal transfer pricing rules in Iraq, however the tax authority reserves the right to adjust transactions for tax purposes which they consider to be not at arm’s length.

### 5.2 Thin Capitalization

There are no formal thin capitalization provisions in Iraq.

### 5.3 Interest deductibility

There are no unique interest deductibility rules or limitations that apply specifically to the oil and gas industry.

Under the Federal Income Tax Law, finance expenses incurred in relation to the financing of operations in Iraq should be deductible in calculating taxable income.

## 6.0 Transactions

### 6.1 Capital gains

There is no separate capital gains tax regime in Iraq. Gains and losses realized by an Iraqi entity on the disposal of non-current assets should be included within the Iraqi entity’s financial statements and be subject to corporate income tax at the applicable rate.

The Iraqi tax law does not specifically provide for a tax on gains realized by a non-Iraqi resident. However, there are provisions included within the tax law which the tax authority could use to seek to assess tax on a gain realized from the disposal by a non-Iraqi resident of Iraqi assets (including, but not limited to, property which is situated in Iraq and shares in an Iraqi registered company).

### 6.2 Other transactions

There are no specific provisions which apply to oil and gas set out in either the Iraqi Federal Income Tax Law, or the Oil and Gas Tax Law for asset disposals, like-kind exchanges, involuntary conversions, abandonment, sharing arrangements and farm outs. However, specific provisions may be covered under agreed petroleum contracts.

## 7.0 Withholding taxes

Iraq has a complex legislative framework with respect to withholding tax and tax retentions. In practice, there are few final withholding taxes, however specific focus should be given to contracts which fall within the scope of Instructions No. 2 of 2008, concerning contracts with foreign parties, and Instructions No. 5 of 2011, for upstream oil and gas contracts.

### **7.1 Dividends**

In practice, there is no withholding tax on dividends.

### **7.2 Interest**

A tax of 15% applies to payments of interest from an Iraqi LLC or branch to a non-Iraqi resident (e.g. the foreign parent company or non-resident bank).

### **7.3 Rents and royalties**

There are provisions in the tax law which the tax authority could apply to argue that payments for royalties, rents and similar payments should be taxable in Iraq i.e. if the income is considered to be 'income arising in Iraq.'

To the extent that payments for management fees, technical services, rent etc. are made by the Iraqi entity to a foreign entity, there is a risk that the tax authorities could argue that such payments are subject to tax in Iraq, on the basis that they relate to 'income arising in Iraq'. In practice, we have not seen withholding taxes consistently applied on these types of payments, and the tax authorities have verbally confirmed their agreement to this approach on previous occasions.

In practice, the tax authorities generally defer to the legislation regarding tax retentions and we note our comments below in this respect.

### **7.4 Tax retentions**

#### **Instructions No. 2 of 2008 – Contracts between Iraqi and foreign contracting parties**

The main provisions regarding tax retentions are set out in Instructions No.2 of 2008 which requires that information relating to contracts with foreign suppliers should be disclosed to the General Commission for Taxes ("GCT") in order for the tax office to determine whether the contractor is liable to tax and confirm the rate of retention.

Broadly, services considered to be "trading in" Iraq are subject to tax retentions whilst those that are "trading with" Iraq may be exempted from retention tax.

Retentions of tax on payments for certain contracts must be made by the payer at rates varying from 1.5% to 10% of the gross payments, depending on the nature of the contract / services performed, plus the whole of the final payment installment.

In practice, tax retentions are not consistently applied as the guidance from the tax authority can vary significantly. Historically, most contracts have been subject to a 3-3.5% retention, with 7% on contracts relating to the upstream oil and gas sector (and we note also our comments below with respect to the Oil and Gas Tax Law).

Tax retentions under Instructions No. 2 of 2008 are not intended to be a 'final' withholding tax. Amounts retained on installment payments should be transferred to the tax authority (although no specific timeframe is defined within which retentions on installment payments should be paid over to the tax authority). In addition, according to Instructions No. 2 of 2008, the whole of the final installment payment should be retained from the contractor, unless the contractor is able to obtain written approval, or a tax clearance, from the tax authority. Tax clearance can strictly only be awarded once the supplier has filed a tax return together with audited financial statements to the tax authority (i.e. a supplier who is trading in Iraq is required to register a local legal entity and submit local accounts prepared in Arabic under Uniform Accounting Standards). If no tax clearance is obtained within 90 or 180 days from the end of the contract (depending on the type of contract), then the amounts retained should be transferred to the tax authority.

#### **Instructions No. 5 of 2011 – Oil and gas contracts**

The Oil and Gas Tax Law Instructions provide that subcontractors to whom the Oil and Gas Tax Law applies should be subject to withholding tax on their contract payments at a rate of 7% of the gross amounts.

The Instructions provide that the entity making the payment should remit the retained amounts to the tax authority within 30 days of making the payment. The supplier should in turn complete their annual corporate income tax filing in Iraq, at which point they may claim a credit for the withholding tax suffered at source, against their final corporate income tax liability.

### **Instructions No. 2 of 2013 – Instructions amending Instructions No. 5 of 2011**

Instructions No. 2 of 2013 were published in December 2013, and amend Article 4(2) of the existing Instructions No. 5 of 2011. Instructions No. 2 of 2013 state that withholding tax should apply at a rate of 7% for “petroleum” subcontracts, and a rate of 3.3% for “non-petroleum” subcontracts. Critically, however, Instructions No. 2 of 2008 remain silent as to the intended distinction between “petroleum” or “non-petroleum” subcontracts.

While the Instructions refer to a rate of 3.3% for non-petroleum activities, it is not specified how these Instructions are intended to interact with the existing tax retention rates set out in Instructions No. 2 of 2008 (which provide for specific rates of tax retentions for certain industries) and therefore there remains a number of areas which will require further clarification from the authorities in Iraq.

### **7.5 Foreign tax treaties**

Iraq has not entered into any material tax treaties with other jurisdictions. There is a treaty of the Arab Economic Union Council, of which Iraq is a signatory; however we do not see this applied widely in practice.

## **8.0 Indirect taxes**

### **8.1 Value added tax, goods and services tax, and sales and use tax**

There are currently no sales taxes or VAT in Iraq that are applicable to oil and gas activities.

### **8.2 Import, export, and customs duties**

Under Iraqi domestic legislation, customs duty on goods brought into Iraq is generally 5% of the cost, insurance and freight (“CIF”) value of the goods imported. Customs duty exemptions may be available for goods and equipment imported in connection with upstream oil and gas activity, or goods imported on a temporary basis.

### **8.3 Federal and state excise taxes**

There are no federal and state excise taxes in Iraq tax law.

### **8.4 Stamp tax**

Stamp Duty Law No. 71 of 2012 provides that the signing of contracts should be subject to stamp duty at a rate of 0.2%.

In practice, the payment of stamp duty is not common for contracts between private parties, where the contract is not intended to be presented to a court or official office. In such instances, the parties will not pay the stamp duty at the time of signing the contract, but only if it becomes necessary at a later date to either present the document to a court or an official office.

Conversely, for contracts to which a government is a party, stamp duty will be paid at signing unless an exemption is relevant.

Technical services contracts entered into between foreign oil companies and the Ministry of Oil may be exempted from stamp duty.

### **8.5 State and municipal**

There are no state and municipal indirect taxes in Iraqi tax law.

## 9.0 Other

### 9.1 Choice of business entity

As a general rule, any non-Iraqi company which is “carrying on business” in Iraq is required to establish an Iraqi legal presence (e.g. company, branch office). While there is no specific definition of what constitutes “carrying on business” in Iraq, typically an obligation would arise when the company obtains premises (including rented premises) in Iraq, or retains personnel on a more than temporary basis. Penalties may apply in respect of failure to register the enterprise.

There are a number of forms of business entity in Iraq, however the most common forms of entity for foreign investors in Iraq are a Limited Liability Company (LLC), and a branch of the foreign company.

From an Iraqi perspective, the tax position for an LLC and a branch of a foreign company should be broadly similar. The rate of corporate income tax applicable to LLCs and branches of foreign companies is the same. There is currently no withholding tax on dividends or branch profits remitted by an Iraqi entity to a foreign parent company. Therefore, the choice between an LLC and a branch entity is likely to be driven by wider commercial and legal considerations.

It is difficult to predict the time taken to register a legal entity in Iraq, but in our experience a time frame of 6-12 months would be typical. It is generally faster and more straightforward to register a branch of a foreign company than an LLC in Iraq.

### 9.2 Foreign currency

The currency in Iraq is the Iraqi Dinar. Iraqi entities are required to prepare financial statements denominated in Iraqi Dinars. Reporting for tax purposes should also be in Iraqi Dinars.

US Dollars are widely used for transactions between foreign oil companies and their subcontractors.

## 10.0 Oil and gas contact information

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