

May 17th, 2006

Egypt National Investment Reform Agenda Workshop

Taxation Session: Successfully Implementing a New Tax Law

Draft Background Document

This document provides a background for discussion of the National Investment Reform Agenda Item 'Enhancing Market Integrity - Issuing a New Tax Law'. It highlights the significant changes introduced to the tax environment in Egypt, the measures implemented by the Egyptian government, as well as the anticipated challenges.

I. Issue Background

1. Egypt has historically relied on high tax rates to maintain its revenue base. At the same time, it has introduced tax incentives to compensate for the high tax rates and other deficiencies in the enabling environment for investment. These incentives over time became more and more generous as Egypt competed with other countries for similar attractive investments. This has resulted in a cumbersome tax administration, identified as one of the key impediments to investment and, in particular, foreign direct investment in Egypt.

2. In the World Bank Investment Climate Survey of Egypt (2004), which surveyed close to 1000 enterprises, tax-related issues were ranked as ‘severe’ by almost 80% of the participants, ahead of all other regulatory complaints. A key finding of this survey was that tax administration officials exercised substantial discretion in applying rules in most areas of enterprise regulation or public service access. Additionally, the survey concluded that tax inspections imposed a strikingly large time and resource cost on firms – over 8 inspections per firm in 2004.¹ The result of relying on high tax rates and generous incentives, while at the same time imposing costly administration was significant revenue loss, fiscal imbalances, unintended economic distortions and low tax compliance.

3. The Egyptian Government recognized that without significant structural tax and incentive reform, investment would be diverted to other regions, economic growth would stagnate and unemployment would grow. With the help of leading international and resident experts, the Government analyzed all aspects of tax policy and administration and developed a set of tax reforms to transform the Egyptian tax system into modern and efficient system that supports direct investment in Egypt. The Egyptian Parliament enacted this comprehensive tax law on June 20th 2005.

II. Current Tax Policy Reforms

4. The chief aims of the new law are to attract additional investment and reduce the scope for tax evasion by the gray economy through lower tax rates, limited incentives and improved tax administration. From the private sector perspective, the most important achievement was the reduction of the corporate tax rate from 42% to 20%. This significant reduction in the corporate tax rate increases Egypt’s competitiveness within the MENA region as well as with other countries that attract foreign direct investment. Investor surveys and analysis have shown clearly that low ‘headline’ statutory rates help send out a clear signal to investors of a competitive and stable tax environment.

5. Taken alone, low corporate tax rates could result in revenue shortfalls requiring increased borrowing and public debt to fund infrastructure development and other key public expenditures required to address impediments to investment. To maintain revenue yield, the law broadened the base by restricting incentives for new investment and phasing out incentives for existing investment.

6. To bring the tax system in line with modern international tax practices and to provide domestic investors with an incentive to invest in Egypt, rather than abroad, the new law introduces residence- based taxation for corporate taxpayers. Previously, Egypt levied tax only on income generated within their borders; a system known as source taxation. Adoption of a residence based system coupled with credits for foreign source tax paid should help Egypt retain domestic investment.

¹ Over 60% of small firms identified tax administration as a major or very severe constraint, while over 50% of medium and large firms identified it as a serious constraint.

7. The new law also introduces significant new international tax provisions and tax base protection rules to guard against aggressive tax planning and to enable collection of a fair and reasonable share of tax revenue from foreign investment. These include transfer pricing rules, thin capitalization rules and definitions of permanent establishment and royalties

8. Another important aspect of the new law is the reduction of the maximum personal income tax to 20% from the previous 32%. Furthermore, this legislation restructured income tax brackets (subject to tax rates of 10%, 15%, 20%) as well as raised the personal exemption to EP 10,000, thus eliminating taxation for thousands of the lowest paid workers.

9. This new tax law also encompasses elements to increase compliance and modernise tax administration in general. The law fundamentally revamps the enforcement of the legal framework, introducing random audits and high penalties for violators instead of the previous system of bonuses for inspectors. The Egyptian government hopes that by introducing a lower rate of tax and a stricter enforcement system, the incident of tax evasion will decline. The Government has also issued key regulations and other critical guidance to educate taxpayers on the benefits and goals of the new tax law.

10. As a result of these reforms, it is anticipated that Egypt will have a stable revenue base, transparent and effective policymaking and a more modern and efficient tax administration regime: in short, the fiscal environment necessary to attract investment. While this law is a significant achievement, accomplished over a short period of time, many challenges remain as the law is implemented and taxpayers will shortly file their first tax returns under the new law.

III. Key Challenges in Tax Policy

11. With the passage of the tax law, the Government is faced with three important priorities to ensure the law accomplishes its tax policy objectives. First, the Ministry of Finance is committed to developing further its internal analytical capacity to estimate the likely revenue effects of the new law, the marginal tax burden placed on various types of investment and the cost of ongoing incentives. Establishing a specialized unit for tax analysis will ensure that policy decisions are based on full information about their likely impact. Over time, the Ministry could introduce tax expenditure budgeting, entailing the measurement and reporting of revenue lost through the main tax incentive programmes. With the introduction of tax expenditure budgeting, tax incentives would be considered alongside direct public expenditure amounts targeted at similar activities to see how much public funds are being allocated to a given area.

12. Another challenge is implementing the new residence based system and anti-abuse rules for corporate taxpayers. Residence based taxation is much more complicated than the previous source based system. This change, coupled with the sophisticated anti-abuse rules, such as transfer pricing and thin capitalization, will require significant retraining of tax inspectors and outreach and education for corporate taxpayers. In addition, Egypt will make more use of the exchange of information procedures in their double tax treaties to curb aggressive cross-border tax planning. While the Ministry of Finance is in the process of retraining staff and conducting workshops for taxpayers and auditors, much more training is needed to ensure these important changes are understood and complied with.

13. Export zones, a particularly popular type of incentive in Egypt and throughout the MENA region, is another area to address. While these zones have attracted significant foreign investment to Egypt, more analysis is needed to determine whether these zones adversely affect local domestic markets and impede efforts to attract foreign investment outside the zones. At the same time, discrimination between companies

on the basis of nationality or sectors should be eliminated in favor of objective criteria to access the benefits of the zone.