WORLD BANK

Somaliland PFM Education and Training Programme (phase 2)

DRM Module 3: – Direct Taxes

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Overview

- Learning Objectives
- Direct taxes, business, rental, income
- Partnership Taxes
- Residence and Persons assessable
- Returns, assessments, deduction and exemptions
- Taxpayer Charter

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Learning Objectives

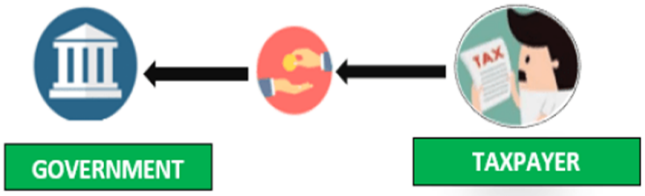
Topic	Learning Objective
Direct Taxes	A knowledge of direct taxes in Somaliland including the following: • Revenue Act • Major types of direct taxes – income, business, rental, withholding • Persons assessable • Residence • Returns and Assessment, including deductions, exemptions etc • Objections and appeals • Tax collection including withholding tax.

What are Direct Taxes? (2.0)

- Direct taxes are a type of tax that are paid straight or directly to the government by an individual or an organization.
- Payment of direct taxes are usually through a government tax agency. A taxpayer pays direct taxes to the government for different purposes, for example, income tax, corporate tax, real estate or property tax.

How are direct taxes paid?

- A direct tax is paid directly to the government entity in charge of collecting taxes
- Direct taxes cannot be passed on to a different person or entity
- The individual or organization upon whom or which the tax is levied is responsible for the fulfilment of the full tax payment.



Are Direct Taxes Progressive?

- Direct taxes are considered a progressive tax
- Tax raised rises with the increases with income
- The more a person earns the greater the tax that they pay.

Conversely, a regressive tax is a tax where the tax raised decreases with the increase in the amount subject to tax, as in the case of indirect taxes.

Advantages and Disadvantages of Direct Tax (2.1)

Advantages

Equity: A direct tax is an equitable tax as the people with more income and wealth should pay more than those with less income. In case of necessity, the lower income people may be granted exemption from payment of certain taxes.

Certainty: A direct tax satisfies the canon of certainty. Therefore, the liable taxpayers pay income tax that they know. They know how much tax required to pay and appropriately account for that beforehand.

Elasticity: A direct tax has elasticity whereas the income of the people goes up, the rate of income tax can also be increased. If the income of the people falls, the rate of income tax can also be lowered.

Productivity: Direct taxes constitute crucial for government t revenue; it is a major component of tax collected by the government with lower collection charges. Thus, indirect taxes are productive.

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Advantages and Disadvantages of Direct Tax (2.1)

Disadvantages

Evasion: possibly, the direct tax is liable to be evaded. Hence, some taxpayers try to evade income tax by submitting false returns, Unless the civic sense of the taxpayers is well developed and there is spread of education among the society.

People's Indifference: Direct tax may not develop the society sense of tax education as people with incomes below a certain level are not liable to pay tax. Clearly when a person directly bears the burden of a tax that person tries to know how the government spends that money. But the people that are not directly affected by the burden of taxation remain unaware of that.

Impact on Work and Savings: as the rate of the direct tax is generally higher it has impact on people's perception to work and save. Thus, in many cases direct taxes reduce incentives to work hard and save.

Lack of Popularity: As direct taxes are raised there is resentment against the government tax policies and taxpayers are critical for tax hikes.

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Class discussion

- Considering Adam Smith's Canons of taxation discuss the advantages and disadvantages of direct tax in Somaliland context?

Somaliland Revenue Act (3.0)

- Somaliland Revenue Act (Law No. 72/2016) or SRA 2016
- The governing law for revenue taxation within the Somaliland jurisdiction
- Passed in 2016 to:
  - consolidate Somaliland's different tax legislation and issuances into one document;
  - contribute to a modernized tax system that is envisioned to be simple, fair and efficient; and
  - establish a revenue administration authority.
- Repeals the laws on Direct Taxation No. 89/96, Sales Tax Law No. 84/96, as well as other legislation relating to tax revenues.

Purpose of SRA 2016

1. To specify that the Somaliland Revenue Authority is an independent institution.
2. To strengthen the ability of Inland Revenue to collect.
3. To be implemented equally for all taxpayers.
4. To disclose the Inland Revenue Act to all citizens.
5. To specify that all citizens have a right to know of revenue information.
6. To increase Government revenue.
7. To simplify revenue collection processes

Types of Direct Taxes (4.0)

There are various types of direct taxes:

Main Types of Direct Taxes in Somaliland

The following are the main direct taxes that are collected in Somaliland

Business Tax

Employment Tax

Rental Income Tax

Income Tax in Somaliland (4.1)

- Imposed on individuals or entities that varies with respective income or profits.
- Income tax is generally computed as the product of a tax rate times taxable income.
- The government impose an income tax on all income generated by individuals and businesses within the Somaliland jurisdiction.
  - According to the SRA 2016, taxpayers must file an income tax return annually to determine their tax obligations.
  - There are penalties for not filing a tax return, filing late or for filing false return (Sections 16, 17 and 21 of Revenue Act 72/2016).
  - The taxpayer may not pay taxes on all of their income due to exemptions and deductions provided by the tax system.
- Under Section 57 (Rates of Tax for Individuals) of the SRA 2016, the rate chargeable on an individual for a year of income (period of 12 months ending on 31 December) is charged to tax at the rate of 10%. This does not include the rates for employment income. It also covers the rate for rental income which is 10%.

Employment Tax (4.2)

- Taxes that the government impose on employees who work for employers in Somaliland
- Calculated as a percentage of the total income that employees earn from their employment.
- The employment tax is 6% of the gross income and is paid on a monthly basis
- The employer should complete and submit to the Inland Revenue office the monthly return of employment income withheld within 15 days after the end of the period

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Example: Employment Tax

- Example; Abdi works for a XYZ Company and he has earned from the employment $2,000 for the month of June. Then Abdi is liable for 6% of employment tax.

• Employment Income	$2,000
• Rate of tax	5%
• Stamp tax	1%
• Solution : Tax to be paid	$120

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Business taxes (4.3)

- Includes any trade, profession, vocation, or adventure in the nature of trade but does not include employment.
- Corporation tax is another form of a direct tax. This is the tax that corporations and other businesses must pay to the government on the profits they earn.
- Partnerships and sole proprietorships do not pay corporate taxes. The corporate tax in the U.S. is separate from income tax.
- Businesses pay income taxes on their earnings
  - the Inland Revenue taxes income from corporations, partnerships, self-employed contractors, and small businesses. Depending on the business structure, either the corporation, its owners, or shareholders report their business income and then deduct their operating and capital expenses.
- The difference is their taxable business income.

Example: Business Tax

- Example: Ahmed and Layla are married and have ABC company. They have earned SL Shillings 50 million for the year ended 2019.

- Requirement: How much tax should Ahmed and Layla pay from their business income?
- Solution:
- Net profit of the ABC company SL Shillings 50,000,000
- Tax year of income 2019
- Tax on income amount 10%
- Administration tax 2%
- Stamp tax 2.5%

- Tax to pe paid SL Shillings 5,000,000+1,000,000+1,250,000 = SL Shillings 7,250.000

Corporation Tax

- Corporations are required to pay to the government a corporate tax from their profits on a yearly basis.
- In Somaliland the corporate tax is the same as business tax, for that reason focus will be on business taxes.

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Tax on rental income (4.4)

- Section 56 of the SRA (2016) States that all rental receive income from property qualifies rental income and it is taxable at 10%
- Rental income tax is an annual tax payable by individual owners of the properties that are rented which is called rental income.
  - The corporate taxpayers do not pay rental income tax. However, they are obliged to include their rental income with other income earned through the ordinary course of the business in their annual income tax returns.
- The rental income can be with deduction only allowed for net capital losses, if any, arising from the disposal of rental assets during the year of income are deductible from taxable rental income
- All taxpayers whether they are individuals and business other than corporate business who earns rental income from the leases of rented properties in Somaliland are required to pay annual rental income tax in respect of each year. For instance, the rental income tax of 2019 should be paid before 30 April in 2020.

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Example: Rental Income

Mohamed owns three properties in Hargeisa in 26 June, Ahmed Dhagah, and Koodbuur Districts. The 26 June property is rented for business purposes where $25,000 is earned, the Koodbuur property is a residential building where $10,000 is earned while Ahmed Dhagah property is a guest house rented for $12,000.

- **Requirement:** How much rental tax shall Mohamed have to pay for his properties?
- **Solution:**
- Gross rent income $47,000
- Tax on amount 10%
- Administration tax 2%
- Stamp Tax 2.5%
- Tax Liability $4,700+$940+$1,175 = $6, 815

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Property Tax (4.5)

- Property tax is charged on properties such as land and buildings and is used for maintaining public services such as the police and fire departments, schools and libraries, as well as roads.
- In Somaliland, property tax is the same as rental income tax.
- Rental income tax is an annual tax payable by individuals on their rental income.
- "Rental income" is the total amount of rent derived by an individual during a year of income from the lease of immovable property in Somaliland with deduction only allowed for net capital losses.

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Capital Gains Tax (4.6)

- This tax is charged when an individual sells asset such as stocks, real estate, or a business.
- The tax is computed by determining the difference between the acquisition amount and the selling amount.
- The amount of any gain arising from the disposal of an asset is the excess of the consideration received for the disposal over the cost base of the asset at the time of the disposal.

Partnership Tax (4.7)

- Generally, in most countries partnerships only pay taxes on their profits.
  - You only pay tax on income after deducting expenses. Similar as sole traders partnerships can deduct any expenses incurred exclusively for the business including: rent, utilities and internet.
- Partnership net income is calculated by subtracting total expenses from total revenues. After allowed expenses are subtracted from net Income, and the result is remaining Income is divided equally in accordance with the partnership agreement
- Sec 116 of the SRA 2016 defines partnership as an association of persons carrying on business for joint profit.

Class Discussion on Direct Tax

Direct taxes are the responsibility of the taxpayer and should be fulfilled by no one else but the taxpayer.

Discuss This statement !

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Example

Example: Ali and Abdi are partners of professional firm A&A accountants, they earned SL Shillings 6,000,000 net profit for the year ended.

Requirement :How much tax each liable ?

Solution:

A&A Net profit for the year	SL Shillings 6,000,000
Tax on amount	10%
Administration tax	2%
Stamp Tax	2.5%
Tax Liability for Ali	300,000+60,000+75,000 = SL Shillings 435,000
Tax liability for Abdi	300,000+60,000+75,000 = SL Shillings 435,000

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Persons assessable (5.0)

- The SRA 2016 provides guidance on persons assessable, the residency rules for tax purposes and the manner of assessment.
- The chargeable person is a person on whom certain tax is imposed. They are individual or body of individuals having in a year of assessment, any income chargeable to tax. Resident persons are assessed on the income they earn on earth in a year of assessment. Non-resident persons are however subject to tax on income that has a source in the country.

Example:

- Hanna has two businesses where Business A is a food processing business while Business B is a small advertising firm. Hanna also works for Dahabshiil Group of Companies.
- Hanna is chargeable person for three different taxes one employment tax and two business taxes.

Residence (6.0)

- The criteria for residence for tax purposes vary considerably from jurisdiction to jurisdiction, and "residence" can be different for other, non-tax purposes.
- For individuals:
  - Physical presence in a jurisdiction is the main test.
  - Some jurisdictions also determine residency of an individual by reference to a variety of other factors, such as the ownership of a home or availability of accommodation, family, and financial interests.
- For companies:
  - Some jurisdictions determine the residence of a corporation based on its place of incorporation.
  - Other jurisdictions determine the residence of a corporation by reference to its place of management. Some jurisdictions use both a place-of-incorporation test and a place-of-management test.

The leading residence test case

International Case Study for Company Residence:

- The test of residence for the corporations have been a critical issue over the past, in common law countries the binding precedent for this is the landmark case De Beers Vs Howe.
- The UK House of Lords famously decided that Dee Beers a company incorporated in South Africa was resident in London given that it was centrally managed and controlled by its London directors despite all of its diamond mining operations are being conducted in South Africa. Hence, "centrally managed and controlled has become the main test to decide the residency of the company".

Source: Oxford University, Faculty of Law

Example: Residence

- ABC company has been established in Somaliland in 2018 in accordance with Somaliland laws but has operations in Djibouti and Ethiopia. ABC company operates in Somaliland in 51 % of its operations and the Board of Directors and company management held its necessary decision-making meetings in Somaliland at least one time in 2018.
- Then ABC comply is liable to pay Somaliland taxes.

Resident Individuals

- In Somaliland, Section 60 of SRA 2016 provides the rules for Resident Individuals. These rules are in general uniformity with international standards and practices.
- It provides that an individual is a resident individual for a year of income if that individual –
  - a) has a permanent home in Somaliland;
  - b) is present in Somaliland for a period of, or periods amounting in aggregate to, 183 days or more in any 12-month period that commences or ends during the year of income;
- Or during the year of income and in each of the two (2) preceding years of income for periods averaging more than 122 days in each such year of income;
- Or is an employee or official of the Government of Somaliland posted abroad during the year of income.

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Assessments(7.0)

- Normally raised on the profits of both individuals/businesses and the income or profit of companies or corporations, arising from trade or business carried out by those entities.
- Assessment is to be imposed on the profit of an enterprise in relation to an accounting period. There are two principal types of assessments, namely:
  - Self-Assessment; and
  - Government Assessment
- See Section 2.6.1 of Module 1 for the basics

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Self-Assessments

- Aims at shifting the duty of raising of assessment to the taxpayers themselves.
  - Under this system, taxpayers complete their tax returns and pay tax to IRD based on that self-assessment. Section 137(7) of SRA 2016.
- The law says that where a taxpayer has furnished a return of income for a year of income it is deemed that the IRD has made an assessment of the chargeable income of the taxpayer and the tax payable on that chargeable income for that year, being those respective amounts shown in the return.
  - In such cases the taxpayer's return of income is treated as a notice of an assessment served on the taxpayer by the IRD on the due date or the date the return is submitted, whichever is later.
- Despite of the fact that the taxpayer can make a self-assessment the IRD may still make an assessment on a taxpayer in any case in which the IRD considers necessary

Government Assessments

In Module 1 it was explained that there are a number of forms of government assessments, viz:

1. Administrative assessment (currently used for business profits tax) and raised in accordance with audited accounts and computations filed by the taxpayers. Section 137(1) SRA 2016
2. Best-of-judgment (BoJ) assessment where the taxpayer has not filed a tax return - based on estimated profit or profit perceived to be fair and reasonable. Section 137(2)(a) SRA 2016
3. Best-of-judgment (BoJ) assessment where IRD is not satisfied with a filed tax return – usually as the result of a tax audit. Section 137(2)(b)
4. Amended/additional assessment. Section 137 (13) SRA 2016

Form of an assessment to tax

Where an assessment has been made it should state –

a) the amount of chargeable income of the taxpayer;
b) the amount of tax payable;
c) the amount of tax paid, if any;
d) the time, place, and manner of objecting to the assessment.

- It is important to note that the IRD can, within three (3) years after service of a notice of assessment, make an additional assessment amending an assessment previously made.
- If the additional assessment arises by reason of fraud or any gross or wilful neglect by, or on behalf of, the taxpayer or the discovery of new information in relation to the tax payable for any year of income, the IRD may make an additional assessment for that year any time.

Deductions (7.2)

- A trading company is generally permitted to deduct expenses that are incurred wholly and exclusively for the purposes of the company's trade, provided those costs are not capital in nature and are charged to the profit and loss account.
- Relief is generally given in the period the expenses are accrued in the accounts, though sometimes subject to some specific exceptions.
- The general rule is made subject to a range of specific statutory provisions, some of which allow deductions and others of which limit them; some of the more important of these are discussed below, but there are many others. One example is that the costs of business entertainment cannot generally be deducted.
- In Somaliland, general expenses involved in making profits are covered by Section 73 (Expenses of deriving Income).

Allowable deductions

- For the purposes of ascertaining the chargeable income of a person for a year of income, there shall be allowed as a deduction –
  1. all the expenditures and losses incurred by the person during the year of income to the extent to which the expenditures or losses were incurred in the production of income included in gross income;
  2. the amount of any loss as determined under Part 69, which deals with gains and losses on the disposal of assets, incurred by the person on the disposal of a business asset during the year of income, whether or not the asset was on revenue or capital account.
- There are exceptions in the SRA 2016 (Section 74) that allows for a deduction for Meals, Refreshment, and Entertainment Expenditure. Specifically, a deduction is allowed for expenditure incurred by a person in providing meals, refreshment, or entertainment in the production of income included in gross income, but only where –

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Allowable deductions (cont.)

- Interest and other Expenses Related to Debt Obligations are allowed under Section 76. Specifically, a person is allowed a deduction for payments (other than repayment of the principal) made to a holder of a debt obligation, including service fees, commissions, prepayment and late payment penalties, during the year of income in connection with a debt obligation to the extent that the debt obligation has been incurred by the person in the production of income included in gross income.
- Start-up Costs and in Somaliland Section 81 applies. Under these rules a person who has incurred expenditure in starting up a business to produce income included in gross income or in the initial public offering at the stock market shall be allowed a deduction of an amount equal to twenty-five (25) percent of the amount of the expenditure in the year of income in which the expenditure was incurred and in the following three (3) years of income in which the business is carried on by the person.
- Charitable Donations are allowed in most counties as deductible expenses though there are various rules that govern the exact donations that are permitted.

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Allowable deductions Continued..

- Intangible fixed assets: Generally special regimes apply to intangible assets, such as patent rights, know-how, and trademarks, and goodwill. In Somaliland the Costs of Intangible Assets are allowed as a deduction by Section 82 of SRA 2016. Specifically, a person who has incurred expenditure in acquiring an intangible asset having an ascertainable useful life is allowed a deduction in each year of income during the useful life of the asset in which the person wholly uses the asset in the production of income included in gross income of an amount calculated.
- Income costs relating to R&D are normally deductible in any event, and in Somaliland section 83. Deals with Scientific Research Expenditure. It states that a person is allowed a deduction for scientific research expenditure incurred during the year of income in the course of carrying on a business, the income from which is included in gross income.
- Expenses on training expenses are allowed if the meet the rules under section 84.
- scientific research expenditure, in relation to a person carrying on a business, means the cost of scientific research undertaken for the purposes of developing the person's business, including any contribution to a scientific research institution which is used by the institution in undertaking research for the purposes of developing the person's business

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Industrial Building Allowance

- The Industrial Buildings Allowance (IBA) was introduced by many governments across the world in the 1950s to boost post-war productivity in industry.
- In Somaliland section 80 deals with industrial buildings allowance.
  - Specifically it provides that where a person has incurred capital expenditure in any year of income on the construction of an industrial building and the building is used by the person during the year of income in the production of income included in gross income, the person is allowed a deduction for the depreciation of the building during the year of income.
- Partially the business is allowed to claims where the whole building is not in use for the business. There are further rules in Section 80 m that apply.

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Carry Forward Losses

- Subject to this Section, where, for any year of income, the total amount of income included in the gross income of a taxpayer is exceeded by the total amount of deductions allowed to the taxpayer, the amount of the excess.
- The Act refers to as an "assessed loss" and this shall be carried forward and allowed as a deduction in determining the taxpayer's chargeable income in the following year of income.

Objections and Appeals (8.0)

- Taxpayers are free to raise objection to any government assessments, which they believe are incompatible with the relevant tax laws or where they are of the opinion that such assessments were raised on wrong premises and are therefore objectionable. These are provided for by Section 138 (Objections and Appeals) of SRA 2016.
- As learnt in Module two the established Tax appeals Tribunal is open for all taxpayers and tax authorities to lodge objections and appeals.
- The Taxpayer can appeal within the duration permitted by the law.

Withholding Tax (9.1)

- The amount that is withheld by a company against the direct tax payable by the individual or a corporate body when making their tax returns. Also called a retention tax
  - It is a collection method to help counter potential tax payment defaults.
- In most jurisdictions, withholding tax applies to employment income.
  - Many jurisdictions also require withholding tax on payments of interest or dividends.
  - In many jurisdictions, there are additional withholding tax obligations if the recipient of the income is resident in a different jurisdiction, and in those circumstances withholding tax sometimes applies to royalties, rent or even the sale of real estate.
- Governments use withholding tax as a means to combat tax evasion, and sometimes impose additional withholding tax requirements if the recipient has been delinquent in filing tax returns, or in industries where tax evasion is perceived to be common.

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Example: Withholding Tax

- Mohamed paid renumeration of $15,000 to non-resident team coach which is not tax-exempt. The onus that the team coach should pay the tax is on Mohamed. Thus, Mohamed is obliged to pay that tax to IRD.

- In the case that the taxpayer may not pay tax liabilities, the employer has an obligation to pay tax on behalf of his staff or client. However, he can deduct tat paid tax from his next payment.

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Taxpayer Charter (10.0)

- The Inland Revenue Department developed a taxpayer charter with the aim of improving the relationship between the tax authorities and taxpayers.
  - The charter provides a basic rights and obligations information that builds trustful relationship with common mutual interest.
  - However, this taxpayer charter does not substitute the existing laws of taxation.
  - The taxpayer charter spells out what the taxpayers as customers expect from tax authorities and what the IRD also expects from the taxpayers.
- The purpose of the taxpayer charter is to provide fair and efficient service to the customers and facilitate the process of tax collection.
- The charter consists two parts; taxpayer rights and taxpayer obligations.

Taxpayer Rights

- Information: the tax authorities provides any information requested by the taxpayer at any time and assist to comply with the revenue law. The Inland Revenue Department is willing to help the taxpayers in completing forms and where appropriate reasons for decisions made by IRD.
- Treatment :The tax author and staff will treat all taxpayers equally in respect, courtesy, dignity and impartiality;
- Complains: The IRD is open to tax complaints, object and appeal. The IRD will respond to customers as soon as possible in matters relates to tax decisions and complaints.
- Privacy: The personal and business information and data must be protected from unauthorised access. Hence, all information received from the taxpayers will be treated as confidential. The information about taxpayers will only be shared internally to enable the Ministry to do its work. In some cases where the law permits or requires to do so it may be shared with consent of the taxpayers.

Taxpayer Obligations

- Registration: The taxpayer must register with the IRD swiftly and promptly if turnover exceeds the registration threshold of Sl.sh 5 million.
- Taxpayer Identification Number (TIN): the taxpayer must apply TIN on the official form within 21 days of from the date that business became operational or whenever requested by the IRD.
- Tax Returns : The taxpayer is obliged to file tax returns and to pay their taxes on time.
- Records: the taxpayer must keep complete, accurate and up-to-date records for at least five years; the records should include transactions and assets that are sufficient to assess the tax liabilities. It is also important to translate if some records are required in Somali language.

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Taxpayer Obligations (continued)

- Honesty :The taxpayer must be honest in all tax matters such as completing tax forms and providing accurate and reliable returns to tax authorities. If there are questions to be answered the IRD is willing to help.
- Cooperation: The taxpayer must treat the tax authority and staff with respect, courtesy, and dignity. The taxpayer must also listen tax officers politely and respectfully. It is important to avoid any actions that can obstruct tax officers to conduct their duties and responsibilities. Taxpayer must be polite and respectful in dealing with our staff.
- Advise and Learning: It is necessary that taxpayers understand their obligations to avoid mistakes, the taxpayers should learn and seek advice from IRD. They should also ensure that they understand the requirements and the information being given to the IRD.

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Thank you!

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