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Azerbaijan Tax News

Substantial changes to the Tax Code

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Introduction

On 30 November 2018 the Law "On amendments to the Tax Code of the Republic of Azerbaijan" (hereinafter, referred as "Draft Law") has been approved by the Parliament of Azerbaijan and is now pending the approval by the President of the Republic of Azerbaijan.

The Draft Law envisages amendments and new provisions with respect to the goals set out by the Government to decrease significantly the shadow economy and to increase the transparency by applying certain tax reductions and tax exemptions as well as broadening the tax base and improving the tax administration.

In this newsletter, we are pleased to share with you highlights of the most important changes and additions, which we trust you will find helpful.

Please feel free to contact us if you have any questions with respect to the changes to the Tax Code and the Law "On Social Insurance".

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Personal income tax rates

One of the major changes to the Tax Code is the exemption of monthly income up to 8,000 manats of the individuals employed by private businesses other than in the oil and gas sector industry from personal income tax for seven years. Monthly income exceeding AZN 8,000 manats will be taxed at a rate of 14 percent.

The Government is additionally going to adopt criteria for differentiation of operations in oil and gas industry and private sector.

Rates of social insurance contributions

According to the changes proposed to the Law "On Social Insurance", the rates of social insurance contributions for the individuals employed by private businesses other than in the oil and gas sector will change in a similar manner:

Monthly income subject to SIC	**SIC Rates[1]**		
	Total	**Deducted from employee's income**	**Paid by employer**
Up to AZN 200	25 percent	3 percent	22 percent
Over AZN 200	25 percent	AZN 6 manat + 10 percent of income exceeding AZN 200	AZN 44 + 15 percent of income exceeding AZN 200

Current rates of social insurance contributions for the individuals employed in the oil and gas sector will not change.

Change in tax exemption for endowment life insurance

Another and yet very important change is related to the exemption from personal income tax for insurance premiums paid under the endowment life insurance policies concluded for not less than three years. Before the changes full amount of insurance premiums were exempt from personal income tax. However, going forward this exemption will be applicable to only insurance premiums paid in the amount up to 50% of taxable income of insured persons.

New exemptions from personal income tax

[1] These rates are effective from 1 January 2019 for seven years.

The Draft Law stipulates following major new exemptions from personal income tax as well:

- The dividends received by the shareholders of a resident legal entity with revenues of up to AZN 200,000 over consecutive 12 months, not registered as a VAT payer, and holding a full record of its revenues and costs, will be tax-exempt;

- Personal income tax rate on sales transactions in retail business and catering completed with a bank card will be reduced by 25 percent for three years;

- 50% of taxpayer’s income from disposal of shares and participating interests held at least for three years;

- Income from the innovative activities of micro or small entrepreneurs will be exempt from taxation for three years upon receipt of the startup certificate;

- Portion of income of SME cluster member individual entrepreneurs, earned from supply of goods (services, works) under the contract concluded with SME cluster company, which are directed for capital expenditures will be exempt from income tax for seven years;

- New tax benefits will be introduced for the micro-, small, and medium businesses, exempting 75 percent of their income (individual entrepreneurs classified as micro-business will also be eligible).

Taxation of proceeds from disposal of shares

The Draft Law formally establishes new taxable income for individuals from disposal of shares:

- where the sale price of the shares in the charter capital of a legal entity exceeds proportionate value of its net assets, the difference between the sale price and the nominal value of the shares; and
- where the sale price of the shares is lower than proportionate value with its net assets, the difference between the proportionate value of the net assets as at the date of disposal and the nominal value of the shares constitutes taxable income.

2. Taxation of corporations

Thin capitalization

The Draft Law introduces thin capitalization rules. Where the foreign borrowing of a company is two times (or more) greater than its net asset value (the foreign leverage ratio), the part of the interest relating to the share of the debt exceeding the x2 threshold will not be tax-deductible.

Taxation of proceeds upon company liquidation

The definition of the term "dividends" is going to be expanded to include the value of the property of a legal entity purchased out of its net profit upon liquidation and the value of shares of the legal entity purchased back at nominal value and which was formed at the expense of its net profit.

New exemptions from profit tax

The Draft Law sets new tax exemptions:

- Income of educational institutions (excluding of the portion of profit paid as dividend);
- 50 percent of income from the disposal of shares/participation interest held for at least three years;
- 75% of profit of legal entities from micro-entrepreneurship;
- Profit of SME cluster company for seven years;
- Profit of legal entity startups classified as subject of micro or small entrepreneurship for three years upon receipt of the startup certificate;
- Profit tax from sales transactions in retail business and catering completed with a bank card will be reduced by 25 percent for three years;
- The dividends received by the shareholders of a resident legal entity with revenues of up to AZN 200,000 over consecutive 12 months, not registered as a VAT payer, and holding a full record of its revenues and costs, will be tax-exempt.

Taxation of proceeds from disposal of shares

The Draft Law formally establishes new taxable income for legal entities from disposal of shares:

- where the sale price of the shares in the charter capital of a legal entity exceeds proportionate value of its net assets, the difference between the sale price and the nominal value of the shares; and
- where the sale price of the shares is lower than proportionate value with its net assets, the difference between the proportionate value of the net assets as at the date of disposal and the nominal value of the shares constitutes taxable income.

Non-commercial organizations engaged in entrepreneurial activities are going to be added to the list of payers of the profit tax.

Taxpayers with tax-exempt operations are going to be liable to keep full record of their revenues and costs.

3. Transfer Pricing

Between the current version of the Tax Code (Article 14-1.4.) and the Transfer Pricing Rules (the "Rules") approved by the Ministry of Taxes (Article) exist a collision with respect to the application of the Transfer pricing rules to controlled transactions. Specifically, different from the Rules, the Tax Code provision was interpreted as a requirement on application of the Transfer pricing rules only to transactions exceeding AZN 500,000 per counter-party per year. With the amendment to Article 14-1.4 the above contradiction is being resolved, and as a result, all controlled transactions are going to be subject to the Transfer pricing requirements.

Definition of Transfer pricing has been updated and has become more precise. As per the new definition, it is the price corresponding to the prices determined by comparable transactions carried out under the same conditions between independent persons.

According to the Draft Law, range of application of Transfer pricing has been expanded and transfer pricing rules will also be applied to the transactions between *the permanent establishment of a non-resident in the Republic of Azerbaijan and any related party of this non-resident in another jurisdiction.*

Under the current Tax Code, theoretically transactions that are subject to the Transfer pricing rules, could also be subject to application of the Market Price rules. However, with the new changes this collision is going to be eliminated, and transactions subject to the Transfer pricing rules are not going to be within the scope of application of the Market price rules.

The threshold of AZN 500,000 set for the reporting purposes has been amended. Whereas before the changes taxpayers were required to file notification on controlled transactions exceeding the threshold of AZN 500,000 (which was understood as transactional amount), going forward the AZN 500,000 threshold must be interpreted as the amount of the transfer price.

Under the current version of the Tax Code, Article 110 restricts deductibility of intragroup loan interest. The deductibility of such interest expenses is not governed by the Transfer pricing rules. According to the changes, going forward limitations for intragroup loans originating from abroad are going to be regulated by the Transfer pricing rules.

It should also be noted that currently applicable financial sanction of AZN 500 is imposed for late or failure to submit the Notification on controlled transactions. With the new changes, additionally the same amount of sanction will apply for stating inaccurate information in such Notification.

4. Withholding Tax

Article 13.2.16.14-1, as amended, now envisages a 10-percent withholding tax on direct and indirect payments made to entities incorporated in low-tax jurisdictions, including the payments to branches and representative offices in other countries, as well as transfers to bank accounts in low-tax jurisdictions.

Provision of assets and cash to the shareholder other than for the purposes of economic activity (except for disbursement of loans to the shareholder and repayment for the loans received from the shareholder) as well as the set off of the shareholder’s debts owed to other persons are treated as dividend payment and will be taxed at the source of the payment at a rate of 10-percent.

5. VAT

Rules of VAT recovery

The Draft Law stipulates certain changes with regard to recoverable VAT. Taxpayer providing both VATable and VAT-exempt services are allowed to fully recover VAT paid for purchases done in relation to its VATable operations if it keeps records of its VATable and VAT-exempted purchases separately with all necessary records in place.

New exemptions from VAT

With the new changes the following new exemptions have been granted:

- Provision of assets within the bankruptcy procedures of a bank will be exempt from VAT until 1 January 2020;
- Import of machinery, technological equipment and installations for the purposes of production and processing by SME cluster company for seven years.

VAT cashback

Consumers are going to be entitled to cashback of up to 15 percent of VAT paid in retail and catering.

6. Excise Tax

Energy drinks and liquid for electronic cigarettes are added to the list of excisable goods. Excise tax rate for these products is as follows:

- Alcoholic energy drinks - 2 manats per each liter;
- Non-alcoholic energy drinks –3 manats per each liter;
- Liquid for electronic cigarettes –20 manats per each liter.

Excise tax for cars is going to increase as well.

7. Simplified Tax

According to the proposed changes, trading exceeding AZN 200,000 will be excluded from the list of qualifying activities for the simplified taxation regime. Companies with a headcount over five employees engaged in production, wholesale trade, and supply of services (except where the services are supplied to individuals who are not registered as taxpayers) will no longer be eligible for the simplified taxation regime, too.

The amendments to the Tax Code are going to offer additional preferences to the simplified tax regime users:

- the simplified tax rate is going to be 2 percent throughout the entire territory of Azerbaijan[2] (except for catering, where the simplified tax rate is going to remain at 8 percent);
- the simplified tax rate on sales transactions in retail business and catering completed with a bank card will be reduced by 25 percent;
- the dividends received by the shareholders of a resident legal entity with revenues of up to AZN 200,000 over consecutive 12 months, not registered as a VAT payer, and holding a full record of its revenues and costs, will be tax-exempt;
- barbers and tailors will be eligible for the fixed simplified tax regime, too.

8. Tax Administration

The Ministry for Taxes will take over from the State Social Protection Fund (SSPF) in collecting SIC. As a result, instead of two separate audits of payroll tax and SIC, conducted by the Ministry of Taxes and SSPF, businesses will have to pass only one audit, conducted by the tax authorities. Separate filings with the SSPF is expected to no longer be required, either.

The newly introduced Article 65.7-1 will enable the tax authorities to require that the taxpayer's bank convert the funds in a foreign currency into AZN to settle the client's outstanding tax liabilities.

[2] Currently, the simplified tax rates in Baku and other parts of Azerbaijan are different: 4 percent and 2 percent, respectively.

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