

KAZAKHSTAN'S DOUBLE TAXATION TREATIES AND TAX CODE ARTICLE 666 – RESOLVING A WEB OF COMPLEXITIES

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By virtue of the nature of its economy, Kazakhstan's prosperity depends in large measure upon its ability to effectively do business with other nations and for trade to be able to pass as smoothly as possible across the country's frontiers. As overseas investors evaluate the attractiveness of doing business with Kazakhstan, one of the primary factors considered is the level of certainty and transparency around how profits generated from trade with Kazakhstan are taxed both "in country" but also – critically – how cash payments are remitted from Kazakhstan to the investor's trading counterparty jurisdiction.

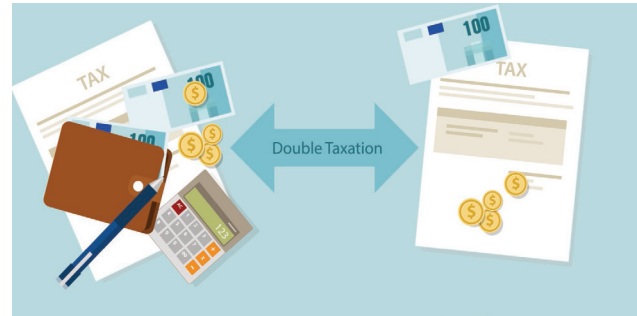


Many factors contribute towards the "risk premium" involved in trading with a maturing jurisdiction like Kazakhstan. These include rule of law, exchange rate stability, and political climate as well as unfavourable tax and other state regulations – issues all discussed at length in previous issues of this publication. Stability, predictability, equity and transparency of taxation, however, are probably factors that have the most immediate and significant impact upon investors and can determine whether trade with Kazakhstan is profitable, successful and attractive on the one hand or, conversely, an experience that investors have no wish to go through again.

Like most countries, Kazakhstan has signed a wide network of *Double Taxation Conventions* intended to provide a framework of clarity concerning the taxation rights of (respectively) Kazakhstan and its overseas trading partners. These conventions set out the bases upon which each country can tax both the trading profits generated by trade between the relevant nation states, as well as the remittances of cashflows from Kazakhstan to these overseas jurisdictions.

Alongside the codified principles enshrined in these double taxation treaties is a widely accepted international principle of taxpayer good faith that taxpayers are required to demonstrate: their entitlement to benefits under the relevant double taxation treaty (usually in the form of an obligation to

provide a certificate of tax residency from the counterparty jurisdiction) and self-assess their obligations to taxation of profits and/or remittances of funds in line with the treaty.



This self-assessment of obligations does not in any way violate or erode the rights of each treaty jurisdiction to perform audits, inspections and/or make supplementary assessments (and collections of taxation) insofar as any of the relevant commercial counterparties are suspected to have or found to have not properly recognized their taxation obligations in line with the provisions of the relevant treaties.

Notwithstanding the fact that these rights always remain, Kazakhstan has also historically seen fit to embed multiple provisions in its local tax legislation that impose a series of onerous obligations upon taxpayers (resident and non-resident) in order for such taxpayers to be able to avail themselves of the relieving provisions of the relevant double taxation conventions.

These provisions exist to increase the levels of taxation collection in Kazakhstan – *prima facie* a good thing for the State Budget in these turbulent economic times. However, as they fundamentally conflict with prevailing international practice and the long-established and widely accepted norms of cross-border taxation, they have a terrible impact upon both the international reputation of Kazakhstan as being "open for business to international investors" and Kazakhstan's attractiveness for foreign investment.

One of the most worrying developments in the last year in the sphere of Kazakhstan's international taxation relates to the provisions of Article 666 of the Tax Code. Article 666 sets out the obligations of local tax agents when remitting income to non-residents who have the right to receive such income free from withholding tax (on the condition that such non-residents are the final recipient of income and are residents of a country with which Kazakhstan has a double tax treaty in force).

The vast majority of international double tax treaties confer the right for signatory jurisdictions to assess taxation upon "permanent establishments" of non-residents insofar as profits of a non-resident are attributable to such permanent establishments (in broad terms, where the permanent establishment plays an active role in the generation of such profits).

However, Article 666 employs a much blunter instrument in this regard that runs contrary to international taxation principles governing this technical issue. Article 666 dictates that if a tax agent concludes that a permanent establishment has been created by the non-resident, the tax agent is not entitled to apply the provisions of any double tax treaty to exempt income paid to the non-resident from withholding tax. Instead, income paid to the relevant non-resident should be subjected to withholding tax regardless of whether or not this permanent establishment has any role whatsoever in the generation of the profits in question.

This position significantly contrasts with the previous approach that allowed certain decision-making authority to the tax agent to determine the existence of a connection (or lack thereof) between the paid income and the non-resident's permanent establishment, and to independently apply an exemption under the treaty where relevant.

To implement the new approach, the Kazakhstan tax authorities launched a series of desk-top audits in the course of the past two years. Those tax agents who received desk-top audit notifications are required to self-assess withholding taxes for all past periods where they remitted income to non-residents that have permanent establishments in Kazakhstan.

If notifications are not executed and taxes are not paid, the taxpayers risk having their bank accounts closed until taxes are paid or an appeal is filed. Many companies do not want to paralyze their operations due to closed bank accounts and feel that the only course of action to maintain continuity of business operations is for them to pay the tax assessed.

Those who appeal the notifications hoping for a fair consideration by the higher tax authority almost in all cases fail, as the new approach originates from the central tax office and is cascaded down to regional tax offices.

The Kazakhstan position is that this provision (and accompanying administration practice) does not violate any obligations under the Double Tax Treaties to which Kazakhstan is a party because non-residents have the right to obtain treaty relief via an application to have tax refunded. This requires demonstrating that the permanent establishment in question ought to have had none of the relevant profits attributed to it and thus treaty relief was due.

However, obtaining a tax refund in Kazakhstan is an extremely burdensome, lengthy and difficult task due to lack of transparent mechanisms for determining income attributable to the non-resident's PE. This leaves a significant degree of subjectivity and latitude in interpretation of Tax Code provisions by tax authorities and frequently leads to double taxation on non-residents.



Given that many tax agents have significant volumes of transactions with non-residents, the application of the refund procedure can lead to an ongoing tax audit of both the tax agent and the non-resident's branch, which may have nothing to do with the services being taxed.

At the same time, non-residents report this income in their home country and bear the burden of double taxation. Taxes withheld in Kazakhstan cannot be offset by them in their country of residence due to the fact that withheld taxes are not taxes on the income of their PE in Kazakhstan and should not be withheld in line with the provisions of double tax treaties in force.

Overall this approach to the taxation of non-residents is one which may have short term benefits to the State Budget but has negative impact from the perspective of the attractiveness of Kazakhstan's investment climate. The combination of poor law (the drafting of Article 666 itself) which is out of line with internationally accepted principles of taxation combined with aggressive tax authority actions and poor, unclear, inconsistently applied administration (ineffective and ambiguous tax refund processes) leads to a situation where non-residents are routinely subjected to double taxation. The result is not just bad for business but detrimental to Kazakhstan's economic prosperity.

President Tokayev has publicly stated that the Kazakhstan's international taxation framework must be improved to enhance the country's investment climate. The issues surrounding Article 666 would be a good place to begin.

