



International Tax Planning in Azerbaijan The Double Tax Treaty with the Netherlands

Nuran Kerimov
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General overview

General overview

- International tax planning is important when engaging in cross-border investment activity
- **International tax planning** – application of various methods in order to minimize effective tax rate of the legal or natural person by utilizing favorable provisions of national legislation and tax treaties
- International tax planning can be regarded successful if effective tax rate was reduced
- Double Tax Treaties (DTT) as important tools in international tax planning
- **Their importance in international tax planning are mainly twofold**
 - Prevention of double or burdensome taxation of income, capital gains and capital
 - An efficient tool for connecting favorable provisions in the tax system of different countries

However, it is very important to consider national tax system

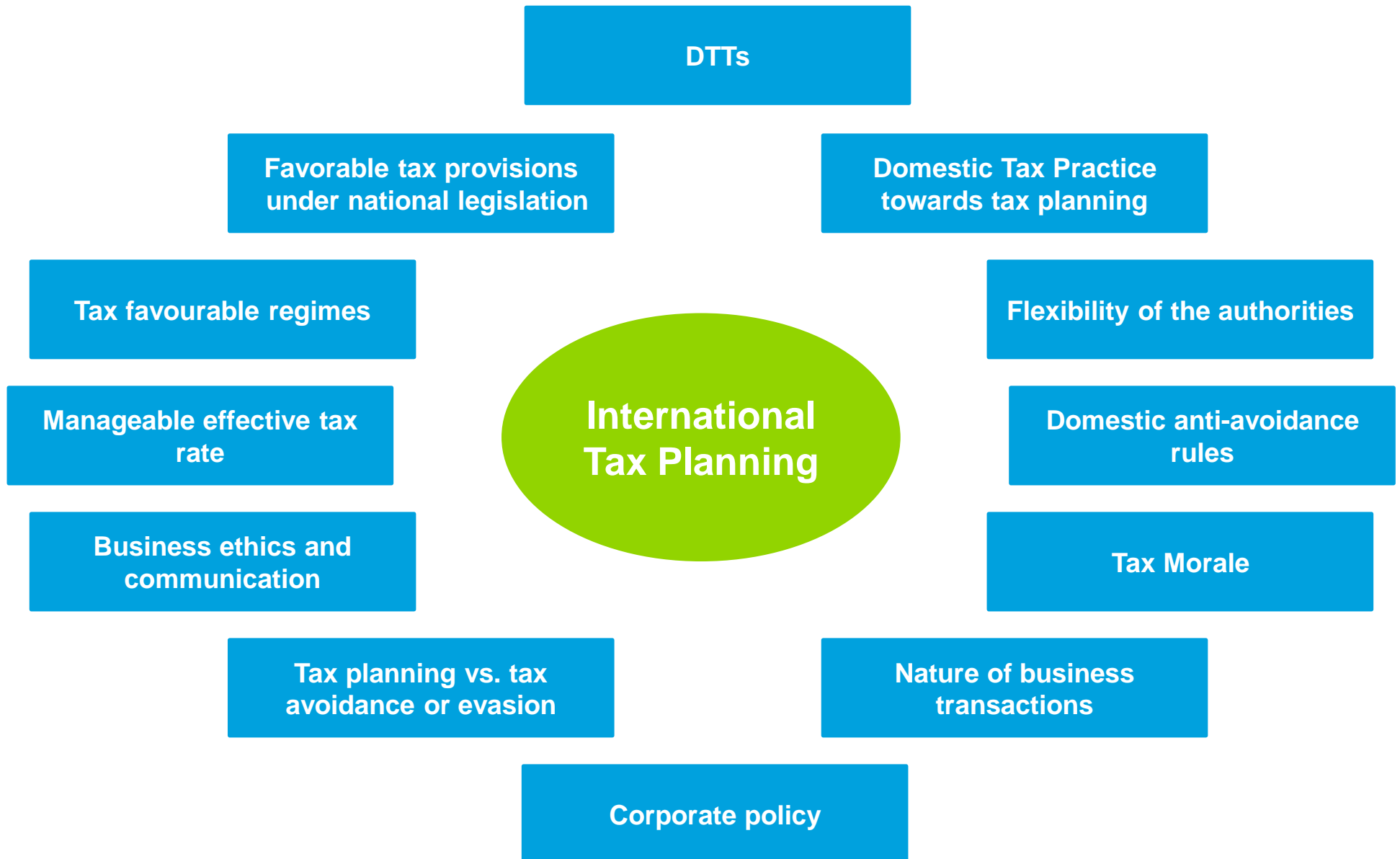
Practical aspects of international tax planning

Practical aspects of international tax planning

- International tax planning should not be simple and benefits should be carefully considered
- Comprehensive tax and legal research must be conducted
- International tax planning vs. tax evasion
- A right to tax planning as a well-recognized principle
- Position of the tax authorities and their practice

Practical aspects of international tax planning

What should be considered



DTTs as a tax planning instrument

DTTs as a tax planning instrument

Purposes

- Elimination of double taxation
- Prevention of tax avoidance
- Allocation of taxing rights
- Limitation of restrictive national legislation

Benefits

- Eliminated or minimized double taxation
- Reduced tax rates
- Determined residence and source state
- Opportunity for tax planning

Scope

- Taxes: income and capital taxes
- Persons: residents and non-residents
- Territories: contracting states' territories

DTTs as a tax planning instrument

Features of DTTs of Azerbaijan

- Based on the OECD Model Convention
- **1994-2011** – 41 DTTs were signed and 37 of them are effective
- **Major DTTs** – UK, the Netherlands, Switzerland, Austria, Luxembourg, Germany, UAE and etc.
- **Negotiations** – Spain, Malta, India, Denmark, Macedonia, Morocco and etc.
- Prevalence over national law in case of collision
- Protocols of the DTTs are important as DTTs

DTTs as a tax planning instrument

Effective DTTs of Azerbaijan

1. Austria
2. Belgium
3. Belorussia
4. Bulgaria
5. Canada
6. China
7. Czech Republic
8. Estonia
9. Finland
10. France
11. Georgia
12. Germany
13. Greece
14. Hungary
15. Iran
16. Italy
17. Japan
18. Kazakhstan
19. Korea
20. Latvia
21. Lithuania
22. Luxembourg
23. Moldova
24. Netherlands
25. Norway
26. Poland
27. Qatar
28. Romania
29. Russia
30. Serbia
31. Switzerland
32. Tajikistan
33. Turkey
34. UAE
35. UK
36. Ukraine
37. Uzbekistan

DTTs as a tax planning instrument

Withholding tax rates applicable to payments made to non-residents

Payments	Statutory Rates	Netherlands	Luxembourg	UK	Russia	Belgium	Germany	Switzerland
Dividend	10%	5 -10%	5 -10%	15%	10%	5-15%	5-15%	5-15%
Interest	10%	10%	10%	10%	10%	10%	10%	5-10%
Royalty	14%	5-10%	5-10%	5-10%	10%	5-10%	5-10%	5-10%

DTTs as a tax planning instrument

Recent trends

There are more favourable provisions in DTTs signed in recent years:

- **Reduced WHT rates for dividend payments – 5%**
- **Reduced WHT rates for royalty – 5 %**
- **Exemptions on certain interest payments:**
 - Interests which payer or recipient is state body or municipality or central bank
 - Interests on loan confirmed and guaranteed by the governments
 - Interest from sale of Industrial, Commercial and Scientific Equipment on credit
 - Interest from the government confirmed loans for export promotion
- **Capital gains:**
 - DTT with Luxembourg exempts gains from disposal of shares of property rich Azerbaijan subsidiary from tax in Azerbaijan
 - Gains from alienation of shares are not taxable in Azerbaijan

The Netherlands- Azerbaijan DTT

The Netherlands-Azerbaijan DTT

General

- Signed on 29 September 2008 and is effective from 1 January 2010
- Protocol which contains important provisions was annexed to the DTT

Taxes covered

Netherlands: Income tax, Wages tax, Company tax, Dividend tax, Capital tax (extended by the Protocol)

Azerbaijan: Profit tax, Personal income tax, Assets tax

Persons covered

Persons who are residents of one or both of the Contracting States:

- Legal entities
- Individuals

The Netherlands-Azerbaijan DTT

Permanent Establishment

- **Fixed place of business PE**
- **Construction PE** – >12 months
- **Agency PE**
- **Service PE** – > 6 months within 12 months
- **Offshore services PE**
 - >30 days within 12 months
 - if activities of both associated entities last more than 30 days

No Permanent Establishment:

- Auxiliary activities
- Activities of independent agents

The Netherlands-Azerbaijan DTT

- **Business profit taxation:**

No PE =

The profits of an enterprise of a Contracting State taxed only in that State

PE =

The profits of an enterprise of a Contracting State taxed in the other State but only as attributable to the PE

Attribution of profits to a PE

- Separate entity approach for attribution of profits to a PE
- Apportionment method – relevant business activity approach

Clarifications by the Protocol

- Only portion of income from the sale of goods attributable to activities of a PE is taxable
- Only portion of income derived from turn-key projects attributable to activities of a PE is taxable

Deduction of overhead expenses:

- Any expenses wherever incurred for a PE should be considered by the source state
- Overheads must be supported by primary documents

- **Income from shipping and air transportation**

Income from shipping and air transportation shall be taxable in a place of effective management

The Netherlands-Azerbaijan DTT

- **Dividends:**

No PE required

Recipient is a beneficial owner:

- 5% - if a beneficial owner holds directly $\geq 25\%$ participation in value of 200.000 EURO
- 10% - if a beneficial owner holds directly $< 25\%$ participation

- **Interest:**

- General WHT rate – 10%
- Loans from public institutions is exempt from taxation
- Interest paid by a PE is also covered by the DTT
- Transfer pricing adjustment can be made

- **Royalties**

- 5% - patent, design or model, plan, secret formula or process or information concerning industrial, commercial or scientific experience if they are not older than three years
- 10% - others
- Royalties paid by a PE is also covered

- **Beneficial owner**

- There is no definition of a concept of beneficial owner in the Azerbaijani tax system

The Netherlands-Azerbaijan DTT

- **Capital gains**

Capital gains derived from disposal of immovable property and movable property attributable to a PE is taxable in the source state

Tax exemption for the capital gains derived from the disposal of shares in Azerbaijani subsidiaries

Source state (Azerbaijan) can tax capital gains from the alienation of shares in an immovable property rich subsidiary

However, it can be mitigated

IF:

*Immovable property is used as a place of business OR
Shares were disposed within the M&A transaction*

Amendments of the Protocol

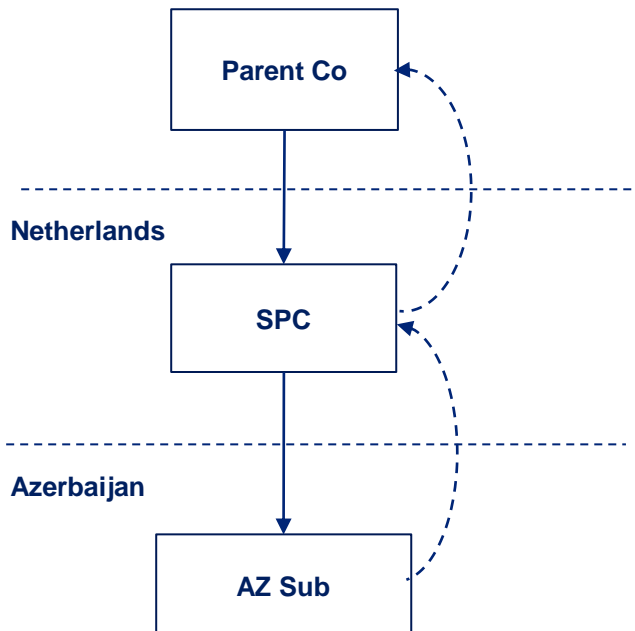
No capital gains:

- Income from partial liquidation of the company
- Income from a purchase of own shares by a company

The Netherlands-Azerbaijan DTT

Holding structure via using the DTT

EU or DTT Country



Brief description of the structure:

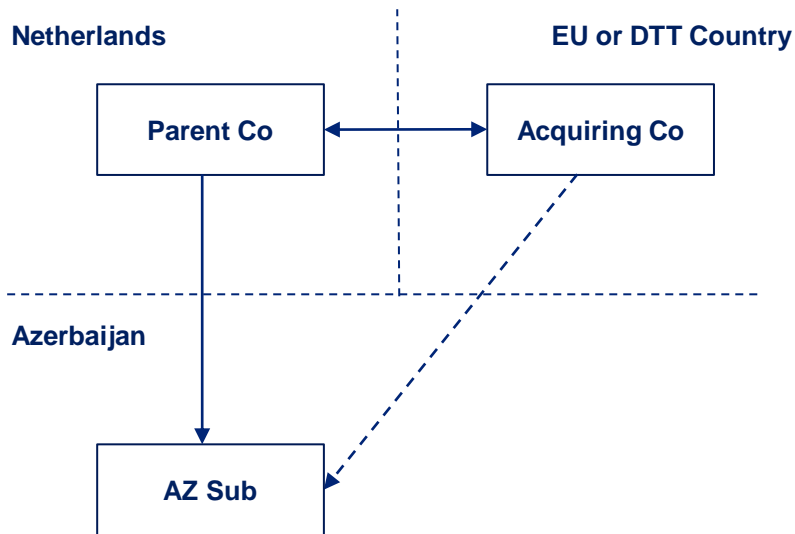
- An investor establishes a Parent Co in EU Member State or a jurisdiction that has a DTT with the Netherlands
- These jurisdictions can be Malta, Netherlands Antilles
- The Parent Co establishes the SPC in the Netherlands
- The SPC holds shares in Azerbaijani companies

Advantages

- Dividend distribution from Azerbaijani subsidiaries may be taxed at 5% rate
- Dividend income of the SPC from the Azerbaijani subsidiaries may be exempt from taxation in the Netherlands under the participation exemption
- Dividend distributed to and the capital gains of the Parent Co will be exempt from taxation under certain conditions.

The Netherlands-Azerbaijan DTT

Tax favorable taxation of capital gains under the DTT



Brief description of the structure

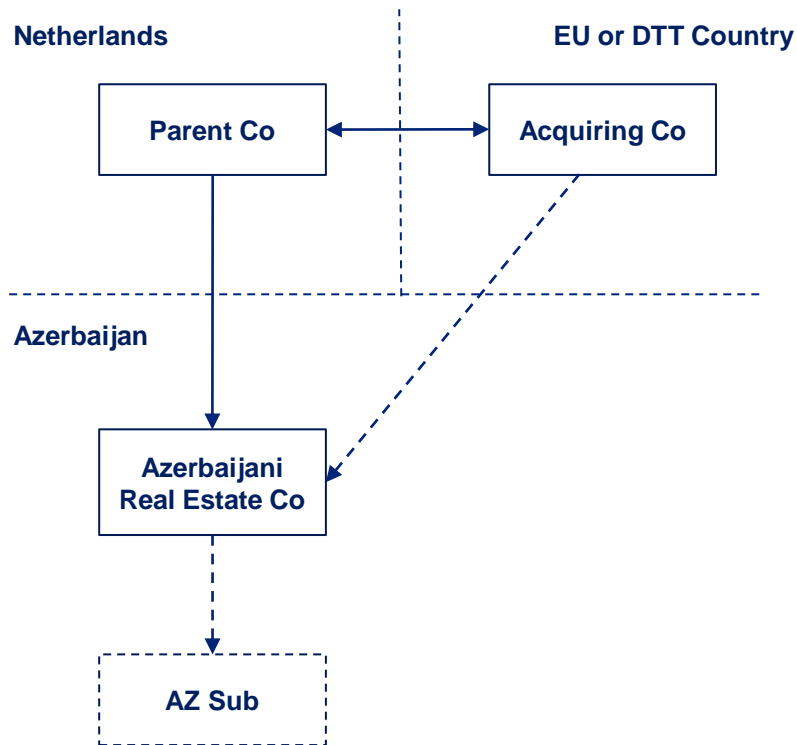
- Dutch Parent Co holds shares in the Azerbaijani subsidiary
- It is planning to sell its shares to another company

Advantages

- Capital gains from the sale of shares in the Azerbaijani subsidiary will not be taxable in Azerbaijan in accordance with the DTT
- Capital gains of the Parent Co from the sale of shares in Azerbaijani subsidiary may be exempt from taxation in the Netherlands under the participation exemption
- Tax exemption for the capital gains under the DTT may be applied directly without referring to the Rules on Administration of Double Tax Treaties

The Netherlands-Azerbaijan DTT

Tax favorable taxation of capital gains under the DTT



Brief description of the structure

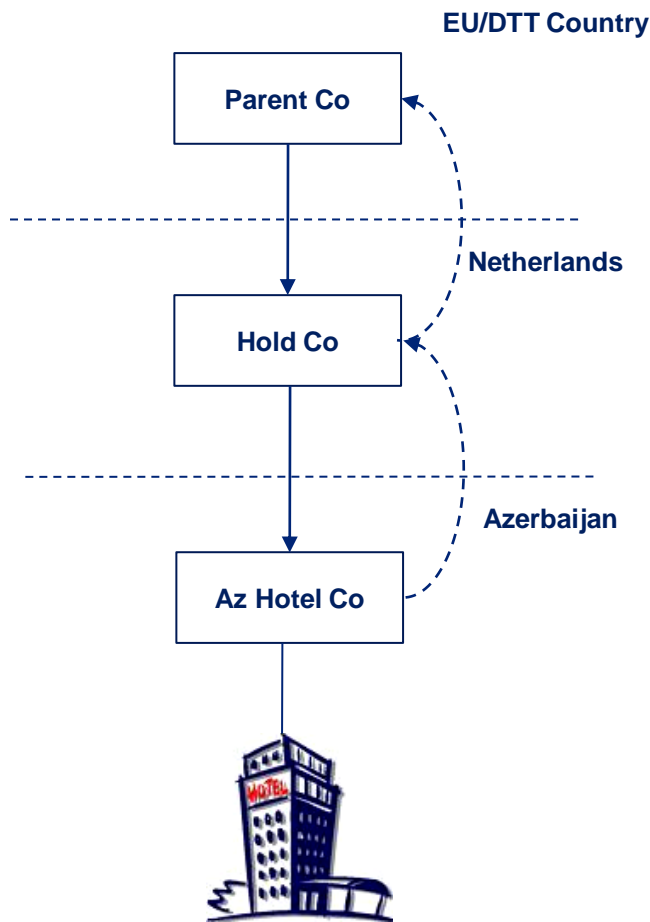
- Dutch Parent Co holds shares in Azerbaijani Real Estate Co
- It is planning to sell its shares to another company
- Azerbaijani real estate rich subsidiary goes to corporate reorganization in the form of spin off and the immovable property is contributed to a newly established entity

Advantages

- Capital gains from the sale of shares in the Azerbaijani real estate subsidiary will not be taxable in Azerbaijan in accordance with the DTT since a target entity will not directly derive 50% of its value from an immovable property in Azerbaijan;
- Capital gains of the Parent Co from the sale of shares in Azerbaijani subsidiary may be exempt from taxation in the Netherlands under the participation exemption;
- Tax exemption for capital gains under the DTT may be applied directly without referring to the Rules on Administration of Double Tax Treaties

The Netherlands-Azerbaijan DTT

Example of tax structure for hospitality business under the DTT



Brief description of the structure

- Parent Company which is a resident of EU Member State or a jurisdiction that has a DTT with the Netherlands establishes Hold Co in the Netherlands
- Hold Co holds shares in Azerbaijani subsidiary
- The Azerbaijani subsidiary can be a hotel company owning the hotel building

Advantages

- Dividend distribution from Azerbaijani subsidiaries to other EU jurisdiction will be taxed at the effective 5% rate
- Capital gains from the disposal of the shares in Az Hotel Co will be exempt from taxation in Azerbaijan in accordance with the DTT as gains from the alienation of shares of the company deriving its principal value from immovable property which is used as place of business is exempt from taxation
- No taxation of received dividends and capital gains in the Netherlands under the participation exemption rules.
- Under the EU Parent –Subsidiary Directive, dividend distributions to Parent Co will be exempt from taxation in the Netherlands

The Netherlands-Azerbaijan DTT

- **Employment income**

Home state taxation

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- Not working in the host state
- Presence less than 183 days in the host state
- Not working for an employer which is a resident of the host state
- Not working for a PE located in the host state

Host state taxation

- If person works in the host state and the above facts do not exist

- **Other income**

- Only taxable in the state of residence
- However, income of a PE from third countries is taxable in the host state

- **Elimination of double taxation**

- Azerbaijan – ordinary tax credit
- The Netherlands – exemption with progression/tax credit, tax credit for passive income

The Netherlands-Azerbaijan DTT

- **Article 24 - Offshore activities taxation**

- Special provisions on taxation of offshore activities
- Offshore activities are exploration, development, production and exploitation of natural resources in offshore zones
- Special PE provisions, however if a PE exists under Article 5, the offshore provisions will not apply
- **No PE** = auxiliary activities, towing and anchor handling by ships, transport of supplies/personnel

- **Article 25 - Non-discrimination**

- Discrimination against nationals, PEs and foreign owned entities is prohibited

- **Article 26 - Mutual Agreement Procedure**

- Taxpayers can initiate mutual agreement procedure in order to solve any taxation problem
- This can be used in making a special mechanism for claiming tax treaty benefits

- **Article 30 – Territorial Extension**

- The DTT may be extended to the Netherlands Antilles and Aruba if the parties intend to do so

- **Interpretation of the DTT**

- The DTT must be interpreted in accordance with OECD or UN Model Convention Commentaries

Claiming DTT benefits

Claiming DTT benefits

- No automatic treaty relief possible
- Regulations on administration of DTTs ("Regulations") as a mechanism of claiming DTT benefits
- **Special Forms** – confirmation of residency, receipt of paid taxes, refund of over-paid taxes, advance exemption for certain payments

- **Forms of exemption and limited taxation:**

Advance exemption

Refund of taxes

- **Distinguishing feature:**

Advance exemption for royalty, interest, dividends and income from transportation services

- Automatic exemption for capital gains

Claiming DTT benefits

DTA-01

Application for confirmation of residency

DTA-02

Application for confirmation of foreign source paid taxes

DTA-03

Application for advance exemption for dividend, interest and royalty payments to non-residents

DTA-04

Application for advance exemption from taxation for non-residents operating through a non-PE division

DTA-05

Application for confirmation of Azerbaijani source paid taxes

DTA-06

Application for refund of over paid taxes

Claiming DTT benefits

Entitlement to DTTs – confirmation of residency is required

- **Entitlement to DTTs – confirmation of residency is required**

- **Advance exemption:**

- *Dividends, royalties and interests*
- *Income from international transportation services*
- *Income attributable to non-PE division*

DTA-03 Form must be submitted

- **Non-PE division**

DTA-04 Form is required for income of non-PE division

Non-PE division can only be established if a DTT provides for certain time threshold for PE creation

- **Refund of the overpaid taxes:**

All other types of income

DTA-06 Form must be submitted

It is complicated

- **Confirmation of the paid taxes:**

- DTA-05 Form must be submitted

Challenges for international tax planning in Azerbaijan

Challenges for international tax planning in Azerbaijan

International tax planning can be challenged on the two basis:

- Domestic anti-avoidance rules
- Practice of the tax authorities

Domestic anti-avoidance rules:

Transfer Pricing

- Article 14 of the Tax Code contains general provisions concerning transfer pricing regulations
- Lack of well-developed transfer pricing practice
- No reference to the OECD Guidelines

Controlled Foreign Corporations (CFC) rules

- If Azerbaijan resident owns greater than 20% shares of a non-resident deriving income in a preferential tax jurisdiction
- Preferential tax jurisdiction - tax rates two or more times lower than in Azerbaijan or with legislation protecting financial and beneficial ownership information
- Lack of practice

Challenges for international tax planning in Azerbaijan

Anti-treaty shopping rule:

- Article 2.6 of the Tax Code stipulates that privileged provisions of the DTT will not be applied in cases where it is applied by a person who is not the resident of the state that entered into such treaty solely for the purpose of obtaining tax privileges.

Interest deductibility limitations

- Interest deduction cannot exceed the expense calculated using an interest rate of 125 percent of the inter-bank credit auction rate set forth by the Central Bank of Azerbaijan
- However, there is no any requirements for debt-equity ratio in the legislation

Mitigation of risks can be achieved via careful planning

Practice of the tax authorities:

- No developed judicial or administrative practice on challenging international tax structures
- However, the tax authorities may also challenge tax structures if they see significant reduction of tax burden

Contacts

Nuran Kerimov

Partner

nkerimov@deloitte.az

Tel: +994 (12) 598 29 70

Fax: +994 (12) 598 29 75

www.deloitte.az

Deloitte & Touche LLC

Landmark III, 8th floor

Nizami str. 96

Baku AZ1010

Azerbaijan



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