AMBIGUITIES IN KAZAKHSTAN'S NEW DIVIDEND TAXATION POLICY

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The Tax Code has been amended from 1 January 2021 to significantly change how dividends paid by Kazakhstan companies to foreign investors are taxed and to make it more diffi cult to fully exempt profit distributions from tax in Kazakhstan. Generally, dividend payments to foreign shareholders are taxed at source at 15% (or 20% if the shareholder is registered in a low-tax country). International treaties can be applied to reduce the standard rate (15%).

To help attract long-term investment into the country, both non-resident companies and individuals have had access for over a decade to domestic tax exemptions on dividends received from Kazakhstan. To apply such exemptions the recipients of dividends must not be registered in a low-tax jurisdiction and are required to have held the relevant shares / interests for at least three years and have no (or insignificant) links to subsoil user assets in Kazakhstan.

The Tax Code amendments signed into law by the President on 10 December 2020 impose additional qualification requirements such that from 1 January 2021, only dividends paid from "income previously taxed" are eligible for tax exemption (provided all the other above conditions are also met).

We believe the amendment has made it much more challenging to achieve the tax exemption of dividends and leaves a number of questions open on how the new provision can be applied in practice.

Ambiguity of "income previously taxed"

The legislator has provided no detailed instructions on how to identify cases where income may be treated as "already taxed", leaving ample room for random interpretation, in particular:

- the possibility to treat dividends paid out by holding companies as "already taxed" at operating company level

A shareholder may own assets in Kazakhstan through a holding company, which holds shares in Kazakhstan operating companies. Given the Tax Code requirement to adjust aggregate annual income by the value of dividends received, the holding company may actually have no income subject to corporate tax, while profits distributed to shareholders would be sourced from and fully taxed by the operating companies.

In other words, these dividends could be considered as already taxed, but only at the operating company level. The lack of any clear rule enabling such income to be treated as "already taxed" leads to economic double taxation of the same taxable object – at both the operating company and shareholder levels.

- defining the net income distributed by a resident legal entity, and the period when it should be "previously taxed"

The amendments do not appear to be taking into consideration unavoidable differences that the taxpayers have in their financial and tax accounting due to different income and expense recognition principles. Probably the most significant aspect, from the perspective of investors and production companies, is the difference between financial and tax accounting in depreciation of fixed assets due to different depreciation methods, rates and accelerated depreciation allowances – "investment tax preferences".

Thus, due to timing differences caused by differences between financial and tax accounting rules, a Kazakhstan company paying dividends may record losses in tax accounting and net profit for financial accounting purposes.

In other cases, a Kazakh company may pay dividends on retained earnings from net profits generated three, five, ten or more years ago. It is not clear, given the statute of limitation restrictions, how the tax authorities in these cases intend to check whether corporate income tax has been paid on such net income, and on which part of this income. In other words, income could have been taxed in previous tax periods (or will be taxed in future), but the tax exemption would not apply due to ambiguity of the new amendment.

Lack of definition of net income

The tax law does not contain a definition of net income for dividend taxation purposes.

Under a general dividend distribution procedure set out in the Kazakhstan LLP law, net income received by an LLP is distributed based on the decision of the shareholders' general meeting approving financial results for the year. This decision is made based on approved financial statements of a company – i.e., source of dividends is the net income (net profit) as per accounting data and financial statements.

Given that dividends are not based on corporate tax reporting results, we believe it is improper to equate net income per financial statements distributed to shareholders to after-tax income reported in a corporate tax return.

The logic behind comparing these results and the methodological approach proposed in the new provision are not clear.

If we assume that the new approach was introduced so that exemptions could be disallowed in those cases when net distributable profits have not been taxed in Kazakhstan, then the concept is flawed merely because under Kazakhstan accounting law this situation is not possible.

In Kazakhstan, recognition of income and expenses

(including income tax expense) is based on the accrual method. Under the accrual method, even if taxpayers do not have taxable income and CIT expenses in the current tax period, they are required to report deferred income tax expense in their financial statements, which reduces net income to be distributed among shareholders.

This deferred tax recognition mechanism does not allow for situations when untaxed net income (profit) is paid as dividends. Thus, the restriction of the tax exemption on the grounds of non-taxation of underlying income is based on the confusion of the terms "taxable income after CIT according to tax accounting" and "net income (profit) according to financial accounting", which distorts the general principle of forming dividends.

We believe the new dividend exemption rules will create an uneven playing field for many taxpayers: for example, those that had enjoyed additional CIT deductions by applying accelerated depreciation option, will find themselves discriminated against when paying dividends to shareholders, i.e. they will be forced to pay an additional 15% tax.

Because dividend income is these days mostly exempted, this WHT will be an absolute loss to such groups of companies, as there is generally no scope to credit or otherwise relieve this tax. This renders investment into Kazakhstan less attractive.

Likewise, taxpayers that did not apply the accelerated deduction option in the current period (retained it for a future period), will be able to make use of the dividend tax exemption.

This sends out a signal to investors that capital investment in production assets (which was the reason for introducing accelerated deduction option in the first place) is no longer worth it because it can have the reverse effect, i.e. lead to additional tax on dividends.

Retrospective application of the new dividend taxation concept

Until the amendments were adopted, foreign investors did not have any issues with using the domestic tax exemption on the grounds that underlying income had not been taxed (except in specific cases where CIT was reduced by 100% for certain types of activities).

However, in their recent opinion published before the discussed amendment was signed into law, the tax authorities stated that dividends tax exemption was not applicable if the entity paying the dividends did not generate taxable income. As far as we understand, this position is based on the definition of net income as "income after taxation", which, as we noted above, does not correspond to the principles for forming dividends.

Although tax authority clarifications are not binding, any such Tax Code interpretation may have far-reaching consequences and allow the tax authorities to consider the amendments from 1 January 2021 as of clarifying nature. Thus, the tax authorities' opinion can now be used as a tool for legalizing the retrospective application of restrictions and making additional assessments during a tax audit, including for earlier periods.

Interestingly, this position places doubt on the exemptions historically applied to dividends paid not only to foreign investors but also to Kazakh resident individuals.Given that the desktop audits on this issue have already started and they currently target dividend payments to non-residents, we recommend that Kazakhstan companies that paid dividends to foreign shareholders in previous periods be ready to support their position and prepare a defence strategy.

Clarification or amendment that worsens the taxpayer position?

Based on the Tax Code, amendments may be made to:

- change objects of taxation / tax bases and repeal tax concessions – but only by 1 July of the current year and can take force not earlier than 1 January of the year following the year they are adopted, and
- change tax administration, tax reporting provisions and where such changes improve taxpayer position - by 1 December of the current year.

In our opinion, the provision introducing a new restriction for applying tax exemption is a significant change that impacts the object of taxation and abolishes concessions stipulated by the Tax Code. Therefore, adopting this provision after 1 July 2020 and enforcing starting 2021 as if the change clarifies or improves taxpayers' position is questionable.

Thus, bearing in mind the governing principle of certainty of taxation, we believe the new provision restricting tax concessions for dividend distributions to foreign investors requires further discussion and improvements around clarity of implementation and application rules.

Without this clarity, the current ambiguity of the new provision is likely to be one of the major dispute issues for foreign investors in Kazakhstan and is a reform that significantly reduces the attractiveness of Kazakhstan as a destination for foreign investment.