

# Preface

## *DISCLAIMER*

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# Country Overview

## General statistics

<b>Population:</b>	8.4 million
<b>Territory:</b>	87,000 square kilometer (approx. 34,000 sq. miles)
<b>Neighboring states:</b>	Russia, Iran, Armenia, Georgia, Turkmenistan.
<b>Titular nationality:</b>	Azerbaijani (85%)
<b>Ethnic minorities:</b>	Russian, Lezghi, Talysh, Tatar.
<b>Capital:</b>	Baku (pop. 1,900,000)
<b>Other main cities:</b>	Ganja (pop. 306,000), Sumgait (pop. 294,000)
<b>Autonomy:</b>	Nakhichevan Autonomous Republic (pop. 376,000)



Azerbaijan, formerly the Azerbaijanskaya S.S.R. within the USSR, regained its independence in 1991. It joined with 11 other republics to form the Commonwealth of Independent States (CIS) in 1993.

According to the Constitution of 12 November 1995, Azerbaijan is a secular, democratic presidential republic. The country is headed by a President who can be elected for no more than two consecutive five-year terms. Presently, Azerbaijan is governed by President Ilham Aliiev. The government (Cabinet of Ministers) is subordinate to the President, who appoints the prime minister and other ministers subject to the approval of the legislature. The highest legislative body is the single chamber 125-member Milli Majlis (National Assembly), which is elected for a five-year term. The Milli Majlis may not be dissolved by the President; however the President is able to veto its decisions.

## Economic structure

Vast oil reserves determined the attraction of foreign investment to the Azerbaijani economy. Over 90 percent of all foreign investments are in the energy sector. Several major oil contracts have been signed since 1994. Turan News, a local news agency, has recently reported that investments made in Azerbaijan's economy in the year of 2006 amounted to 6.0 billion new manats (over USD 6.9 billion ), which exceeded the index of 2005 by 10.7 %. Foreign capital investments totaled 3,2 billion new manats (over USD 3.7 billion), while inner capital investments amounted to 2.8 billion new manats (USD 3.2 billion), which constitute 53.9% and 46.1%, respectively. In comparison to 2005, the foreign investment decreased by 9.0% while the inner investment grew by 46.8%. The above figures have originally been reported by the State Statistical Committee. The leading foreign investors to date include: BP, Statoil, LukOil, and TotalFinaElf.

On May 26, 2000 the President of the Azerbaijan Republic signed a law regarding the Main Export Pipeline (MEP). The MEP, which connects Baku with the Turkish oil terminal in Ceyhan via Georgia, will be the main route for transportation of Azeri crude oil to the world oil market.

The Agreement on South Caucasus Pipeline (SCP) was executed on 29 September 2001 and was approved by the Law of the Azerbaijan Republic on 26 October 2001. The SCP is the main route for transportation of Azeri gas to the world market. In particular, the pipeline will be used to ship natural gas from the offshore Shah-Deniz gas field to Turkey.

The country has two oil refineries, with total technical capacity of 22 million tones of crude oil per annum. Five big petrochemical plants as well as two metallurgical plants are located in Sumgait, 28 kilometers from Baku. Industrial and agricultural production, after four years of decline has been stabilized from 1996. A five-fold increase in oil production is anticipated in the future.

The tight monetary stance of the central bank has continued to show success and as a result the value of the local currency, the Manat, has stabilized in comparison to the US dollar in the last years. The banking system consists of a little over forty banks including several foreign banks.

# Tax Terms Applicable to Production Sharing Agreements (PSAs) and Host Government Agreements (HGAs)

## Introduction

There is currently no legislation in Azerbaijan specifically governing the oil and gas sector. The draft of the Law on Oil and Gas was resubmitted to the Azeri parliament a while ago. However, information on approximate date when that law will be finalized is not yet available. As per the draft Law, it will not govern the PSAs signed so far and will only apply to agreements signed in the future.

In accordance with the legislation of Azerbaijan, ownership of all petroleum resources existing in its natural state in underground and surface strata, including the portion of the Caspian Sea within the jurisdiction of the state is vested with Azerbaijan.

The State Oil Company of the Azerbaijan Republic (“SOCAR”) has been given the authority to control and manage the country’s petroleum resources. Several oil consortia with participation from a number of major oil companies are engaged in exploration and production activities in the Azerbaijani sector of the Caspian Sea and in onshore exploration. All consortia were created on the basis of PSAs.

The MEP and SCP activities are governed by the respective Host Government Agreements.

There are substantial differences between the general tax legislation and the tax regimes of the existing PSAs, as well as those of the HGAs. Generally speaking the PSAs and the HGAs have negotiated taxes that provide for substantial relief to investors, while those operating outside the above mentioned agreements, must pay the whole range of standard Azerbaijani taxes under the statutory tax regime.

## State Oil Company of Azerbaijan Republic (SOCAR)

SOCAR was established by an edict of the President of Azerbaijan on 13 September 1992. Its initial charter was adopted by a Presidential edict in November 1992 followed by a second charter approved by a Presidential edict on 5 April 1994 and registered with the Ministry of Justice of Azerbaijan on 24 June 1995. Based on this second charter, SOCAR’s functions generally included making decisions on the development of newly discovered fields, reviewing and approving the implementation of oil and gas projects in Azerbaijan. Furthermore, SOCAR manages the extraction, refining and transportation of oil, gas and gas condensates. The property used by the enterprises, organizations and agencies under the control of SOCAR is in fact the state’s property. However, SOCAR, being the state’s representative, has the right to manage and dispose of such property.

SOCAR has recently been restructured and its new charter was approved by a presidential decree on January 24, 2003. The main purpose of the restructuring was to increase the efficiency of SOCAR’s operations by changing the way in which the various SOCAR entities transact with each other. As regards SOCAR’s main functions, they largely remain the same.

## Export routes

At this moment there are two operating pipelines. One is the Northern route through Russia to the port of Novorossiysk located on the shores of the Black Sea. The other one is the Western route, which passes to the Georgian port of Supsa. During the 1999 OCSE summit in Istanbul, the presidents of Azerbaijan, Georgia, Kazakhstan, Turkey and the United States signed an agreement to begin the construction of the Main Export Pipeline (MEP), which would run from Baku to the

Turkish port of Ceyhan in the Mediterranean Sea. Throughout 2000 and 2001, preliminary and detailed engineering studies were undertaken. On 18 September 2002 MEP was officially inaugurated during a ceremony at Azerbaijan's Sangachal terminal. On 3 February 2004 the official signing ceremony on the MEP financing took place.

# The Range of Applicable Taxes, Duties, and Bonuses in PSAs

## Contractor parties

Oil and gas contractors (PSA partners) are subject to Profit tax and social fund contributions for local employees. Other major payments include bonuses and acreage fees. The PSA parties are exempt from all other taxes including royalties.

### Profit tax

Under the PSAs currently in effect, contractor parties carrying out business in Azerbaijan in connection with petroleum operations are subject to tax on profit. The profit tax rate is negotiated and varies from 25% to 32%.

Taxable income is calculated in accordance with internationally accepted accounting practices in the petroleum industry rather than in accordance with Azeri statutory accounting procedures. Losses incurred by contractor parties to a production sharing agreements during the period of exploration are deductible once production starts.

Activities that are not connected with hydrocarbon activities in Azerbaijan and/or relevant contract areas are deemed to be outside the scope of production sharing agreements and the related protocol tax regimes. In the event that a company is engaged in both hydrocarbon and non-hydrocarbon activities, separate accounting books in accordance with statutory rules must be maintained to reflect income and loss generated from non-hydrocarbon activities. The operating companies under the PSA's are not taxable and allocate income and expenses to contractor parties in proportion to their participating interests in the production sharing agreements.

### Social charges

Under the PSAs, contractor parties involved are allowed to employ personnel as required for the purpose of carrying out their operations. There may be requirements to give preferences, as far as they are consistent with the operations, to employ citizens of Azerbaijan within the framework of overall quotas.

It is required that the contractor parties make contributions to Social Insurance Fund in the amount of 22% of the gross local payroll. These contributions are made at the expense of the employer. Further 3% of the employees' salaries is withheld from local employees and paid to the same Social Insurance Fund.

### Bonus payment, acreage fee

The terms of bonus payment and the size of the bonus are negotiated and vary for each individual PSA. Existing PSAs call for the bonus to be paid in three installments, connected with the stages of the agreements.

Starting with the second consortium agreement signed, there has been an acreage fee payable for the contract area during the exploration period and additional exploration period. An annual acreage fee is negotiated and for some PSAs the range of the acreage fee is \$1,200 to \$2,000 per square kilometer.

### Royalties

Under the existing PSAs, the contractor parties are not subject to Royalties existing for extraction of hydrocarbon resources in Azerbaijan.

## Sub-contractors

Both Azeri legal entities and foreign legal entities are treated as sub-contractors to PSAs. Azeri legal entities are subject to tax in accordance with general taxation rules. Registered foreign sub-contractors, on the other hand, are generally only subject to withholding tax, as described below, as well as social fund payments in the same manner as contracting parties. The sale of goods or equipment to which title is transferred outside Azerbaijan and the provision of services outside of Azerbaijan should not be subject to the withholding tax.

### Withholding tax

Foreign subcontractors carrying on business in Azerbaijan in connection with hydrocarbon activities are deemed to earn a taxable profit of 20–25%, depending on the particular PSA, of the payments received in respect of transactions performed in Azerbaijan. These subcontractors are subject to tax on such profit at the rate of 25% to 32% resulting in a total withholding tax obligation at the rates of 5%, 6.25%, 7.5% or 8% (depending on the particular PSA) of the gross contractual payment. Withholding tax on foreign sub-contractors selling goods should only apply to a mark-up charged on such goods. Under certain PSA, in case no mark-up is indicated, the tax may apply to the gross sales price. However, under some of the existing PSAs, certain foreign subcontractors are subject to profit taxation under the domestic law. Such foreign subcontractors include those working after approval of the development and production stage of the agreement or selling goods without indicating a mark-up on such sales (*for details on the statutory tax regime, see “The taxation of non-PSA activities” section*).

### Social charges

Similarly to the contracting parties, subcontractors are allowed to employ personnel as required for the purpose of carrying out their operations. There may be requirements to give preferences, as far as they are consistent with the operations, to employ citizens of Azerbaijan within the framework of overall quotas.

It is required that the subcontractors make contributions to Social Insurance Fund in the amount of 22% of the gross local payroll. These contributions are made at the expense of the employer. Further 3% of the employees’ salaries is withheld from local employees and paid to the same Social Insurance Fund.

## Other benefits

### Export/Import regulations

Each contractor or subcontractor is entitled to import and re-export (free of any taxes) machinery, equipment, fixed assets, goods, works, and services for use in respect of petroleum operations. However, customs processing fees are payable. A customs duty exemption certificate must be obtained from the customs authority in connection with the production sharing agreement.

### Value added tax

Contractors and sub-contractors are “exempt with credit” from VAT (i.e., a zero percent rate is applied) in connection with petroleum activities on all:

- goods, works and services supplied to or by them
- exports of petroleum
- imports of goods, works and services

Additionally, any supplier of works and services (including, subcontractors) to each contractor should treat those supplies as being exempt from VAT with credit.

A VAT exemption certificate must be obtained from the relevant tax authority in connection with the production sharing contract.

### **Tax residency rules for individuals**

Local employees are generally subject to taxation under the Azeri domestic tax regime, whereas most existing production sharing agreements separately address the issue of expatriate taxation. Normally, an expatriate employee of an operating company, a contractor party, an affiliate of a contractor party or a foreign subcontractor, who is present in Azerbaijan on “ordinary business” becomes a tax resident in the event that he/she spends in Azerbaijan more than 30 consecutive days in a calendar year. Income earned after the 30th day is taxable in Azerbaijan. Individuals spending fewer than 30 consecutive days but more than 90 cumulative days in Azerbaijan in a calendar year are also treated as tax residents, and income earned after the 90th day becomes taxable. Rotating employees and foreign employees who have primary place of employment in Azerbaijan qualify as tax residents if they spend more than 90 cumulative days in Azerbaijan in a calendar year and are taxable from the first day of their presence in Azerbaijan.

### **Penalties**

In general, penalties applicable to contractor parties and subcontractors under the PSAs tend to be less strict than those provided for by the general domestic legislation. One of the typical penalties applied is interest for late payments of tax at the rate of LIBOR plus 4%.

# The Range of Applicable Taxes and Duties in HGAs

## Participants

Participants (the HGAs partners) are only subject to Profit tax at 27% and social fund contributions for local employees. The participants are exempt from all other taxes.

### Profit tax

Profit tax may apply to all Participants (i.e. companies investing in the Pipelines), though actual or deemed tax treaty relief may protect such parties from taxation in Azerbaijan. Profit tax applies individually to each participant.

The profit tax rate is fixed at 27% in the Azerbaijan Host Government Agreement and is based on the prevailing statutory rate in effect on the date of signature of the Agreement.

### Social charges

The Participants are allowed to employ personnel as required for the purpose of carrying out their operations.

It is required that the Participants make contributions to Social Insurance Fund in the amount of 22% of the gross local payroll. These contributions are made at the expense of the employer. Further 3% of the employees' salaries is withheld from local employees and paid to the same Social Insurance Fund.

## Contractors

Both Azeri legal entities and foreign legal entities are considered as Contractors (subcontractors in common sense) to the HGAs. The registered Contractors are exempted from all type of taxes except for social fund payments in the same manner as the participants.

### Social charges

Similar to the Participants, the Contractors are allowed to employ personnel as required for the purpose of carrying out their operations.

It is required that the Contractors make contributions to Social Insurance Fund in the amount of 22% of the gross local payroll. These contributions are made at the expense of the employer. Further 3% of the employees' salaries is withheld from local employees and paid to the same Social Insurance Fund.

## Other benefits

### Export/Import regulations

The HGAs allow for import and re-export (free of any taxes) of machinery, equipment, fixed assets, goods, works, and services for use in respect of the HGAs operations. However, customs processing fees are payable. A customs duty exemption certificate must be obtained from the customs authority in connection with the HGAs operations.

### Value added tax

Participants and Contractors are "exempt with credit" from VAT (i.e., a zero percent rate is applied) in connection with the HGAs activities on all:

- goods, works and services supplied to or by them
- imports of goods, works and services

Additionally, any supplier of works and services (including, Contractors) to each participant should treat those supplies as being exempt from VAT with credit.

A VAT exemption certificate must be obtained from the relevant tax authority in connection with the HGAs operations.

### **Tax residency rules for individuals**

For expatriate employees of the Participants and Contractors, special residency rules apply. Specifically, a foreign individual who spends more than 182 days in a calendar year in Azerbaijan will be considered to be a tax resident. Residents are liable to pay personal income tax only on income received from the Azeri sources.

# The Taxation of non-PSA and non-HGA Activities

## Tax code

The tax regime outlined below is based on the Tax Code that was implemented on January 1, 2001 and amended as of 1 January 2007. While the Tax Code is the main document governing tax matters of the Azerbaijan Republic, it recognizes an exceptional status of the PSA, MEP and SCP taxation regimes. The main taxes affecting companies operating under the statutory regime are as follows:

- Profits tax
- Value added tax
- Excise tax
- Customs duties
- Road tax
- Land tax
- Property tax
- Payroll tax and social charges
- Withholding tax
- Royalty
- Personal income tax
- Simplified tax

In general, all companies carrying out business activity in Azerbaijan are subject to the taxes discussed below (unless protected by the above mentioned PSA and MEP tax regime).

## Profit tax

All legal entities engaged in commercial activities in Azerbaijan are subject to Profit tax. The Profit tax rate is 22%. Taxpayers make quarterly payments of Profit tax computed either as  $\frac{1}{4}$  of last year tax or as multiplication of current quarter revenue to proportion of tax amount in the last year profit.

## VAT

The standard VAT rate in Azerbaijan is 18%. Sales of goods and services, including imported goods (at customs) are subject to VAT. VAT on business inputs, including that paid on the purchase of fixed assets, can generally be offset against output VAT. Services rendered under projects financed by foreign credits and loans issued on the basis of Governmental agreements are subject to 0% VAT.

## Excise tax

Excise taxes for domestically produced hydrocarbons range from 8.0 percent to 101.0 percent, alcoholic beverages from 0.08 to 0.08 AZN per liter and for tobacco products 12.5 percent. Excise tax and VAT shall not be included in the taxable base.

Excise taxes for imported hydrocarbons and hydrocarbon products range from US\$1 per ton to US\$250 per ton, tobacco products US\$5 per 1,000 pieces and alcoholic beverages from US\$0.05 per liter to US\$3 per liter. Taxable base (excluding excise tax and VAT) is the higher of the value declared at the customs and the market wholesale price.

In addition, effective from 1 January 2007 imported automobiles, and yachts will also become subject to excise taxes. The tax rates for these goods vary from 0.15 AZN – 1 AZN per sm<sup>3</sup> of engine capacity.

## **Import tax**

The maximum rate of the import tax is now 15%. Goods temporarily imported by enterprises for use in their own production for a period of less than a year and not for the purpose of deriving income are exempt from import tax.

Customs charges of 0.15% or 0.3% of the value of declared goods (if goods cleared for customs after regular working hours or outside customs territory) are payable on the customs value of imported goods as a customs processing fees with a few exceptions.

## **Export tax**

Exports of most goods are free from Export tax.

## **Road Tax**

The Road tax is designed to tax vehicles of non-residents enterprises and individuals, entering the territory of the Azerbaijan Republic. Vehicles entering the territory of the Azerbaijan Republic will be taxed at rates USD 15-2,800 depending on the type of vehicle. Amount of road tax will be also affected by the length of the distance run by vehicles in the territory of the Azerbaijan Republic, length of the period during which vehicles are in the territory of the Azerbaijan Republic and danger of items carried by vehicles. Road fund tax is paid to Customs bodies.

Starting January 1st, 2005, vehicles used locally for any purposes are also subject to Road fund tax based on the following annual rates:

- For cars with an engine volume of up to 2,000 cubic centimeters – 0.01 AZN per 1 cubic centimeter;
- For cars with an engine volume exceeding 2,000 cubic centimeters – 0.02 AZN per 1 cubic centimeter;
- For buses and other vehicles – 0.02 AZN per 1 cubic centimeter.

Road fund tax and respective tax declaration for vehicles used locally must be paid/filed no later March 31st of the following year.

## **Land tax**

Companies using land are generally subject to a land tax calculated as 0,1-10 AZN applied to every 100square meters.

## **Property tax**

All entities are subject to Property tax at the rate of 1% of the average annual residual value of their fixed assets (excluding vehicles). Property tax is deductible for profits tax purposes.

## **Payroll tax and social charges**

All Azerbaijani registered enterprises must make payments to Social Insurance Fund. Effective January 1, 2003 payment to the Social Insurance fund is 22% of gross wages paid at the cost of the employer. In addition, 3% of the employees' salaries is withheld from employees and paid to the same Social Insurance Fund.

## Withholding tax

Withholding tax is applicable to the repatriation of profits and other cross-border payments to foreign companies without a permanent establishment in Azerbaijan. The tax is payable at the following rates:

Nature of payment	Rate of withholding (%)
Insurance premiums and leasing fees	4
International communication and freight fees	6
Dividends and interest,	10
Management fees and fees for other services performed or deemed to be performed on the Azeri territory but not connected with an Azeri permanent establishment	10
Rents and royalties	14

Profits derived from a permanent establishment of a foreign company are subject to a branch remittance tax at 10 percent of net profits after tax.

## Double tax treaties

The rate of withholding tax may be reduced by double tax treaties. However, a mechanism on advance tax clearance under double tax treaty is not provided.

Under the existing double tax treaties the rate of withholding tax varies depending on the contents of the particular treaty. The maximum rates of withholding tax taking into account current double tax treaties are shown in the following table.

Payee resident in	Dividends (%)	Interest (%)	Royalties (%)
Austria	5/10/15 (a)	0/10 (h) (i) (j) (k)	5/10 (s)
Belarus	15	0/10 (l)	10
Belgium	5/10/15 (b) (c)	0/10 (i) (m) (n)	5/10 (t)
Canada	10/15	0/10 (h) (o)	5/10 (u)
China	10	0/10 (i) (l)	10
Czech Republic	8	0/5/10 (i) (n) (p)	10
Finland	5/10 (d)	0/10 (h) (i) (j) (k)	5/10 (w) (x)
France	10	0/10 (h) (i) (r)	5/10 (v)
Georgia	10	0/10 (n)	10
Germany	5/15 (e)	0/10 (i) (n)	5/10 (w) (y)
Kazakhstan	10	0/10 (n)	10
Latvia	5/10 (f)	0/10 (h) (k) (l)	5/10 (z)
Lithuania	5/10 (f)	0/10 (i) (l)	10
Moldova	8/15 (g)	10	10
Norway	10/15	10	10
Poland	10	10	10
Romania	5/10 (f)	0/8(i) (l)	10
Russian Federation	10	0/10 (n)	10
Turkey	12	0/10 (n)	10
Ukraine	10	10	10
United Kingdom	10/15	10	5/10 (t)
Uzbekistan	10	0/10 (n)	10

#### Notes:

- a. 5% of the gross amount if the beneficial owner is a company which holds directly at least 25% of the capital of the payer and the participation exceeds USD 250k or an equivalent amount in any other currency;
- b. 5% of the gross amount of the dividends if the beneficial owner is a company which holds, directly or indirectly, at least 30% of the capital of the payer and has invested at least an amount equivalent to USD 500K in the payer at the date of payment of the dividends;
- c. 5% of the gross amount of the dividends if the beneficial owner is a company which has invested at least an amount equivalent to USD 10,000K in the payer at the date of payment of the dividends;
- d. 5% of the gross amount of the dividends if the beneficial owner is a company (other than a partnership) which holds directly at least 25% of the capital of the payer and the participation in the payer exceeds EUR 200K or its equivalent in the national currencies of the Contracting States;
- e. 5% of the gross amount if the beneficial owner is a company (other than a partnership) which holds directly at least 25% of the capital of the payer and the participation in the payer exceeds EUR 150K or its equivalent in the Azeri mantas;
- f. 5% of the gross amount of the dividends if the beneficial owner is a company (other than a partnership) which holds directly at least 25% of the payers;
- g. 8% of the gross amount of the dividends if the beneficial owner is a company and the participation in the payer is at least USD 250K;
- h. 0% if the payer or the recipient of the interest is a Contracting State itself, a statutory body, an administrative territorial subdivision or a local authority thereof or the Central Bank of a Contracting State
- i. 0% if the loan in respect of which the interest is paid is made, guaranteed or insured by, a Contracting State itself, a statutory body, an administrative territorial subdivision or a local authority thereof or the Central Bank of a Contracting State;
- j. 0% if the interest is paid in respect of a loan which has been approved by the Government in the Contracting State where the payer of the interest is a resident;
- k. 0% if the interest is paid with respect of an indebtedness arising on the sale on credit of any merchandise or industrial, commercial or scientific equipment to an enterprise of the other Contracting State;
- l. 0% if the interest is derived and beneficially owned by the Government or the National Bank of the other Contracting State;
- m. 0% if the interest is on commercial debt-claims - including debt-claims represented by commercial paper - resulting from deferred payments for goods, merchandise or services supplied by an enterprise;
- n. 0% if the interest is paid to the other Contracting State, a political or administrative-territorial subdivision or a local authority thereof or any agency or instrumentality thereof;
- o. 0% if the interest arising in Azerbaijan and paid to a resident of Canada if it is paid in respect of a loan made, guaranteed or insured, or a credit extended, guaranteed or insured by Export Development Canada;
- p. 5% if the interest is paid in connection with a loan or a credit of whatever kind granted by a bank;
- r. 0% if the loan is in connection with the sale and the conditions of such sale are customary in such contracting state;
- s. 5% if the patent, the design or model, the plan, the secret formula or process, or the information concerning industrial, commercial or scientific experiences, in consideration of which these royalties are paid, is not older than 3 years;
- t. 5% in respect of any copyright of literary or artistic work (including cinematograph films, and films or tapes for radio or television broadcasting);
- u. 5% if the royalties are for the use of, or the right to use, computer software or any patent or for information concerning industrial, commercial or scientific experience (but not including any such royalty provided in connection with a rental or franchise agreement);
- v. 5% to royalties in respect of copyright of literary or artistic work, cinematography films and tapes broadcasted via TV or radio;
- w. 5% in the case of payments for the use of, or the right to use, any computer software, patent, trade mark, design or model or plan; for the use of, or the right to use, any secret formula or process, or for information concerning industrial, commercial or scientific experience (know-how);
- x. 10% in the case of payments for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, and films or tapes for television or radio broadcasting;
- y. 10% in the case of payments for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, and films or tapes for television or radio broadcasting, as well as the right to use names, portraits or any similar copyrights;

Treaties with Italy, Pakistan and Luxembourg are in the ratification stage. Azerbaijan has initiated tax treaties with Bulgaria, Denmark, Estonia, Kuwait, Netherlands, Oman, Qatar, Sweden, Serbia and Montenegro. It is negotiating tax treaties with Greece, Hungary, India, Iran, Kyrgyzstan, Saudi Arabia, San Marino and United Arab Emirates.

## Mineral fields tax (royalty)

All companies and individuals engaged in the extraction of mineral resources are subject to a royalty tax at the appropriate rate in addition to any land tax due. Royalty tax is deductible for profits tax purposes. The tax is applied wholesale prices of oil, natural gas and all types of mining resources at rates ranging from 3% to 26%. For all other taxable mineral resources royalty tax is calculated based on a certain ratio of the conventional financial unit per cubic meter of the mineral.

According to the list provided by the Tax Code, the tax is applied to the extraction of crude oil, natural gas, metals, non-ore minerals, processed and decorative stone, cement, barium, clays, volcanic ash, sand and other construction materials inputs, salt, gravel, precious and semi-precious stones, iodine and mineral water.

Taxpayers are required to submit their declarations monthly by 20th of the following month. The tax due is payable monthly by 20th of the following month.

## Personal income tax

Personal income is subject to the following marginal income tax rates:

Monthly taxable income	Tax rates
Up to AZN 1,000	14%
Over AZN 1,000	35% of the amount exceeding AZN 1,000 + AZN 140

**Individuals whose monthly income is less than AZN 200, are exempt from tax on the portion of their income in the amount of AZN 30.**

Foreign individuals physically present in Azerbaijan for 183 days or more during a calendar year are subject to personal income tax in Azerbaijan on their worldwide income. Those present in country for less than 183 days are subject to tax only on Azeri source income.

Virtually all forms of compensation are taxable to an employee including hardship and cost of living allowances, payments by employer for employee's child's education and payment of taxes on behalf of an employee, unless they are specifically exempted. Such an exemption includes housing allowance and employee meal paid by an employer on behalf of employees provided that no tax deduction is taken for these expenses on the profit tax return.

If a taxpayer's only income is from Azeri sources, which is subject to withholding tax at source, such taxpayer is not required to file an income tax declaration.

Residents must complete and file their income tax declarations by no later than April 15th of the following tax year. Non-residents must file their income tax declarations no later than March 31st of the tax following year. Payment of tax must be made before the filing deadline.

Employers are required to compute and withhold taxes from the salaries of all local employees and foreign employees. Taxes withheld are to be remitted to the Government immediately. Local employees and foreign employees whose taxes are withheld have no tax filing obligation.

## Interest and penalties

There are certain interest and penalties applicable for failure to comply with the tax filing and payment requirements. For example, interest on outstanding tax liabilities accrues at a rate of 0.1 percent per day. The following penalties may also be applicable:

Offence	Penalty
Failure to register as a taxpayer with the tax authorities	40 New Manat
Failure to file declarations	40 New Manat
Understatement of tax liability	25 percent of understated tax
Payments from petty cash while bank accounts are imposed tax sanctions or penalties by the tax authorities	20 percent of expenses paid from petty cash
Failure to notify tax authorities on changes in a taxpayer's registration documents	40 New Manat

The statute of limitation period for tax law violation is set to be three years.

## Simplified tax system

Companies and individual entrepreneurs that are not required to register for VAT purposes are subject to the simplified tax regime, under which tax is levied at 4% for companies and individual entrepreneurs conducting business in Baku and 2% for companies and individual entrepreneurs conducting business in the other regions of Azerbaijan. The taxable base is gross income received from sales of goods, provision of works and services. Legal entities working under the simplified tax regime are exempt from property tax.

Any taxpayer engaged in transportation of passengers and cargos (except for international transportation) will be subject to a simplified tax at established tax rates and will need to obtain what is referred to as a “distinctive number”. Taxpayers not involved in local transportation businesses and having vehicles for their own use will need to obtain a “special distinctive number” to differentiate themselves from the simplified taxpayers. Both the distinctive numbers and special distinctive numbers should be issued by the Ministry of Transportation at no cost within 2 or 5 days, respectively, after an application is submitted.

Taxpayers under the simplified tax regime submit their declarations quarterly by 20th of the following month. Tax due is payable quarterly by 20th of the following month.

The simplified tax regime is not applicable to credit and insurance organizations, investment funds, taxpayers producing excisable goods, securities' market participants, taxpayers receiving income from leasing of property and taxpayers owning property in the amount of more than approximately 1.2 million US Dollars.

Additionally, based on the most recent amendments to the Tax Code, which are effective from 1 January 2007, companies engaged in construction of apartment complexes also fall within the category of simplified tax payers. As a result such construction companies should pay a fixed amount of tax. Special rules on calculation of this tax for construction companies are expected to be introduced by the decree of the Cabinet of Ministers. Based on the currently available

information, the tax rates under this regime will vary depending on the district/ region where the construction site is located.

# Labor licensing requirements

Regardless of which tax regime a company operating in Azerbaijan is subject to, foreign employees of such company are required to have individual work permits issued by the Ministry of Labor and Social Security. The work permit is valid for one year and can be extended up to four times. After five years an individual must leave Azerbaijan for one year to be eligible for a new work permit. The management personnel of foreign companies and foreign entrepreneurs are exempt from requirement to obtain the work permits.

# Accounting and Reporting

Azerbaijani accounting system is much governed by the accounting legislation and Civil Code.

All entities registered in Azerbaijan (Azeri Legal entities, representative offices and branches) are required to maintain their books and records on the territory of Azerbaijan, in local currency, and in accordance with the Azerbaijan accounting legislation (AAL). This includes the use of a mandatory, and quite rigid, chart of accounts. In most cases this will necessitate the employment of a full-time, experienced Azeri chief accountant.

A new Law on Accounting that has been adopted recently charges the Cabinet of Ministers with the task of publishing new National Accounting Standards (NAS), which are yet to be developed. The Law stipulates that all significant entities including credit institutions, insurance companies, investment funds and commercial organizations meeting certain criteria will be subject to International Financial Reporting Standards (IFRS). Others (except for small private businesses) will have the choice of using either the IFRS or NAS. Small private business will have the right to choose between the NAS or a simplified method of accounting.

The period of transferring to the new accounting standards for significant entities and other commercial organizations is from January 1, 2008. In accordance with the Law during the transition period companies should follow the rules provided by the old accounting legislation. As such currently companies should continue using the old Law on Accounting and the statutory chart of accounts.

In practice, foreign companies participating in the various PSAs are exempted from following AAL, and are instead allowed to maintain their books in accordance with generally accepted industry practices.

## Differences between AAL and IFRS

AAL differ substantially from IFRS and generally accepted accounting principles in other countries (e.g., the United States). A summary of the most significant differences is as follows.

## Accounting policies

AAL do not require detailed disclosure of accounting policies used in the preparation of the financial statements or footnote disclosures that provide additional information, analysis and clarification of the financial statements.

## Property, plant and equipment (PPE)

Property, plant and equipment is maintained under the historical cost convention (at acquisition price or cost of production including transportation and assembly costs) as modified by the revaluation of assets. At various times since 1992, PPE was revalued in accordance with Government decrees (most recently in 1996).

Indexes used for these revaluations did not necessarily properly account for the changes in the value of Manat nor did they result in the value of the underlying fixed assets to which they were applied being revalued to a current market value. Revaluations of property, plant and equipment are generally not required under IAS and US GAAP.

## Impairment of assets

AAL does not permit the recording of an allowance against the carrying value of an impaired asset. This includes setting up an allowance for tangible assets as well as inventories, accounts receivable and other assets.

IAS requires, among other things, that long-lived assets and certain identifiable intangibles that are held and used by an entity be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. In addition, allowances may be made upon the carrying value of short-term assets (for example, accounts receivable) when it is likely that the full carrying value of the asset will not be recovered.

## **Deferred taxes**

Deferred tax assets and liabilities under IAS are recorded for the expected future tax consequences of existing differences between financial reporting and tax reporting basis of assets and liabilities, and loss or tax credit carry forwards. Under AAL rules, there are no provisions regarding deferred tax accounting.

## **Equity**

In the balance sheet of an Azeri company equity is represented by charter capital, paid-in-excess capital, reserve capital, appropriated earnings, social funds and retained earnings for the current and previous years. Deductions can be made directly from reserve funds for non-tax deductible expenses.

Under IAS, equity is generally represented only by capital stock, additional paid-in capital and retained earnings for the current and previous years.

# Ernst & Young Azerbaijan

## Introduction

Ernst & Young have been undertaking projects in Azerbaijan continuously since 1993. The Ernst & Young organization was the first of the international accounting and tax consulting networks to establish a member firm in the Republic of Azerbaijan. Our office in Baku, the capital, opened in 1994. A team of over 64 staff is led by an audit partner Jody Campbell, a Member of the American Institute of CPAs and a tax partner Erlan Dosymbekov.

## Services

Ernst & Young Azerbaijan, in conjunction with partners and staff from other members of the Ernst & Young organization, provide audit, accounting and tax consulting services to international and local clients in Azerbaijan. A number of major assignments have been undertaken in the country relating to inbound investment, enterprise and sector restructuring, and public policy.

## Business assurance

Ernst & Young has been licensed to conduct audits in Azerbaijan since 1994. During this time we have gained unparalleled experience. We currently have four auditors who have obtained the status of certified public accountant in the USA and several others currently taking the CPA and ACCA examinations. We provide US GAAP and IFRS audits for many companies including BTC, SCPC, AGSC, Garadagh Cement, BP, Statoil, State Oil Fund of Azerbaijan Republic (SOFAR), Azpetrol, Azertrans, Crescent Beach and Azeurotel to mention only a few.

We also provide audit services to numerous companies operating in Azerbaijan under production sharing agreements (PSAs). We audit the cost recovery reports and profit tax returns for all PSAs in which BP Amoco is the operating company. We also perform the audit of LukOil's PSAs and perform the profit tax return audits for numerous contractor parties which own interests in various PSAs.

Our statutory audit clients include companies such as Azeri MI, Caspian Shipyard Company and Caspian Drilling Company, all being joint ventures with the State Oil Company of the Azerbaijan Republic (SOCAR).

We also provide accounting advice and other business assurance services for foreign and Azeri companies preparing accounts in accordance with IFRS, US GAAP and UK GAAP.

## Tax and legal

Ernst & Young is recognized as the leading tax advisor in Azerbaijan. With our department combining an expatriate tax partner, Erlan Dosymbekov, with local tax manager and tax consultants, Ernst & Young advises on all aspects of corporate and personal tax planning and compliance. We have provided advice on local and international tax issues to a number of international enterprises that have made, or are considering making, investments in Azerbaijan. Our areas of expertise include international tax planning, transaction structuring, expatriate tax affairs, local tax compliance, and currency and foreign exchange planning. Our impressive client base speaks for itself. The firm has established good contacts with key state authorities and is in a position to facilitate negotiations between potential investors and the authorities. This continues to be a key service in a legislative environment that is ever changing and open to interpretation. The firm's tax practice receives technical support and a wider perspective on tax affairs in the former Soviet Union through its links with the rest of the Ernst & Young network.

# Contacts

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