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Inadmissibility of taxation of the amounts funded to the representation office from the foreign parent company

Contents

Legal opinion relating the taxation of the amounts funded to the representation office from the foreign parent company

Issues of the representation offices funding by the parent company based abroad will be covered in this document.

According to the definition set forth in Article 43.2 of the Civil Code of the Republic of Kazakhstan, the term "Representation Office" means "a separate subdivision of a legal entity which is located outside a place of its location, which protects and represents the interest of the legal entity and conducts transactions and any other legal acts on behalf of the legal entity".

Due to the absence of the status of an independent legal entity, in general the representation office cannot exercise independent business activities for purposes of making profit, and does not derive a profit consequently. In general, representation offices are incorporated to carry out auxiliary tasks and are maintained by the parent company on this purpose. The representation office receives payments from the parent company in order to finance this type of activities.

For many years the Kazakh tax authorities uphold the position that the amount of unused funds shall be taxed in Kazakhstan at the end of the tax period.

A respective explanation was published by the State Revenue Committee of the Ministry of Finance of the Republic of Kazakhstan (hereinafter referred to as the SRC MoF), where the financial resources funded to the representation offices by the parent company shall be considered as an income for taxation purposes of the corporate income tax[1](hereinafter referred to as CIT).

In this case, expenditures for the maintenance of representation offices are allowed for tax deduction. The amount of funds unused at the end of the tax period (calendar year) shall be taxable, as a representation offices' income.

Regarding the terms of the Double Taxation Agreement, Tax and Civil Codes of the Republic of Kazakhstan, and Kazakh Law "On Accounting and Financial Statements" this position of the Kazakh Ministry of Finance causes profound concerns.

In particular:

[1] Letter No. KGD-05-3-YuLE-705-KGD-8129 dated April 28, 2015 issued by the State Revenue Committee of the Ministry of Finance of the Republic of Kazakhstan.

1 NO TAX LIABILITY SUBJECT TO THE LEGISLATION OF THE REPUBLIC OF KAZAKHSTAN

Conditions to originate the taxation right in accordance with the Kazakh legislation will be reviewed further.

To generate the right of taxation it is required; inter alia, that the representation office is considered as a so called resident and as a taxpayer consequently. Finally the representation office must receive a taxable income resulted from economic activities in Kazakhstan. Only in this case Kazakhstan has a right for taxation

We believe that the representation office cannot be considered as a resident under the legislation of the Republic of Kazakhstan, therefore it is not a taxpayer.

1.1 Representation office is not a taxpayer under the Tax Code of the Republic of Kazakhstan

According to the authors, the representation office cannot be considered as a resident; therefore the representation office shall not be liable for paying the corporate income tax and net profit tax.

Pursuant to Article 81.1 of the Kazakh Tax Code (hereinafter referred to as the "Tax Code"), legal entities based in the Republic of Kazakhstan (so-called residents), and foreign legal entities (so-called non-residents) carrying out their activities in the Republic of Kazakhstan through their permanent establishment or receiving income from sources in the Republic of Kazakhstan are payers of the corporate income tax. Branches and representation offices are not directly mentioned within the norm above.
The authors join the opinion of the Kazakhstan Taxpayers Association[2] (hereinafter referred to as the KTA), where this very legal fact shall already describe that unused amounts of funding provided to the representation offices by the foreign parent company exceeding the expenses of such representation office shall not be subject to the taxation.

Therefore there are no legal reasons for exercising the taxation right.

1.1.1 Absence of a residence status of representation office in Kazakhstan

Pursuant to Article 189.5, in the context of the Tax Code, residents of the Republic of Kazakhstan are legal entities founded under the legislation of the Republic of Kazakhstan, and (or) legal entities founded under the legislation of a foreign country and having their head office(the actual management board) based in the Republic of Kazakhstan.

[2] Letter No. 728-04/15 dated April 12, 2015 "Concerning Taxation of the Representation Office Funding Amounts from the Foreign Investors" issued by the KTA.

As a head office (location of the actual management board) is considered the place of the central administration (Board of Directors or equivalent board) where fundamental entrepreneurial decisions regarding the management, administration and monitoring of the legal entity are made and implemented.

A power of attorney may be issued to the manager of the representation office certifying and restricting his/her power and authority in accordance with Article 191.4 of the Tax Code or Article 5.4 of the Double Taxation Agreement (hereinafter referred to as DTA).

Therefore, the director of the representation office is not authorized to make decisions regarding the business activities (i.e. activities to derive income) of the representation office.
Decisions regarding the economic activity are still made by the company management with its head office (parent company) based abroad, but not in Kazakhstan. So the representation office cannot be treated as a Kazakhstani resident. But this stipulation is one of the main conditions for exercising the taxation right in the Republic of Kazakhstan.

1.1.2 Permanent Establishment

In addition, the emergence of the taxation law requires the company to carry out its economic activity through a permanent establishment in the Republic of Kazakhstan.

However, it is provided by Article 191.4 of the Tax Code that activities of preparatory or auxiliary character implemented by non-residents within the Republic of Kazakhstan differing from its primary activities do not result in the formation of a permanent establishment, if the duration of performing such activity does not exceed a period of three years.

Activities of preparatory or auxiliary character can only be carried out to the benefit of the non-resident only, but not of third parties.

Preparation and supporting activities shall be defined as:

- use of any location solely for the purpose of storage and (or) demonstration of the goods owned by the non-resident;
- maintenance of a permanent place of business solely for the purpose of purchasing goods without their selling;
- maintenance of a permanent place of business solely for the purpose of collecting, processing and (or) distribution of information, advertising or exploration of the sales market of goods and products as well as works and services performed by the non-resident, if such activities are not the primary activity of the non-resident.

Thus, the representation office cannot be considered and treated as a permanent establishment if the duration of the foregoing activities does not exceed a period of three (3) years. In this case, Kazakhstan has no right for taxation.

1.1.3 Absence of the right for taxation subject to Article 191.12 of the Tax Code

Frequently the Kazakh tax authorities refer to the provisions of Article 191.12 of the Tax Code to justify the taxation of unused amounts exceeding the funding provided to the representation office from the foreign parent company.

The regulations of Article 191.12 of the Tax Code indicate that through the exercise of activities, which do not lead to the formation of a permanent establishment in accordance with the DTA or Article 191.4 of the Tax Code, the provisions for permanent establishments of the Tax Code shall be applied.

In this context and according to the letter issued by the State Revenue Committee of the Ministry of Finance of the Republic of Kazakhstan (hereinafter referred to as the "State Revenue Committee")[3], the representation office of a foreign legal entity shall be obliged to submit a tax return (Form 100.00) where it must indicate its total annual income as the funding to the representation office from the parent company and its deductive expenses.
Thereby according to the opinion of the State Revenue Committee of April 28, 2015, funds received from the parent company must be taken into account in line 100.00.04 "Other revenue" of the CIT Return. If the amount of the total annual income exceeds the tax deductions amount, the representation office must pay the corporate income tax and net profit tax[4].

Article 191.12 of the Tax Code refers to Article 217 of the Tax Code, wherein the representation office is entitled to apply the exemption of taxation in accordance with the provisions of the DTA. Further aspects for using the DTA regulations are listed in Part II hereof.
Pursuant to this standard, provisions of Article 217 of the Tax Code shall be applied accordingly.

1.2 Absence of taxable incomes

As envisaged by Article 192.1.29 of the Tax Code, other revenues of a non-resident derived from activities in Kazakhstan shall be taxable. This directly stipulates the revenue of the representation offices not forming a permanent establishment subject to provisions of the Tax Convention or the Article 191.4 of the Tax Code. As the Tax Code does not expressly provide a definition of the term "revenue", the definitions of this term stated in the Kazakh Law "On Accounting and Financial Statements" and the IFRS shall give guidance for the purposes of taxation.

[3] Reply dated March 11, 2015 issued by the Ministry of Finance to request No. 294912 dated February 24, 2015.
4 Reply issued by Mr. D.E. Yergozhin, Chairman of the State Revenue Committee to request No. 295505/1 dated April 21, 2015, http://blogs.e.gov.kz/ru/blogs/kgd/questions/296469.

Provisions of Article 192.1.29 of the Tax Code cannot be applied if the funding provided by the parent company to the representation office does not match the definition of the term "revenue" set forth in the Article 13.2 of the Kazakh Law "On Accounting and Financial Statements".

As defined in Article 13.2 of the Kazakh Law "On Accounting and Financial Statements", revenue is an increase in economic benefits during a reporting period in terms of an inflow or increase of assets or a reduction of liabilities that causes an increase in equity different from increases in equity as a consequence of contributions from individuals involved in the equity.

Based on this definition, cash inflow in terms of funding provided by the parent company within the same legal entity is no revenue, since increases in form of contributions from individuals involved in the equity are expressly excluded in the definition of the term "revenue".

Thus, funding provided by the parent company is no other revenue. Therefore it cannot be indicated among the total annual income in the Form 100.00 of the Kazakhstani tax return. Similar aspects are applicable in relation to the representation offices' expenses not related to activities targeted to generate income pursuant to Article 100.1 of the Tax Code.

2 NO TAX LIABILITY UNDER PROVISIONS OF THE DTA

Conditions for the formation of permanent establishment according to the OECD model agreement will be reviewed further. We would like to note that the DTA between the Republic of Kazakhstan and Federal Republic of Germany is used herein as a basis for a better illustration of the circumstances. The provisions of the OECD model agreement do not differ from the respective provisions of the DTA between the Republic of Kazakhstan and other countries and if so, then to a small extent only.

Background for creating a right for taxation includes, but is not limited to the fact that the representation office carries out business activities through a permanent establishment and derives income in the Contracting State. In addition, non-residents cannot experience taxation in the Contracting State that does not comply with the non-discrimination principle of the DTA.

In our opinion neither does the representation office carry out business activities; nor is it a permanent establishment. Therefore, no income is derived in the Contracting State. Besides, the taxation of funding provided by the parent company would cause an unequal treatment, which violates the principle of non-discrimination.

2.1 Representation office is not a resident according to the Tax Code

According to the authors, the representation office cannot be considered as a resident; therefore the representation office shall not be liable for paying the corporate income tax and net profit tax.

2.1.1 Representation office is not a permanent establishment under the DTA

Pursuant to Article 5.4 of the DTA, a representation office maintained solely to execute activities of preparatory or auxiliary character for the Company (parent company) cannot be considered and treated as a permanent establishment.

According to the State Revenue Committee of the Ministry of Finance, this provision is applicable regardless to the duration of the execution of activities of preparatory or auxiliary character.

As defined in Article 2.5 of the Tax Code, regulations of the DTA take precedence over the regulation in Article 194.4 of the Tax Code. So the regulations of Article 5.4 of the DTA must be applied. Moreover, as subject of Article 4.3 of the Kazakh Constitution, international agreements ratified by Kazakhstan precede over the Kazakh national law and will be directly applicable, except to the extent when the international agreement states that the legislative jurisdiction is required to ratify its application.

Thus, maintenance of the representation office solely for executing activities of preparatory and auxiliary character does not entail the foundation of a permanent establishment. Otherwise, the opposite viewpoint will directly contradict the provisions of the DTA.

2.1.2 Compliance if Article 191.12 of the Tax Code with the DTA provisions

Pursuant to Article 7.1 of the DTA, the income of a company in the Contracting State shall be taxable in that State only, unless a company executes business activities in another Contracting State through a permanent establishment based in such State. If a company implements such business activities, then the company's income may be taxable in the other state but only to the extent where it refers to such permanent establishment.

Thus, the fact that a company conducts business activities in another Contracting State through a permanent establishment based there is a requirement for income taxation in the other Contracting State.

In the case of funding the representation office by the parent company based abroad the representation office does not conduct any business activities which generate income.

According to Article 5.1 of the DTA, the term "permanent establishment" means a fixed place of business used by an enterprise[5] to implement its business activities fully or partially. The legislative definitions of the terms "representation office" and "permanent establishment" are different. According to Article 5.4 of the Tax Convention (as mentioned above[6]), a representation office is no permanent establishment.

Therefore, the provisions of Article 191.12 of the Tax Code shall not be applicable, as the DTA provisions precede the provisions of the Kazakh law.

Even if we would assume that the amounts allocated for funding the representation office can be considered as a revenue of the representation office and this revenue shall be declared, which results in the payment of the corporate income tax (which actually already contradicts Article 5.1 of the Tax Convention), then the return of the unused funding amounts from the representation office to the parent company would have to be considered as a tax deduction, reducing the total annual income of the representation office. However, the Tax Code does not provide such deduction.

2.1.3 Non-discrimination Principle

As provided by Article 24.1 of the DTA, the citizen of the Contracting State shall not be subject to any other or more oppressive taxation or related liabilities in the other Contracting State, other than taxation or related liabilities imposed or may be imposed on the citizen of such other State under the same circumstances, especially in terms of residence.

Article 81.1 of the Tax Code sets forth, inter alia, that a Kazakh residents legal entities and non-residents legal entities, operating their business activities in the Republic of Kazakhstan through a permanent establishment or deriving income from their sources based in the Republic of Kazakhstan are considered as payers of CIT. Payments of CIT by representation offices of a residents' legal entity are not intended in this case.

In addition, tax return of the corporate income tax (Form 100.00) does not forsee its submission by representation offices of the residents'[7] legal entities.

A foreign parent company which satisfies and discharges its tax liabilities abroad experiences additional tax liabilities in form of the calculation and payment of the CIT on the amounts allocated for funding the representation office in Kazakhstan.

This approach of the tax authorities results in a double taxation (first abroad at its head offices' country and second – at the location of the representation office funded by the parent company (Kazakhstan)) and is considered a double charge compared to the charge

[5] Enterprise's "business" activity is clearly and expressly mentioned in the Russian version of the Tax Convention.
[6] See the Part II No. 1 above.
[7] Attachments No. 1 and 2 to the Decree No. 58 dated December 25, 2014 issued by the Minister of Finance of the Republic of Kazakhstan.

on local enterprises whose offices are not subject to separate taxation, which finally is a direct violation of the non-discrimination principle of the DTA.

The understanding of the Kazakh tax authorities for taxation of the amounts provided by the parent company for funding the representation office is a direct violation of the provisions of Article 24.1 of the DTA.

2.2 A possibility for applying the Article 217 of the Tax Code

As mentioned above, the Kazakh tax authorities do not argue the fact that under Article 217 of the Tax Code, the representation office is entitled to apply the provisions of the Tax Convention in terms of exemption of taxation.

According to Article 217 of the Tax Code, a non-resident (an entity of no fixed place of business, or registered office, or efficient management in the Republic of Kazakhstan) is entitled to demand a refund of the income tax in accordance to the provisions of the DTA, if such non-resident conducts its business activities in the Republic of Kazakhstan through its branch or representation office without founding a permanent establishment subject to the DTA.

This constitutes evidence of the fact that the income of a non-resident without a permanent establishment is no subject to the CIT according to the provisions of the DTA[8].

In this case, it is unreasonable and illegal to submit a tax return and pay the CIT to the state budget on the amounts of funding the representation office allocated by the parent company based abroad.

Pursuant to the DTA, the CIT must not be paid to the state budget, as no business activity was performed in Kazakhstan, and no income derived accordingly.

3 Conclusion

In consideration of the foregoing, it has to be concluded that the understanding of the tax authorities based on the provisions of Article 192.12 of the Tax Code (wherein the amounts of funding the representation office allocated by the foreign parent company are considered as taxable income of the representation office) contradicts the DTAs' provisions.

The position of the tax authorities has not changed, prior to developing this document. Tax-payers funded by international and foreign organizations have been imposed an additional obligation to present the accounts and statements[9]. This issue will not be covered further in this document, as such reporting obligation is a matter of concern for

[8] A case in point is the CIT, but not the withholding tax.
[9] Regulated by the Articles 14, 20, 77, 557, and 627 of the Tax Code and Decrees No. 553 and No. 554 dated October 19, 2016 issued by the Minister of Finance.

entities involved in certain types of activities only (e.g.: legal support, public opinion research, data collection, analysis and distribution).

If the tax authorities put the amounts of funding to the representation office as a part of the total annual income of the representation office, it is recommended to appeal such decisions in court, besides it is recommended to initiate a mutual agreement procedure subject to Article 25 of the DTA.

Along with that, in order to avoid risks and disputes, it is considered reasonable to account the unused amounts of funding as advance payments. In this case, refunding of unused funding amounts accounted as advance payments from the representation office will not entail any tax liabilities.

Consequently we can conclude that the legal proposition of the Kazakh tax authorities causes double taxation de facto, particularly in relation to German companies operating in Kazakhstan through representation offices. It is necessary to counteract such illegal legislative and administrative practice by referring to the responsible Kazakh ministries.

Due to this reason, it is proposed to revise the administrative acts and deeds[10] expired on January 01, 2009, and update them with clear guidelines for their use in terms of inadmissibility of the taxation of amounts funded to the representation offices from foreign companies.

[10] Joint Decree issued by the Minister of Finance of Kazakhstan No. 643 dated December 02, 1999 and by the Minister of the State Revenue of Kazakhstan No. 1478 dated December 02, 1999 "On Approval of the Instruction for established using the Conventions (Agreements) for the double taxation avoidance and prevention of fiscal evasion for income and capital (assets) between the Republic of Kazakhstan and foreign countries".