Tax & Legal Alert

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Will Armenia have a new tax code?

The Government has prepared a draft tax code to consolidate current tax laws. Decree No. 477-A (12 June 2009) establishes the members of a working group to discuss the draft.

This Alert discusses some proposed changes. However, whether the code will proceed remains uncertain.

For more information, please contact one of the individuals identified below.

Big tax changes proposed

The Government has prepared a draft tax code that aims to consolidate all tax laws into a single tax code. Part 1 of the Code was introduced into Parliament last year, while the Special Part was recently made available for public comment. An Appendix to the draft is not yet available.

The draft code proposes significant changes to Armenian tax rates:

	Current	Proposed
Profit tax rate	20%	26%
Services performed in Armenia by foreign companies with no formal presence in Armenia	10%	26%
Value-added tax	20%	18%
Personal tax	AMD 30,000 exemption for Armenian nationals; First AMD 80,000 per month taxed at 10%; Excess taxed at 20%.	26%
Social tax on Armenian employees	3%	Nil
Social tax on employers	AMD 7,000 + 15% of income between AMD 20,000 and AMD 100,000 per month + 5% on excess over AMD 100,000 per month	Nil
Petrol and diesel fuel, cigarette production, and other activities subject to presumptive tax	Presumptive tax	Normal tax

Our comments: Armenia would clearly benefit from more transparent policy development processes. A copy of first part of the draft tax code can be found on the Parliament website, while the special part can be found on the Ministry of Finance website. There does not appear to be any public document explaining the text and changes, so it is necessary to track the document back against existing laws to identify the proposals, which requires a significant investment of time. Given the nature of the proposals, one might have hoped for a bit more effort in engaging the business community in discussions at an earlier stage of the process.

There are some issues that need to be addressed concerning the rate changes. The problem in increasing the profit tax rate is one of competitiveness and investor perception. Russia reduced its corporate tax rate from 24% to 20% at the start of this year. Georgia has a corporate tax rate of 15%, while Azerbaijan's rate is 22%. Kazakhstan reduced its rate from 30% to 20% at the start of this year, and will reduce the rate to 15% by 2011.

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Armenia has more restrictive rules on deductibility than its neighbours. The government has recently proposed to allow the tax authorities to station officials permanently in the premises of some taxpayers. Overall, the picture for potential investors is not encouraging.

An increase in the withholding tax rate on services may also become a major deterrent to foreign entities transacting with Armenia. In many cases, such services should be relieved from Armenian tax, either because the income does not have a source in Armenia or because it is relieved from tax under a relevant treaty. In practice though, it can be a challenge to have the source rules applied correctly, and the process for confirming treaty relief is not always friendly, so many local companies are just treating the 10% withholding tax as a cost of transacting with non-residents – painful but bearable. If the rate is increased to 26%, it will be a huge burden for a local company to bear as a cost of transacting with foreign entities – not to mention the potential cost of reverse charge VAT for companies not entitled to claim VAT input tax.

> The government needs to take a closer look at whether Armenia can risk doing without foreign investment before imposing such onerous taxes.

The change in personal taxes and social security is more understandable. Without a separate charge for social security, the "tax" cost of employing staff will be more easily calculated. However, Armenia needs to ask whether it wants to have expatriates based in the country and making their skills and expertise readily available. Currently, foreign nationals are not subject to mandatory social security contributions, so the effect of the tax code would be to increase their tax burden from 20% to 26%. As a result it may make more sense to base expatriate personnel in countries with less tax burden and have them provide assistance to Armenia remotely.

The draft tax code also misses some opportunities; the draft could go further to address some of the design weaknesses in existing rules. For example, the normal approach for VAT under international rules is that:

- Once a taxpayer exceeds a certain threshold for taxable transactions in the previous 12 months, the taxpayer is required to register for VAT and has to account for VAT until such time as the taxpayer deregisters. The entitlement to deregister is normally based on expected future revenues.
- Because all sales by a registered person are subject to VAT, special rules normally deal with the credit that a new VAT-payer may claim relating to expenses incurred before registration.
- When a taxpayer deregisters, a deemed supply ensures that VAT is paid on any goods and assets that remain in the business when the taxpayer deregisters.

Under Armenia's current rules, taxpayers generally become subject to VAT if their revenues for the previous calendar year exceed AMD 57.35 million, or once their sales in the current year exceed AMD 57.35 million. If their sales for the previous year are less than AMD 57.35 million, the taxpayer becomes a non-VAT payer unless the taxpayer makes a voluntary election to remain as a VAT payer.

> There are still no rules dealing with VAT incurred before becoming registered while the owner can take a 20% benefit on goods retained when sales fall below the registration

The other problem with the registration rules is that Armenia applies the threshold not only to taxable transaction but to the taxpayer's full sales base. This leads to the ridiculous situation that a taxpayer making entirely (or almost entirely) VAT-exempt sales is required to register for VAT and to file VAT returns every quarter. There is no point in imposing such compliance costs on taxpayers.

The draft tax code suggests a new turnover threshold of AMD 50 million, but does not address any of the weaknesses in the current registration rules.

Will a tax code be enacted? This is the multi-million dram question. The indication is that that Part 1 may not have been well received. Faced with an incomplete tax code, Parliament's Agency on Analysing Legislation commented that it was impossible to completely assess the likely effect of the proposed provisions, before explaining in detail why the drafting in some provisions was flawed and the use of defined terms inconsistent in others.

Many of the Agency's comments have merit. The question now is what effect the report may have on Parliament's confidence in the drafting, and willingness to enact, a tax code.

Armenia may or may not have a new tax code in 2010 (or 2011). In any case, the business community needs to be mindful that big changes may be on the way.

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