# Azerbaijani practice of taxing cross-border digital supplies: Needs for Improvement

**By:**

Rashad Abbasov

November 28, 2020

Technological progress and trade liberalization dramatically increased electronic trade and opened new chapter for the businesses to remotely supply services and intangibles to the customers anywhere around the world. Such rise of e-trade and emergence of global economy created new challenges for the policy makers in applying goods and services tax (GST) on cross-border business to consumer (“B2C”) transactions.

The issues to be addressed for consumption taxation of global B2C transactions may be broadly grouped into 3 categories (i) allocation of taxing rights among the jurisdictions (ii) finding suitable collection mechanism and (iii) agreeing on common treatment of digitalized products for consumption tax purposes (i.e. whether they should be treated as services or goods).

Since economic burden of consumption taxes is on the ultimate consumer, the jurisdiction where final consumption takes place charges the GST.  Historically, the determination of place of consumption for B2C transactions were relatively straightforward as traditional supplies involved the services that could be reasonable expected to be consumed in the jurisdiction where the supplies were made[1]. Consequently, many countries treated place of supply as the place of consumption. Technological advancements achieved over the last two decades enabled vendors to provide remote supplies to any jurisdiction. This created a necessity to harmonize the place of supply rules globally to avoid double taxation and double non-taxation.

Traditionally, suppliers collected GST by charging this tax to the customers and remitting to government. This conventional collection mechanism cannot be applied when supplier has no tax registration in the jurisdiction where final consumer resides. In cross-border business to business (“B2B”) transactions where supplier has no tax registration in customer’s jurisdiction, tax administration can collect GST through self-assessment, i.e. a system called reverse-charge mechanism. This mechanism, however, is not capable to provide a meaningful solution for B2C supplies as it needs to be backed by enforcement costs of which would easily outweigh the revenue raised. Thus, such enforcement could involve collection of insignificant amounts from a mass of private recipients.

Also, common treatment of electronically supplied/transmitted digital products which are on-line deliveries, e.g., of music, e-books, films, software and video games also needed to be agreed.

**Global attempt to provide a solution - OECD Guidelines**

These challenges for VAT/GST aspects of the international e-trade was one of the topics to be addressed at Ottawa 1998 Conference where Committee of Fiscal Affairs (“CFA”) published Ottawa Taxation Framework Conditions which have since been generally accepted by most countries as a basis for ongoing work on the taxation of e-commerce.[2]

The OECD CFA launched the project to develop the international VAT\GST

Guidelines (the “Guidelines”) in 2006 which were completed in 2015. In 2015, at the 3rd meeting of the Global Forum on VAT, the Guidelines were endorsed as a global standard for the VAT treatment of international trade in services and intangibles.

The Guidelines reiterated destination principle for place of taxation rules and provided two general rules in this regard:

- **Place of performance** for the so called “on-the-spot services”. Briefly, these services are ordinarily performed at readily identifiable place where both the supplier and consumer are present at the time of supply.
- **Customer’s usual residence** for any other services and intangibles.

This general rule effectively allocated the taxing rights over B2C supllies to the jurisdiction where it can reasonably be assumed that the final consumer is actually located when consuming the supply.

As to the collection mechanism, the Guidelines recommended registration-based collection mechanism as the most effective and efficient approach to ensure appropriate collection of VAT on cross-border B2C supplies.[3] This mechanism requires the non-resident supplier to register and account for the VAT in the jurisdiction of taxation. For the purpose of consumption taxes, OECD concluded that the supply of digitized products should not be treated as a supply of goods.

### Taxation of cross-border B2C transactions in Azerbaijan

Azerbaijan just recently followed the suit in imposing VAT on cross-border B2C transactions. Azerbaijani Parliament passed amendments to the Tax Code (“TC”) that allowed for the taxation of online supplies made to local customers effective from 2017. The Amendments were introduced to boost the revenue amid of two devaluations local currency faced in 2015 losing more than half its value against the United States dollar.

The Amendments targeted only supplies made by non-residents to local customers being private consumers with no tax registration. Cross-border B2B transactions were outside the scope of the amendments as local (tax)

registered businesses accounted for VAT under reverse-charge mechanism. Similarly, Amendments did not cover taxation of goods purchased through e-trade as goods so acquired were subject to border control and VAT, if applicable, may be collected during the customs clearance.

As a general rule, Azerbaijani VAT applies only if the supplly made in the territory of Azerbaijan. So, the Amendments must have targeted place of supply rules first in order to tax online sales. In this regard, separate subparagraph to article 168.1.5 of the TC which governed the place of supply rules were introduced. As a result, in the context of private customers the place of supply of services (works) provided by suppliers of e-trade, as well as lotteries, races, competitions organized online could be considered place where the purchaser is based (located) or registered. Article 168.1.5 this article was initially designed to cover purchases made by local businesses (tax registered entities) for which VAT is paid under reverse-charged mechanism and the services provided to non-residents as these services are considered to be export of services subject to VAT at 0% rate. The TC provides no further clarifications with respect to “place of location” or registration of the customer.

As the TC does not define what is considered rendition of services (works) by sellers (suppliers) of e-trade, both services purchased electronically from non-residents and delivered in person by local tax payers as well as services purchased and supplied electronically are covered. The TC also fails to differentiate between digital supply of services, intangibles and goods.

The TC, however, provides which services (works) supplied electronically would not subject to VAT – namely, hotel services and services on air ticket orders supplied outside Azerbaijan are not covered. Article 169.3 of the TC imposes VAT on the amounts paid by non-registered persons to non-residents without VAT registration for the services (works) supplied electronically. The subparagraph goes on further stating that local banks or Azerbaijani branches of foreign banks processing payments shall deduct VAT from the customer’s funds and shall remit it to the budget. As it is seen, the TC effectively obliges intermediary local banks to shoulder the burden of collecting and remitting VAT on cross-border B2C transactions.

## Needs for improvement

Current legislative framework in Azerbaijan needs to be improved in order to provide more detailed regulations for taxing digital supplies. Most importantly, an alternative collection mechanism shall be put in place. While using local banks as intermediaries made it possible to implement taxation of digital supplies within a very short period of time, it clearly cannot offer proper solution in the long run as it has substantial weaknesses.

First of all, existing collection mechanism imposes significant compliance burden and cost on the third parties as local banks are liable to compute, collect and remit the VAT to the government. Banks already sustained significant start-up costs to develop suitable IT solutions so that they can identify taxable e-supplies, compute and collect due VAT. They also need to periodically incur further expenditures to support these solutions.

Also, current mechanism cannot subject all digital supplies to VAT as tax can only be collected if the local banks process the payment, for example payments using debit or credit cards issued by any of the local banks. Consequently, the following purchases do not suffer VAT:

- **Purchases via digital wallets** (Google Pay, Amazon, PayPall, etc). In such a case, individuals will, however, suffer 10% tax in depositing money from their local bank accounts into their overseas e-wallet accounts as money transfers to the accounts in e-wallets maintained with non-residents was subjected to 10% withholding tax[4]. Nevertheless, the consumer using e-wallets will be better of with 8% less cost as standard rate VAT is charged at 18%.
- **Purchases made from overseas bank accounts.** This may encourage local individuals opening bank accounts with the foreign banks and use these accounts to purchase digital supplies. Therebefore, there are some concerns that local banks may lose some of their customers.
- **Cash Settlements.** One can effectively sidestep of VAT if he/she selects to settle the transaction in cash[5]. This is another side effect of current collection mechanism in that it creates incentive for cash settlements.

Intermediary based collection mechanism also leads to arbitrary application of VAT resulting in double taxation. Local banks do not have sufficient information to identify whether or not given transaction/payment is subject to Azerbaijani VAT.  Consequently, in most cases services supplied and consumed overseas which already includes VAT of the jurisdiction where supply takes place additionally suffer Azerbaijani VAT. Poorly drafted laws also contributed in part to such double taxation. The TC needs to be further developed in order to address the following issues:

- **Definition of digital supplies** - The TC needs to provide clear definitions in order distinguish digital supply of services (works), intangibles and goods. For example, TC does not provide meaningful guidance whether supply of digitalized products (e-books, music, etc) shall be treated as supply of goods, services or intangibles.
- **Determination of place of customer's location –**TC needs to be more detailed guidance how to determine customer's location. If registration-based mechanism is used, the service providers need to know whether or not they need to collect Azerbaijani VAT from a particular supply. As the best practice, the following ties may be used to connect a customer's location to Azerbaijan for a particular supply:
    - An Azerbaijani based intermediary (banks, financial institutions, etc.) is used to make a payment.
    - The customer's phone number or address is in Azerbaijan.
    - An Azerbaijani IP address is used.

- **Elimination of double VAT –** Under the TC, consumption of Azerbaijani based individuals on on-the-spot services overseas are still be considered supplied in Azerbaijan for VAT purposes.  Only transportation services purchased overseas is considered supplied outside Azerbaijan as the place of supply of these services is the place where transportation starts. For any other on the spot-services the place of supply rules treats services being supplied in Azerbaijan as customer is based in Azerbaijan. The TC needs to explicitly provide that services (works) supplied and consumed overseas shall not be subject to local VAT.

In the application of the TC, the tax administration also needs to provide the level playing field both for the digital supplies purchased from non-residents

and from local businesses. For example, passenger transportation services ordered from local businesses suffers no VAT. Local suppliers providing passenger services is subject to simplified taxation[6] under which no VAT is charged. However, the same services, if ordered from non-residents via online platforms using local bank cards, is subjected to VAT.

All the shortcomings associated with the present collection mechanism may be eliminated if registration-based collection mechanism substitutes the current one. This will require the non-resident supplier to register and account for the VAT in Azerbaijan. Azerbaijan should further follow the OECD's recommendation in establishing a simplified registration and compliance regime for the nonresident suppliers. Such mechanism will release local banks from the burden of collecting VAT and associated costs as well as will broaden the tax base as it will enable to collect VAT from all taxable supplies irrespective of the payment methods.

In addition, existing legislative framework of taxation of digital supplies also needs to be developed to provide clear guidance for the non-resident suppliers, to eliminate double taxation and to provide an even treatment for traditional and digital supplies.

---

[1] OECD (2017), International VAT/GST Guidelines, Paris, page

[2] OECD (2001), Taxation and Electronic Commerce – Implementing the Ottawa Taxation Framework Conditions, OECD, Paris, page 64.

[3] Section 3.131 of the Guidelines

[4] As a result of the amendments made to article 125.1 of the TC, as of 1 January 2017 Azerbaijan started to apply 10% withholding tax on money transfers from Azerbaijani bank accounts into digital wallets. As a general rule, withholding tax is applied to the income derived from Azerbaijani sources by nonresidents. Subjecting money transfers to the e-wallet balance to 10% withholding tax is arguable as article 13.2.16 of the TC (which provides the source rules) does not explicitly treat money transfers from local bank accounts to e-wallet balances as income derived from the sources within Azerbaijan.

[5] Typically, such transactions involve the services ordered online and delivered in person, for example passenger transportation services ordered via various online platforms (Uber, Bolt, etc). Customer may select either card payment or cash settlement. If card payment method is selected, money is transferred directly from the customer’s card account to the overseas bank account of the platform owner. Since payment is made using local bank account, the banks can collect 18% when process the payment.

[6] Under this taxation regime

View online: Azerbaijani practice of taxing cross-border digital supplies: Needs for Improvement

Provided by Afronomicslaw