Consultation Paper

AFSA-P-CE-2021-0001

Substantial Presence Rules in the AIFC

Restricted

August 10, 2021

Introduction

Why are we issuing this Consultation Paper (CP)?

1. The Astana Financial Services Authority (AFSA) has issued this Consultation Paper to seek suggestions from the market on the proposed Substantial Presence Rules in the AIFC. This consultation has been approved by the Legislative Committee of the Board of AFSA.

Who should read this CP?

2. The proposals in this paper will be of interest to international tax authorities or organisations, relevant government bodies, tax and law firms and AIFC participants.

What are the next steps?

3. We invite comments from interested stakeholders on the proposed Economic Substance Rules. Comments should be preferably provided in writing and sent to the address or email specified below. If sending your comments by email, please use "Consultation Paper AFSA-P-CE-2021-0001 in the subject line. You may, if relevant, identify the organisationyou represent when providing your comments. The AFSA reserves the right to publish, including on its website, any comments you provide, unless you expressly request otherwise. Comments supported by reasoning and evidence will be given more weight by the AFSA.

4. The deadline for providing comments on the proposed framework is **10 September 2021**. Oncewe receive your comments, we shall consider if any refinements are required to this proposal.

5. Comments to be addressed by post:

   Policy and Strategy Division (Attention: M Ishaq Burney, MD and CLO)
   Astana Financial Services Authority (AFSA)
   55/17 Mangilik El, building C3.2, Kazakhstan

   or emailed to: consultation@afsa.kz

   Tel: +8 7172 613741

Structure of this CP

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Background

1. The OECD/G20 Inclusive Framework on Base Erosion and Profit Shifting (BEPS) brings together over 139 countries and jurisdictions to collaborate on the implementation of the BEPS Package. The BEPS Package provides 15 Actions that equip governments with the domestic and international instruments needed to tackle tax avoidance, improve the coherence of international tax rules and ensure a more transparent tax environment.
2. In January 2017, Kazakhstan joined the Inclusive Framework on BEPS under which it commits to comply with the four minimum standards contained in OECD Action 5 (Harmful tax practices), Action 6 (Treaty abuse), Action 13 (Transfer pricing documentation), and Action 14 (Dispute resolution).
3. Action 5 is one of the four BEPS minimum standards which all Inclusive Framework members have committed to implement. One part of the Action 5 minimum standard relates to preferential tax regimes where a peer review is undertaken to identify features of such regimes that can facilitate base erosion and profit shifting, and therefore have the potential to unfairly impact the tax base of other jurisdictions.
4. To comply with the standard of Action 5 (Harmful Tax Practices) and prevent tax base erosion and profit shifting, the AIFC is to implement the “substantial presence” requirements.

Benchmarking

5. The AFSA has conducted best practice analysis of several no or only nominal (noon) tax jurisdictions as well as financial centers with relevant taxable income recognition practices. The Economic Substance Rules of the UAE, Cayman Islands and the Crown Dependencies were studied along with certain practices of Hong Kong, Malaysia and Thailand, respectively.
6. The analysis showed that approaches adopted across noon jurisdictions are somewhat similar and are based on the following principles:
   - Economic Substance Test applies to all legal entities that are resident for tax purposes unless they are tax resident elsewhere
   - A company must carry out “relevant activities”, which include banking business, distribution and service centre business, financing and leasing business, fund management business, headquarters business, holding company business, insurance business, intellectual property business, shipping business. Investment funds are excluded from this list.
   - Relevant entities must conduct their core income generating activities in their respective jurisdictions.
   - Relevant entities must be directed and managed in their respective jurisdictions
   - Relevant entities must have adequate employees, expenditure and physical assets. There appears to be a move to provide clarity on what criteria is used to determine if such indicia are adequate.

Proposal

7. The proposal is to enact AIFC Rules on the substantial presence of the Centre Participants applying tax incentives for the payment of corporate income tax, value added tax (the “Substance Rules”).

   The Substance Rules will apply to the AIFC participants’ income derived from the tax-exempt services. An AIFC participant will be recognized as substantially present on the territory of the AIFC if it simultaneously fulfills the following conditions:

   a) Core Income Generating Activities (“CIGA”) are provided from the territory of the Centre. The CIGA are the activities specified in the license of the Centre Participant and established by paragraph 3 of Article 6 of the Constitutional Law and (or) Chapter 3 of the List of Financial Services.

   b) has an adequate number of operating expenditures, for which the coefficient of direct expenses is equal or more than the size of the coefficient of direct income;

   c) has an adequate number of qualified full-time personnel, for which the coefficient of expenses for qualified personnel is equal or more than the size of the coefficient of direct income;

   d) lack of outsourcing / subcontracting of the types of work directly related to the CIGA outside the Republic of Kazakhstan.

8. All tax exempt AIFC participants shall be subject to the economic substance test, as they would all be “residents” of the AIFC for tax purposes.

9. Since the State Revenue Committee, Kazakhstan’s tax authority, will be responsible for implementation of the rules, it is important that the rules have straightforward and unequivocal meaning. Therefore, the Substance Rules are based on formulas rather than principles to provide such clarity to the AIFC participants and the relevant tax authorities.

10. In light of the change in international business practices brought by the pandemic most of the jurisdictions had to temporarily waive the “directed and managed” test to meet the economic substance requirement. With the effects of the pandemic still remaining in the economies and communities, it was decided not to introduce this requirement at this stage of the development of the rules. The Substance Rules were developed after consultation with the international tax organisations like OECD and the tax authorities in other leading financial centres.

11. We expect that the relatively lower cost of operations and availability of highly qualified staff at reasonable wages in Kazakhstan may assist in meeting qualified personnel requirements.

12. An example of calculating the coefficients required by the suggested Economic Substance rules is provided by way guidance in the annex to the Substance Rules to provide clarity on application of the formulas and the acceptable coefficients contained in the draft rules.

Questions

13. The AFSA invites targeted stakeholders to provide their comments on the attached **Rules on the substantial presence of participants in the AIFC applying tax incentives for the payment of corporate income tax, value added tax**. We set out some of the questions of interest below:

Question 1. Should all AIFC Activities be subject to the Substance Rules, or should some activities be excluded? If so, which activities and why?
Question 2. The AIFC notes the problems faced by firms in being able to demonstrate the "directed and managed" test particularly in light of the prevailing global pandemic conditions. The AIFC has adopted a specific formula to demonstrate adequate substance. Are the criteria proposed appropriate to the operations of AIFC firms?
Question 3. Does your business expect the consequences of the prevailing global pandemic to affect its ability to comply with the proposed rules?
Question 4. If you are (potentially) an international business, how would the proposed requirements compare to economic substance requirements in other jurisdiction(s) where your business resides / plans to operate from?

Annex 1. Economic Substance Rules

Rules on the substantial presence of participants in the Astana International Financial Centre applying tax incentives for the payment of corporate income tax, value added tax

Chapter 1. General Provisions

1) These Rules on the substantial presence of participants in the Astana International Financial Centre (the "Centre") applying tax benefits for the payment of corporate income tax, value added tax ("Rules") are developed on the basis of clause 6 of theList of financial services provided by the participants of the Centre exempted from the payment of corporate income tax, value added tax approved by the joint order of the Governor of the Centre dated May 26, 2020 No.126, the Minister of Finance of the Republic of Kazakhstan dated May 29, 2020 No.547 and the Minister of National Economy of the Republic of Kazakhstan dated June 12, 2020 No.118 ("Listof financial services").

2) The rules apply to the participants of the Centre and are mandatory for them in the case of the latter Clauses 3 and (or) 8-2 of Article 6 of the Constitutional Law of the Republic of Kazakhstan dated December 7, 2015 "On the Astana International Financial Centre" ("Constitutional Law").

3) For the purposes of applying the Rules, the basic concepts provided by the Constitutional Law, joint orders, as well as other regulatory legal acts of the Republic of Kazakhstan are used in the part that does not contradict the Constitutional Law.

4) The concepts of tax, civil and other branches of the legislation of the Republic of Kazakhstan, used in the Rules, shall be applied in the meaning in which they are used in these branches of the legislation of the Republic of Kazakhstan, unless otherwise provided by the Rules and the Constitutional Law.

5) Provisions on the fulfilment of tax obligations not established by the Rules are governed by the Code of the Republic of Kazakhstan on taxes and other obligatory payments to the budget (the Tax Code), as amended from time to time, of the Republic of Kazakhstan.

6) If violations of the provisions of these Rules are revealed based on the results of a tax audit or tax monitoring, the amount of corporate income tax will be additionally charged by the state authority responsible for collection of taxes and other obligatory payments to the budget (Tax Authority) in the manner and terms established by the Tax Code of the Republic of Kazakhstan.

Chapter 2. Requirements for substantial presence on the territory of the Centre

7) A participant of the Centre is recognized as substantially present on the territory of the Centre if participant simultaneously fulfils the following conditions:
    a) Core Income Generating Activities ("CIGA") are provided from the territory of the Centre. The CIGA are the activities specified in the license of the Centre Participant and established by paragraph 3 of Article 6 of the Constitutional Law and (or) Chapter 3 of the List of Financial Services.
    b) with an adequate number of operating expenditures, for which the coefficient of direct expenses is equal or more than the size of the coefficient of direct income;
    c) with an adequate number of qualified full-time personnel, for which the coefficient of expenses for qualified personnel is equal or more than the size ofthe coefficient of direct income;
    d) lack of outsourcing / subcontracting of the types of work directly related to the CIGA outside the Republic of Kazakhstan.

8) The authorized body individually analyses on a case-by-case basis whether the number of qualified full-time personnel is adequate to the level of activity carried onin the Centre and the amount of operating expenditure is adequate to the level of activity carried in the Centre.

9) When conducting a tax audit, the Tax Authority analyses the compliance of the coefficients of direct costs and expenses for qualified personnel working full-time with the coefficient of direct income in accordance with these Rules.

Chapter 3. The procedure for determining the coefficient of direct expenses

10) The coefficient of direct expenses is determined as the ratio of direct expenses to the total amount of expenses according to the following formula:
$К_{ПР} = Р_п / Р_В$,
where:
$К_{ПР}$ *– coefficient of direct expenses*
$Р_п$ *– direct expenses*
$Р_В$ *– total amount of expenses*

11) The following expenses of a participant of the Centre directly related to the implementation of CIGA on the territory of the Centre are recognized as **direct expenses (*$Р_п$*):**

   1) expenses related to the maintenance and provision of an office on the territory of the Centre, in which workplaces are equipped and the participant of the Centre provides the services provided for in paragraph 3 of Article 6 of the Constitutional Law and (or) Chapter 3 of the List of Financial Services;

   2) expenses for employees, reflected in the Declaration on individual income tax and social tax of a legal entity - a participant of the Centre, as income of such employees, taxes and social payments for which, in accordance with the legislation of the Republic of Kazakhstan, are subject to transfer or payment atthe location of the Centre;

   3) depreciation deductions, determined according to accounting data, calculatedfor assets used in the provision of services provided for in paragraph 3 of Article 6 of the Constitutional Law and (or) Chapter 3 of the List of Financial Services;

   4) other expenses for the purchase of goods, supplies, works, services used in the provision of services provided for in paragraph 3 of Article 6 of the Constitutional Law.

12) The **total amount of expenses ($Р_В$)** is determined in the amount of the total amountof expenses for the reporting period, reflected in the financial statements of the legalentity - participant of the Centre.

Chapter 4. The procedure for determining the coefficient of expenses for qualified personnel

13) The cost ratio for qualified personnel is defined as the ratio of the cost of qualified full-time personnel to the total cost of all personnel using the following formula:

$К_{РП} = Р_{КП} / Р_{ВП}$,
where:
$К_{РП}$ *– coefficient of expenses for qualified full-time personnel*
$Р_{КП}$ *– expenses for qualified full-time personnel*
$Р_{ВП}$ *– the total cost of all staff*

14) **Expenses for qualified full-time personnel ($P_{КП}$)** are the expenses of a participantof the Centre in part related to the CIGA incurred by:

1) full-time employment contracts concluded with employees, and reflected in the Declaration on individual income tax and social tax of a legal entity - a participant of the Centre as income of such employees, taxes and social payments for which, in accordance with the legislation of the Republic of Kazakhstan, are subject to transfer or payment at the location of the Centre;
2) contracts for the provision of personnel concluded with residents or non-residents carrying out activities in the Republic of Kazakhstan through a permanent establishment;
3) contracts of a civil nature, the subject of which is the provision of services, performance of work concluded with individuals, and reflected in the Declaration on individual income tax and social tax of a legal entity - a participant of the Centre as income of such individuals, taxes, and social payments on which, in accordance with the legislation of the Republic of Kazakhstan, are subject to transfer or payment at the location of the Centre.

15) **The total amount of expenses for all personnel ($P_{ВП}$)** is determined in the amountof the total expenses of the Centre participant for employee benefits (including, butnot limited to, salaries, income in kind and in the form of material benefits) for the reporting period, reflected in the financial statements of legal entity - participant of the Centre.

Chapter 5. Procedure for determining the coefficient of direct income

16) The coefficient of the direct income is defined as the ratio of direct income to the total amount of income using the following formula:
$К_Д = Д_П / Д_В$,
where:
$К_Д$ *– coefficient of direct income*
$Д_П$ *– direct income*
$Д_В$ *– the total amount of income*

17) Direct income ($Д_П$) is recognized as income specified in paragraph 3 of Article 6 ofthe Constitutional Law and received from activities from the provision of financial services on the territory of the Centre in accordance with agreements (contracts / transactions) concluded by a participant of the Centre on the territory of the Centre.

18) The total amount of income ($Д_В$) is determined in the amount of the total amount of income for the reporting period, reflected in the financial statements of the legal entity - participant of the Centre.

Chapter 6. Procedure for applying the Rules

19) The bodies of the Centre, if questions arise regarding the application of the Rules that are not regulated by the Rules, have the right to the extent that does not contradict the Constitutional Law and the provisions of the current Rules:

1) to make changes and additions to the Rules in agreement with the state bodyin charge, as well as, within the limits stipulated by the legislation of the Republic

of Kazakhstan, cross-sectoral coordination in the financial sector (if necessary);

2) within the competence, to clarify and give comments on the application of these Rules;
3) to adopt acts related to the application of the Rules, as agreed by the state body in charge, as well as, within the limits stipulated by the legislation of the Republic of Kazakhstan, cross-sectoral coordination in the financial sphere.
4) to provide assistance to the participants of the Centre and applicants by holding seminars, meetings, in obtaining information on a free basis through Internet resources, posting information using media, information stands, booklets and other printed materials, as well as video, audio and other technical means used to disseminate information.

Example of calculating indicators

The AAA company, a participant of the Centre, providing brokerage and (or) dealer, underwriting services, at the end of the period has the following financial indicators:

1) the total amount of income ($Д_В$) - 40,000,000 tenge, including:

- direct income received from activities on the territory of the Centre ($Д_П$) - 20,000,000 tenge;

2) the total amount of expenses ($Р_В$) - 8,000,000 tenge, including:

- the total amount of expenses for all personnel ($Р_{ВП}$) - 4,000,000 tenge;
- direct costs ($Р_П$) - 4,000,000 tenge, of which:
- expenses directly related to the implementation of activities on the territory of the Centre, excluding staff costs - 2,000,000 tenge;
- expenses for qualified personnel ($Р_{КП}$) - 2,000,000 tenge.

Based on the available data, we calculate the required indicators:

3) the coefficient of qualified expenses ($К_{ПР}$) is (paragraph 10 of the Rules):

$К_{ПР} = Р_п / Р_В$,
where:
$К_{ПР}$ *– coefficient of direct expenses*
$Р_п$ *– direct expenses*
$Р_В$ *– total amount of expenses*

$К_{ПР}$ = 4,000,000 / 8,000,000 = 0.5

4) the coefficient of expenses for qualified personnel ($К_{РП}$) is (paragraph 13 of the Rules):

$К_{РП} = Р_{КП} / Р_{ВП}$,
where:
$К_{РП}$ *– coefficient of expenses for qualified full-time personnel*
$Р_{КП}$ *– expenses for qualified full-time personnel*
$Р_{ВП}$ *– the total cost of all staff*

$К_{РП}$ = 2,000,000 / 4,000,000 = 0.5

5) the coefficient of direct income ($К_Д$) is (paragraph 16 of the Rules):

$$К_Д = Д_П / Д_В,$$

where:

$К_Д$ – coefficient of direct income

$Д_П$ – direct income

$Д_В$ – the total amount of income

$К_Д$ = 20,000,000 / 40,000,000 = 0.5

The AAA company is recognized as actually present on the territory of the Centre due tothe simultaneous fulfilment of the conditions provided for in paragraph 7 of the Rules:

a) providing the CIGA on the territory of the Centre;
b) the coefficient of direct expenses is "0.5", which is equal to the size of the coefficient of direct income;
c) the coefficient of expenses for qualified personnel is "0.5", equal to the size of the coefficient of direct income;
d) lack of outsourcing / subcontracting of the types of work directly related to the CIGA outside the Republic of Kazakhstan.