

The American and European Union Chambers of Commerce in Armenia

A Joint White Paper

REFORM OF THE ARMENIAN TAX SYSTEM

The Foreign Investors' Perspective

August 2003

1. Introduction

1.1 Background

The legal framework for the tax system comprises seven main laws, one on taxation in general and individual laws on each kind of tax, plus regulations, instructions, tax and customs administrative rulings and international treaties.

There are eight kinds of taxes which private corporations operating in Armenia may be subject to under the Armenian tax system:

1. Profit Tax ("corporate income tax"),
2. Income Tax ("personal income tax"),
3. Value-Added Tax (hereafter VAT),
4. Custom Duties and Excise,
5. Property Tax,
6. Land Tax,
7. Simplified Tax,
8. Presumptive Tax (Fixed Tax).

In addition to income tax, employers and employees pay social security on salaries.

Armenia has signed bilateral double taxation agreements with 28 European and Asian countries, of which 18 have been ratified by the Armenian National Assembly. The most significant of these 18 are with the Islamic Republic of Iran, Greece, France, China, the Netherlands and the Baltic States although not all these are currently in force or under implementation; one important exception is the United States, with which Armenia does not have a tax or social security treaty.

In 2002 the Armenian State's annual revenues from taxes totaled USD 345 million¹ or 14.6 % of GDP, of which 47.8% was VAT, and 8.7% Profit Tax. In comparison to the other countries of the former Soviet Union, Armenia's proportion of tax revenues to GDP was the second lowest after Georgia (14.5%), and was significantly below the average across the CIS (24.8%). The

¹ All USD conversion from AMD have been calculated at the exchange rate \$1=AMD 575.

International Monetary Fund (IMF) subsequently assessed that the level of tax revenues in Armenia was too low, and has set higher collection targets for the Government for 2003. Several foreign companies however, have expressed the concern that international target setting has the opposite impact on tax revenues because the tax authorities resort to harassing foreign investors in order to meet these targets, which in turn harms the investment climate, inhibiting investment and growth and shrinking the tax base.

Between 1998-2001, Armenia recorded the highest proportion of tax revenues accounted for by VAT amongst the post-Soviet transition economies, whereas Profit and Income Tax revenues had very low proportions in comparison to the other countries. These low levels of income and profit tax revenues, despite the strong growth in national income, can be largely attributed to poor tax administration and high tax evasion. These facts indicate a major imbalance in Armenia's revenue base and collections and suggest a need for a reassessment of the focus and implementation of the tax system. This imbalance is very harmful and inequitable because VAT is a highly regressive tax that has a greater incidence on the poorer members of society, exacerbating poverty in Armenia.

As with all tax systems, the Armenian tax system has three main functions: i) generating revenues for public services, ii) setting economic and social policy, iii) facilitating the oversight of economic activity and prevention of violations. In view of its imbalanced tax burden and poor administration, the Armenian tax system cannot perform these functions effectively.

1.2 Methodology

This White Paper is based on a survey of 34 members of the American and European Union Chambers of Commerce in Armenia concerning the Armenian Tax System. Its aim is twofold:

- To present the aggregated views of the foreign business community in Armenia on the legislative and administrative functioning of the current Armenian Tax System and how it compares to that of other countries, particularly those in transition, as a factor of Armenia's country
- To outline the main changes recommended by participating companies on the Tax System Reform Bill scheduled to be introduced in the National Assembly in September

Overall, this White Paper, as the first joint effort between AMCHAM and EUCCA, aims to provide the basis for a long-term, mutually rewarding future relationship seeking to bring together the entire business community and strengthen its role and participation in policy and law-making in Armenia.

The survey focused on international companies and foreign direct investors as:

1. The membership of these associations is composed mainly of largely international investors,
2. International investors are better positioned to compare Armenia's tax system to other

The survey was mainly conducted by personal interviews with the chief financial directors of large and smaller-sized² companies operating in a wide range of sectors, and evenly split between large and small taxpayers.

All information was collected and analysed on an anonymous, non-attributable basis to encourage participants to identify problem areas candidly and in sufficient detail to propose meaningful and effective solutions.

The questions posed in the interviews focused on 6 main areas:

1. General functioning of the Armenian tax system, and a comparison with tax systems of other countries;
2. Companies' experiences with tax audits;
3. Companies' tax disputes with the tax authorities;
4. Most common/important tax problems faced by companies in Armenia;
5. Specific types of tax that are particularly problematic;
6. Companies' suggestions for the improvement of the Armenian tax system;

Throughout this study, tax system is defined as the system of tax collection in operation, without separating theory from practice, or laws as written from the laws as implemented or applied. This holistic approach has been adopted in order to assess and describe the tax system as it is actually experienced by business taxpayers, focusing on impact and effect, rather than causes.

1.3 Conclusions

The general conclusion that may be drawn is that while Armenia's rates are higher than in Russia and many other countries, the overwhelming problem with the Armenian tax system, as applied by both the tax authorities and private sector, is unpredictability and difficulty of compliance.

This stems from both the application of the laws and the laws themselves.

While the Armenian tax laws are on a par with most of those of the CIS, they fall short in precision and consistency when compared with advanced legal systems; and in respondents' estimation, they are significantly less practical than the tax laws in the Baltic States, Russia or in Eastern European countries.

Moreover, in the view of almost all respondents, the tax administration and the implementation of the tax system in Armenia on the part of the tax authorities is inefficient, inequitable and unprofessional, with widespread corruption and harassment of foreign investors and corporations that try to abide by the laws.

The key results of these weaknesses according to the participants of our survey are that:

1. Tax collection is not as high as it could or should be;

² Based on the size of the company's workforce

2. Foreign Direct Investment (FDI) into Armenia is significantly discouraged, with a very serious negative effect on the

It is therefore vital that any upcoming tax reform initiative evaluates not only the text of the law, but also the results of the law in practice, taking the local institutional capacity of both the public and private sectors into account. A tax law that works well in a developed and advanced economy, where prosperity and profitability permit the use of accountants and tax advisers and where public institutions, courts and tax authorities are relatively well paid, transparent and accountable, may not necessarily be applicable in Armenia.

2. GENERAL OVERVIEW OF THE ARMENIAN TAX SYSTEM

67% of respondents found the Armenian tax system to be illogical at least in part, and only a third found it to be reasonably logical. The four most commonly cited illogical aspects of the system were:

- Frequent changes in laws that create confusion since companies are generally unprepared for them and no process is in place for updating old laws following the adoption of new
- Armenian laws are copied from foreign legal systems (France, United Kingdom, Russia) and are adopted without being adjusted to take into account Armenian
- Corrupt activities of the tax authorities that result in laws not being applied in practice;
- Inconsistency among tax laws and internationally accepted business

In comparing Armenia's tax system to those of other transition economies, in particular CIS countries and to a lesser extent Turkey and the Balkan states such as Romania, Bulgaria and FYROM, respondents stated that tax administration and procedures in Armenia were more cumbersome and difficult to comply with than in most other jurisdictions for the following reasons:

- Armenian tax authorities are excessively draconian and intrusive in their practices, unwilling to accept the work of independent auditors, and are insistent upon personal inspection of companies' accounts.
- The goal of the tax authorities is precisely to make the tax system cumbersome and to create problems for companies because their philosophy and corrupt activities are deliberately aimed at making it as difficult as possible for companies to comply with the tax rules, rather than to assist and encourage them to follow the laws and pay reasonable

Furthermore, preparing the required income and expenses documentation was considered much more difficult in Armenia than elsewhere. VAT refunds were mentioned by numerous participants who stressed that in other transition economies such as Kazakhstan, the refunding of VAT was simple and quick, whereas in Armenia the procedural difficulties in obtaining refunds were not worth the effort for many companies, which simply wrote off these costs.

A particularly negative aspect of the Armenian tax system in comparison to other transition economies is the frequent change in applicable laws, with new laws often being adopted in December when most foreign investors are absent for application on January 1st. This effectively

precludes them from public participation in the law-making process and makes it difficult for companies to prepare for legal compliance.

Moreover, old laws are not always amended to harmonize with new legislation following such changes, resulting in conflicts between laws and legal uncertainty that ultimately increases companies' compliance issues.

3. COMPANIES' EXPERIENCES WITH TAX AUDITS

Of the 34 participating companies in the survey, 54.5% had been audited by the Tax Authorities every year since they came to Armenia, 9.2% once every two years and 33.3% once every three years or had never been audited. 3% had been audited twice in one year.

16 respondents (almost 50%) stated that their previous accounts were not checked by tax inspectors during audits, despite the fact that 13 of these were audited consecutively by different inspectors. The tax authorities checked the past accounts of 6 companies, and 3 of these companies subsequently experienced problems with the authorities.

Audits took up to two weeks for 21 respondents (65%), with 3 taking between 2-3 weeks and 4 lasting one month or more. There was no clear verdict on the disruptiveness of audits, however, 33% of respondents considered tax audits in Armenia to be disruptive, suggesting that the process varies significantly from case to case and depends on individual tax inspectors. In comparison with experience in other countries, tax audits in Armenia are viewed as more disruptive and intrusive than those of Europe, the United States, and other advanced economies.

4. COMPANIES' TAX DISPUTES

82% of respondents (28 out of 34) had experienced at least one tax dispute with the tax authorities, including fines, penalties or legal proceedings. Of these 28 cases, 10 were challenged in court, and in all cases the taxpayers won. While this phenomenon may not be statistically significant, it suggests that the laws are very unclear and too complicated for the tax authorities to apply effectively. It could however also indicate that the authorities are abusing their prosecutorial powers to harass companies into giving bribes or over-paying their taxes so that the authorities meet their tax collection targets.

The following additional observations arose from the comments collected:

- There does not seem to be any indication that tax disputes are prevalent among a particular type of company or that the tax authorities target companies of any certain size or
- The cases that were challenged in court concerned a variety of issues, but four out of ten cases dealt with business involving non-resident partners (importing products from abroad).
- Some respondents suggested that the courts tended to be more sympathetic to businesses than to the tax authorities, but that suggestion must be weighed against the fact that many

companies did not wish to pursue legal proceedings because they do not have faith in the impartiality of

- Many respondents are reluctant to go to court due to procedural complexities, time and cost considerations. In addition, they fear retribution or are concerned that the tax authorities will deepen and expand their audits in the future, if challenged. This view is reinforced given that 6 out of the 10 court cases lasted approximately one year or more. However, although procedures are time-consuming and lengthy in Armenia, they tend to be even longer in other transition countries, including those in Eastern Europe that generally have more advanced tax

5. THE MOST COMMON/IMPORTANT TAX PROBLEMS

Survey results

24 responses (75%) stated that the most common problems companies encountered in their dealings with the tax system concerned:

- Refunding of credits, especially VAT
- Demands for prepayments,
- Extra-legal activities of the tax authorities,

with many respondents stating that their companies do not ask for refunds to avoid tax inspections triggered by such requests.

21 respondents (65%) cited:

- Excessive paperwork/bureaucracy
- Unclear regulations

The three main examples of excess bureaucracy given were:

- Social
- VAT
- Government decrees 314-315 of 31st July 1997³ on the registration of all products bought and sold.

Many respondents explained that these procedures demanded excessive information that was unnecessary and hence burdened businesses with increased operational expenses without apparent benefit to any party. The VAT system was particularly unpopular in this respect as tax payers are required to present a multiplicity of documents to the tax authorities. The procedural time and cost militated against obtaining refunds for several respondents.

³ **Decree 314:** *Registration of goods in the process of shipment, delivery and transportation in the Republic of Armenia.*

Decree 315: *Registration of goods to be sold at their prices in the Republic of Armenia*

The VAT system was also considered problematic because of its unclear regulations in a wide range of areas and contradictions with internationally accepted business practices and tax norms. Many participants expressed similar reservations about the profit tax and in particular the regulations on the treatment of capital investments and deductions for current expenses, seen as illogical and contrary to global practices, particularly for exporters of products and services, having few local-source inputs. This is particularly detrimental for software developers, service providers and the entire hi-tech sector, previously identified as crucial for Armenia's economic development. Most respondents expressed strong views on the disincentives inherent in the current tax system on development of this key economic sector.

Finally, 52% of respondents experienced difficulty in finding and completing the necessary documentation for declaration of income and expenses. More specifically, expense documentation procedures, such as the stamp required on all invoices or the manual inputting of invoices into the Invoice Order Book, are needlessly cumbersome and again increase costs, as is the sewn, cash book, where all petty cash flows are required to be recorded. VAT and Profit Tax documentation were cited as further examples of costly, confusing and complex items.

6. SPECIFIC TAX ISSUES

The specific taxes that cause respondents the most problems in Armenia are

- VAT (24 responses or 75%)
- Profit Tax (11 responses or 34%).

Regarding VAT, the principal concerns were:

- the administrative difficulty in obtaining refunds,
- the cumbersome implementation procedures (stamp invoices, invoice Tax Book etc.),
- the unclear regulations and
- conflicts with other

The seal, Tax Book, paper-based cash book, etc. are outmoded in comparison with global trends towards computer-based record keeping and reinforce negative impressions of Armenia.

Regarding Profit tax, many respondents commented on the

- unclear rules,
- difficulty in obtaining all necessary information and
- lack of refunding of prepayments (principal comment) owed by the tax

7. SUGGESTIONS FOR IMPROVEMENT OF THE ARMENIAN TAX SYSTEM

Given the wide range of answers to this question, this section will only highlight the most common and widely agreed recommendations made by respondents.

Suggestions were both general in nature, dealing with the tax system as a whole, and specific, addressing problems with certain types of tax. General, big-picture suggestions relate to tax administration and application of laws and suggestions to improve tax legislation itself.

The application of tax laws was frequently mentioned as the area most in need of reform, as the current tax environment is too draconian and devoid of positive incentives for attracting foreign investment to Armenia. A change in the philosophy of the entire system itself is required, with corrupt activities being punished and inspectors undertaking tax collection in a professional manner, rather than creating problems to satisfy pre-set tax revenue targets and to add to their own low wages. These issues are particularly relevant and important in view of the very serious obstacles companies face in receiving the prepayment refunds they are legally entitled to, which is the most common specific complaint made by corporations in Armenia.

The following proposals were made for meaningful change to take place in remedying these complaints:

- Ensure that law-abiding companies only have to pay their true tax liabilities and are not subjected to pre-set tax targets and/or harassment from the tax authorities;
- Establish a more professional tax authority, smaller in size and comprised of well-paid, trained personnel conversant with and abiding by tax laws and procedures;
- Increase fines for companies involved in illegal practices and the consistent enforcement of penalties for tax officials that instigate illegal activities;
- Streamline and reduce the number of taxes and tax rates by focusing on a static or fixed, flat tax base, which will be more transparent and easier to administer than a dynamic tax base of profit tax or VAT that are unnecessarily complicated for both the public and private sector, and problematic from a revenue
- The Tax Inspectorate to publish a quarterly report of the most common errors that taxpayers make including guidance on how to avoid such mistakes as well as statistics on the numbers of fines, audits, bases and amounts collected each quarter through these

Many companies believed that the tax administration could be easily and significantly improved if the paperwork/bureaucracy were scaled down to require simple reporting of business information relevant to taxation only. For example, invoices could be made more user-friendly so that the stamp of the purchaser is not required, and receipts could be substituted for invoices. Additionally, the documentation required for tax declarations, such as financial reports or the Tax Book for Invoices, could also be simplified and modernized (computerized instead of manual), making it easier to complete and process, saving time and expense for both companies and the authorities. Furthermore, there are several aspects of tax procedures, particularly in the fields of VAT and Profit tax that many companies would like to see clarified to be made consistent. A case in point is that of representatives of foreign companies in Armenia that do not know if they have to prepare annual financial reports as the requests of the tax authorities vary from year to year.

Regarding tax legislation, suggestions focused mainly on the simplification/clarification of tax laws and on reducing the frequency and number of changes made to legislation. Some respondents with experience abroad suggested that Armenia follow the example of countries

such as Russia or the United Arab Emirates: a unified tax code with a low rate that is simple and effective in attracting FDI. The consensus seems to be that Armenian tax rates in themselves, while not extraordinarily high, are definitely not low enough to give a powerful incentive for encouraging investment. Most participants stressed the importance of harmonizing contradictory legislation and conflicts with internationally accepted business practices (e.g., VAT on free samples). Additionally, they suggested that proposed legislation “imported” from other legal systems be vetted and adapted to the Armenian context, prior to adoption.

In addition to clarifying present laws, companies stressed that the Armenian Government must also aim to reduce the number of amendments to the laws so that the system is easier to follow and companies know which rules apply. It would also be advisable in the future for the authorities to consult the private sector *in advance* on changes they plan to make to tax laws so as to gain an insight on the effects of their proposed changes on business in Armenia and to enable companies to prepare for the changes without excessive disruption to their business cycles.

Suggestions concerning specific aspects of the tax system were directed primarily towards the VAT and Profit taxes and the key problems faced by companies in Armenia that have been outlined above.

7.1 VAT

22 companies (65%) made 26 different suggestions on the changes they would like to see made to the VAT system, the most important of which were:

- An urgently needed clarification of the mechanism for refunding VAT that will make it easy and fast for companies to obtain the refunds to which they are entitled from the tax
- A reduction in the rate of
- A change in the system so that all standard business expenses, indirect as well as direct, become VAT set
- Simplification of the calculation of VAT to be
- Making VAT procedures less time-consuming and cumbersome, (e.g., computerizing the Invoice Tax Book and eliminating purchaser stamps on invoices).
- Re-instituting the right to set-off VAT credits against other tax
- Assuring that VAT refunds are made within 6 months of collection, which is the international norm.

7.2 Profit Tax

There were thirteen total suggestions made specifically concerning the Profit Tax in Armenia, excluding the issue of prepayment refunds addressed above:

The principal suggestions were:

- Streamline and reduce the number of taxes and tax rates, substituting them with a single “profit” tax that will be applied to *all*

- A reduction of the profit tax rate, as in other countries such as Russia, in order to attract more foreign investors to Armenia and encourage
- An increase in the ceilings for expense

7.3 Audits

A significant number of respondents made specific proposals concerning the organization and clarification of auditing procedures in Armenia, offering suggestions linked to general application of the laws and tax administration. Most companies emphasized that the Tax Inspectorate should only undertake inspections if they have objective evidence to suspect malfeasance and must refrain from using audits as a tool for harassing corporations and extracting payments from them that are in excess of their legal tax liability.

A taxpayer's good track record should be factored into the audit process. Moreover, it was suggested that the Armenian tax authorities, as in other countries, begin to accept the validity of the audits of independent auditors, as this would be more efficient for both companies and the authorities themselves.

This study was conducted as a pro bono service by Arlex International Ltd., on behalf of the American Chamber of Commerce, in conjunction with the European Union Chamber of Commerce. The views expressed herein are not the official position of either organization or the United States Embassy or European Union representations in Armenia. The study aims to be an accurate representation of the views expressed by the foreign investors who took part in the survey.
