**ON BEHALF OF THE REPUBLIC OF AZERBAIJAN**

**DECISION**

##### OF THE PLENUM OF CONSTITUTIONAL COURT

##### OF THE REPUBLIC OF AZERBAIJAN

*On interpretation of Article 13.2.15 of the Tax Code of the Republic of Azerbaijan*

# 7 December, 2011 Baku city

The Plenum of the Constitutional Court of the Republic of Azerbaijan composed of Farhad Abdullayev (Chairman), Sona Salmanova, Mahir Muradov, Sudaba Hasanova, Rovshan Ismaylov, Jeyhun Garajayev, Rafael Gvaladze (Reporter-Judge), Isa Najafov and Kamran Shafiyev;

attended by the Court Clerk Ismail Ismaylov,

the legal representatives of the subjects interested in special constitutional proceedings: Vusala Bakhisheva, Judge of the Administrative-Economic Court N1 of Baku city, Rovshan Muradov, Head of Branch of Financial and Budgetary legislation of the Department of Economic Legislation of Milli Majlis of the Republic of Azerbaijan;

experts: Phd. Afat Mirzoyeva, Docent of Chair of Civil Procedure and Commercial Law ofBaku State University,Afgan Isazadeh, lawyer of JSCo “Demirbank”;

specialists: Ilgar Dadashev, Judge of Supreme Court of the Republic of Azerbaijan, Hilal Halilov, Judge of Court of Appeal of Baku city, Jamil Alizadeh, Head of Department of Tax Policy and Incomings of Ministry of Finance of the Republic of Azerbaijan, Anar Asadov, senior adviser of legal department of the Ministry of Finance of the Republic of Azerbaijan, Ilgar Suleymanov, Deputy head of Legal Department of Ministry of Tax of the Republic of Azerbaijan, Vugar Gurbanov, Head of Legal Branch of Tax Department at the Ministry of Tax of the Republic of Azerbaijan ;

in accordance with the Article 130.6 of the Constitution of the Republic of Azerbaijan examined in open judicial session via special constitutional proceedings the case on inquiry of the Administrative-Economic Court No. 1 of Baku city concerning interpretation of Article 13.2.15 of the Tax Code of the Republic of Azerbaijan and some normative legal acts.

having heard the report of Judge Rafael Gvaladze, the reports of the legal representatives of the subjects interested in special constitutional proceedings, specialists and experts, examined the materials of the case the Plenum of Constitutional Court of the Republic of Azerbaijan

**DETERMINED AS FOLLOWS:**

The Administrative-Economic Court No. 1 of Baku city having applied to the Constitutional Court of the Republic of Azerbaijan (hereinafter referred to as the Constitutional Court) asks for interpretation of Article 13.2.15 of the Tax Code of the Republic of Azerbaijan (hereinafter referred to as Tax Code).

The inquiry is proved by that the interpretation of distribution of profit or the income between shareholders in the form of other payments in the notion “dividend” in Article 13.2.15 of the Tax Code of various meanings, creates difficulties at settlement of disputes and becomes the reason of adoption of the judicial resolutions leading to violation of the rights of taxpayers.

In connection with the inquiry the Plenum of the Constitutional Court considers necessary, first of all to articulate the concepts relating to an organizational and legal form of joint-stock company, the rights and duties of its participants, separate types of stocks of this company. These concepts are defined in the civil and tax law of the Republic of Azerbaijan:

Natural person – citizen of the Republic of Azerbaijan, foreigner and person without citizenship (Article 24.2 of the Civil Code of the Republic of Azerbaijan (hereinafter referred to as Civil Code) Article 13.2.3 of Tax Code);

Legal entity is the structure which is specially created and passed the state registration which has the isolated property in property and answers for the obligations this property, can get and carry out on its own behalf the property and personal non-property rights, perform duties, to be the claimant or the respondent in court. The legal entity has to have independent balance (Article 43.1 of Civil Code, Article 13.2.3 of Tax Code).

Commercial legal entities - the structures pursuing generation of profit as a main objective (Article 43.5 of Civil Code).

The joint-stock company is a company which registered capital is divided into a certain number of shares, constituting a special organizational and legal form of the commercial organization (Article 98.1 of Civil Code).

The shareholder who is the participant of joint-stock company acts as the investor in the relations which arose with this company irrespective of preliminary placement of shares at the expense of the means or their acquisition during the subsequent turn.

It should be noted that effective protection of the rights and legitimate interests of investors on securities market for the purpose of mobilization of their financial means is one of the main tasks of economic policy of the state. It is not by coincidence that in the field of regulation of the general social, economic and legal conditions of investment activity (investment), the principles and rules of activity of investment funds, it is adopted a number of important laws (the Law of the Republic of Azerbaijan “On investment activity” of September 13, 1995, the Law of the Republic of Azerbaijan “On investment funds” of October 22, 2010, etc.).

Along with it, in Article 3.10 of the Tax Code the provision on stimulation of entrepreneurial business and investment activity by tax system is provided.

Share is the security confirming membership in joint-stock company and the rights of the owner (shareholder) for receiving a part of profit of joint-stock company in the form of dividends, the right of participation in management of activity of joint-stock company and the right for part of the property which remained after liquidation of company. Only the joint-stock company can be the issuer of a share (Article 1077.1 of Civil Code).

On set of the rights confirmed by shares, the shares are classified on ordinary and privileged.

The ordinary share – the type of an share granting to the owner the rights of receiving a part of profit of the issuer in the form of dividends, participations in management of activity of the issuer and acquisition of part of property after elimination of the issuer (Articles 106-1.3, 1077.5 of Civil Code);

The beneficial share – a type of share, as a rule, guaranteeing to the owner irrespective of his economic activity obtaining the dividend in the form of stable percent of nominal value of share, granting the privilege of acquisition of part of property after elimination of the issuer over the other shareholders, and also other rights provided in conditions of a share issue and the charter of the issuer (Article 1077.6 of Civil Code);

The dividend - the payment in monetary or other form made by the legal entity in favor of the founders (shareholders) or shareholders in connection with distribution of net profit (the income behind a deduction payers of the simplified tax of taxes and expenses).

Dividend — payment in money or other form, made by legal person to its founders (or shareholders) as distribution of net income, profit upon the payment of all costs and taxes by payers of simplified tax (Article 13.2.15 of Tax Code).

Taxpayer- any person who have to pay taxes from subjects of taxation determined in accordance with this Code (Article 13.2.4 of Tax Code).

Due to the question raised in inquiry the Plenum of the Constitutional Court considers important the consideration of the relevant provisions of tax and civil legislations.

According to Article 94.1.15 of the Constitution of the Republic of Azerbaijan (hereinafter referred to as Constitution), the legislator establishes the general rules on bases of financial activity, taxes, duties and collecting. He independently establishes basic elements of the taxation and the size of taxes, structure of taxpayers and objects of the taxation, types of tax rates, duration of the tax period, cost indexes and the quantities necessary for definition of tax base, an order of charge of taxes, etc.

According to the powers fixed in the Constitution the legislator for the purpose of acceleration of development of financial sector, further improvement of quality of banking and insurance services, and also strengthening of solvency of banks, insurance and reinsurance companies, and stimulation of increase of level of capitalization of data of the companies adopted on October 28, 2008 the Law of the Republic of Azerbaijan “On stimulation of increase of level of capitalization of banks, insurance and reinsurance companies”.

Release from payment of income tax of the part of profit of banks, the insurance and reinsurance companies directed on increase of authorized capital is provided in Article 1 of this Law.

In this regard there is a need to clarify the profit and net profit notion.

The Tax Code differentiates notion of profit and net profit.

According to Articles 104.1 and 105.1 of the given Code the object of the taxation of the resident enterprise is its profit, and the profit is defined as a difference between all income (except the income exempted from the taxation) and the expenses specified in chapter X of the present Code subtracted from the income.

According to Article 13.2.19 the net profit is profit which remains after a deduction of income tax.

As for dividends, it should be noted that the main features distinguishing them from other payments and also the bases of their forming and payment are established in Article 106-3 of Civil Code and Article 13.2.15 of Tax Code.

According to Article 106-3.1 of Civil Code, the net profit of joint-stock company is formed after payment of taxes and other obligatory payments and distribution of net profit on fiscal year of company (including, distribution to shareholders in the form of dividends) is made based on the solution of general meeting of shareholders of joint-stock company.

In Article 106-1.3.7 of Civil Code it is noted that to receive the dividend from net profit of company is the right of the shareholder. According to Article 106-3.3 of this Code, the dividend on the ordinary share - the part of net profit of joint-stock company distributed in the form of the payment to shareholders added on each ordinary share.

In the first part of Article 13.2.15 of the Tax Code the general concept of the dividend, and in the second exceptions of the general concept is defined. According to the second part of article, income gained as a result of the section of property in connection with liquidation of legal entity, and also the payments connected with distribution of shares without change of a percentage ratio of shares of shareholders and with a shares redemption (parts, portions) within their nominal value, did not recognized as dividend.

In the specified norm one of the moments excluded from the notion dividend is distribution of shares of shareholders without change of their percentage ratio.

The authorized capital of a joint stock company consists of the nominal value of shares acquired by shareholders of the company (Article 103.1 of Civil Code).

According to Article 104.1 of Civil Code pursuant to a resolution of the general meeting of shareholders, a joint stock company may increase the amount of its charter capital by increasing the nominal value of its shares or by issuing additional shares.

According to point 3.4 of “Rules of issue at association, grinding, increasing and reduction of par value of shares” of the State Committee on Security at the President of the Republic of Azerbaijan of July 08, 2004, the increase in authorized capital of the issuer by increase in par value of shares is carried out only at the expense of retained earnings or the contributions made by the issuer's shareholders.

According to sense of Article 104.1 of Civil Code the distribution of shares without change of a percentage ratio of actions of shareholders can be made:

1) by issue of additional shares and their gratuitous distribution between the available shareholders it is proportional to their shares;

2) by increase in par value of the available shares.

According to Article 1077.1 of Civil Code the share is the security confirming membership in joint-stock company and the rights of the owner (shareholder) for receiving a part of profit of joint-stock company in the form of dividends, the right of participation in management of activity of joint-stock company and the right for part of the property which remained after liquidation of company. Only the joint-stock company can be the issuer of a share.

As appears from this definition, the share grants to the shareholder the following rights:

1) to receive dividends from net profit of company;

2) to participate in management of company with a vote, in proportion to shares which he holds;

3) to receive part of property of the joint-stock company which remained after liquidation of company.

In case of distribution of shares which are not changing a percentage ratio of shares of shareholders, dividends are not paid, the ratio of voices in relation to all voices does not change, and also such distribution has no impact on the right of receiving a certain part of property of the company which remained in case of its elimination.

Considering it, the legislation does not consider distribution of shares which are not changing a percentage ratio of the shares of shareholders as the dividend, having excluded it from the notion the dividend.

At increasing of authorized capital by increase in par value of shares at the expense of property of company, or by placement of additional shares, the shares are distributed between all shareholders. At that, shares of the same category, as belonging to him in a size proportional to them are provided to each shareholder.

From the analysis of Articles 98.4 and 106-1.1 of Civil Code it becomes clear that the shareholder has a property right to property of joint-stock company only within the shares belonging to him, and he has the rights and obligations concerning this property confirmed by shares.

As appears from Articles 106.1.3.7 and 106.1.3.8 of Civil Code, shareholders have the following rights: to receive the dividend from net profit of company, at the termination of activity of company to acquire part of property of the company which remained after satisfaction of requirements of creditors, payments of accrued, but not paid dividends, and also payments of liquidating cost of preferential shares. Besides, Article 106.1.3 of Civil Code establishes the right of the shareholder for participation in management of company, obtaining data on its activity and other rights.

From the specified it is seen that the first two groups of the rights cover the property rights, at implementation of any of which the owner of a share gains income. The legislator did not establish any other circumstance of transition of the rights for property of company to his members.

It is necessary to consider that according to Article 106.1.3 of Civil Code the issue of powers of shareholders the owners of ordinary share of company, the volume of the received dividends at general shareholder meeting in case of liquidation of company, the volume is right regarding rendering influence on making decisions on a share in property of company, to the subject section between shareholders, is defined not by the par value of shares, but number of the shares belonging to the shareholder. Because the increase in par value of each ordinary share of company does not change their quantity and mutual property of legal relationship of shareholders, in the case under consideration the volume of rights belonging to the certain shareholder also does not increase.

The situation will essentially change if joint-stock company increases authorized capital at the expense of the property, but by means of accounts of shareholders. At transfer to the account of the shareholder - the natural person of any means for the purpose of further increase in authorized capital, company is obliged to hold a tax at a payment source.

Follows from requirements of Articles 96.1 and 97 of the Tax Code that object of the taxation according to the income of natural persons is the income gained by the taxpayer, that is, an economic benefit in the estimated volume in the form of money or nature.

Lack of an economic benefit testifies the absence of object of the taxation. In this sense, first of all, clarification of an issue of gaining an economic benefit as a result of increase in par value of shares of shareholders in authorized capital of company is necessary.

The analysis of the legislation shows that the increase in par value of shares does not bring to the shareholder the tangible and real financial benefits.

In spite of the fact that in the Tax Code there is no uniform definition to the income, from its general text it is possible to come to a conclusion that the income is provided as any payment or benefit increasing assets of natural persons (Articles 98 and 99 of Tax Code).

In connection with the issue of gaining by founders or shareholders of benefit in the form of increase in their shares in authorized capital as a result of the direction of profit on increase in authorized capital it is also necessary to note that any payment or benefit gained from a place of employment according to Article 98.1 of the Tax Code belongs to income gained from working for hire and is subject to mobilization not to the tax at a payment source provided in Article 122 of this Code but to income tax. In articles 98.2.2 and 98.2.4 of the Tax Code typical kinds of the payments relating to notion of benefit are established. It is possible to refer to them the granting or donation by the employer to the worker of goods, services and forgiveness by the employer of a debt of worker.

According to Article 99.3.8 of Tax Code the income from non-entrepreneurial activity, include any other income that indicates the increase of the net price of taxpayer’s assets (in the event of submission or calculation of amortization for the taxation purposes) - other than salaries and wages.

Thus, from the above-stated it is possible to draw a conclusion that benefit has to be received not in the future bur in real and only such benefit has to be estimated as the income of the natural person. According to Article 122 of the Tax Code such benefit can be attracted not to a tax at a payment source but to income tax.

According to Article 106.3.5 decision on dividends and rules of their payment (in cases when it is not specified in the Charter) should be made by the board of directors (supervisory board) of the company or, if the same authorities have not been formed, upon the suggestion of the executive authority, by the general meeting.

According to an essence of this article, in cases of deduction of dividends by appropriate authorities of company, the decision on it is made and the dividend is distributed between shareholders in the order corresponding to this decision. At the direction of net profit on increase in authorized capital in the form of the dividend, the dividend is not distributed between shareholders, monetary or other payments in connection with distribution of profit are not made.

Proceeding from sense of Article 99.3.8 of the Tax Code, the real economic benefit of shareholders which par value is increased, arises at implementation of any property right by them, and the income or the profit got by natural or legal entities – shareholders of company, admits the object of the taxation provided in the Tax Code and can lead to charge and deduction of a tax on the income physical and profits of legal entities.

According to the above mentioned Plenum of the Constitutional Court comes to conclusion that:

- since the net profit of the legal entity is not shared between shareholders in the form of the dividend, not paid to shareholders and does not change a percentage ratio of shares of shareholders, the sending of it on increase in authorized capital is not covered by the notion of the dividend provided in Article 13.2.15 of Tax Code and provisions of the tax law on mobilization of dividends to a tax do not extend on these operations;

- the increase in par value of shares of shareholders as a result of the sending of retained earnings on increase in authorized capital can lead to charge of income tax for the shareholder – the natural person, and income tax for the shareholder – the legal entity only in case of submission of stocks.

Being guided by Article 130.6 of the Constitution of the Republic of Azerbaijan and Articles 60, 63, 65-67 and 69 of the Law of the Republic of Azerbaijan “On Constitutional Court”, Plenum of the Constitutional Court of the Republic of Azerbaijan

**DECIDED:**

1. Since the net profit of the legal entity is not shared between shareholders in the form of the dividend, not paid to shareholders and does not change a percentage ratio of shares of shareholders, the sending of it on increase in authorized capital is not covered by the notion of the dividend provided in Article 13.2.15 of Tax Code and provisions of the tax law on mobilization of dividends to a tax do not extend on these operations.

2. The increase in par value of shares of shareholders as a result of the sending of retained earnings on increase in authorized capital can lead to charge of income tax for the shareholder – the natural person, and income tax for the shareholder – the legal entity only in case of submission of stocks.

3. The decision shall come into force from the date of its publication.

4. The decision shall be published in “Azerbaijan”, “Respublika”, “Xalq Qazeti” and “Bakinskiy Rabochiy” newspapers, and “Bulletin of the Constitutional Court of the Republic of Azerbaijan”.

5. The decision is final, and may not be cancelled, changed or officially interpreted by any institution or official.