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Adoption of the Rules regarding implementation of Article 111.3 of the Tax Code

On September 22, 2021, the Cabinet of Ministers of the Republic of Azerbaijan (“**CabMin**”) adopted Resolution #276 on approval of the Rules “On deduction of amounts attributable to the creation of special reserve funds for taxation purposes” (“**Rules**”).

The Rules has been adopted for the purposes of implementation of Article 111.3 of the Tax Code, which states that banks and credit organizations are entitled to deduct amounts attributable to the creation of special reserve funds from their income for tax purposes.

According to the Rules, tax deductions on the loans issued by non-bank credit organizations to related persons (persons related to these non-bank credit organizations) shall be limited to 50% of the amount of these loans.

Article 2 of the Rules determines the procedure of deduction of amounts attributable to the creation of special reserve funds on assets by banks from the income for taxation purposes and specifies deductible and non-deductible amounts. As per this Article, the following amounts attributable to special reserve funds are considered as expenses deductible from income for tax purposes:

- ▶ 100 percent of the amounts on unsecured assets under control, unsatisfactory, dangerous and bad assets attributable to special reserve funds;
- ▶ 50 percent of the amounts on unsecured assets under control, unsatisfactory, dangerous and bad assets attributable to special reserve funds on the loans issued by banks to related persons;
- ▶ 100 percent of the amounts attributable to special reserve funds created on the accrued interest in case of delay in payment of interest on issued loans for more than 90 (ninety) days.

Article 2.2 of the Rules further determines that the following amounts attributable to special reserve funds are considered as expenses non-deductible from income for tax purposes:

- ▶ amounts on satisfactory assets attributable to special reserve funds;
- ▶ amounts assigned to special reserve funds for those assets when the first and second groups of collateral serve as collateral for the asset;
- ▶ investment in securities and shares in the capital of legal entities, except for newly established or profitable enterprises. Except for the liquidation of newly established or profitable enterprises, reserves created for temporary suspension of their activities are considered non-deductible amounts;
- ▶ assets (property) not used in banking activity;
- ▶ reserves required for credit risk assessment in the manner prescribed by the financial market regulator, as well as for loans granted without documents and information to be included in the loan file in connection with the issuance of loans.

Liquid market price of the collateral calculated in accordance with the ratio of the collateral group determined for calculation of the liquid value of the collateral in accordance with the procedure established by the Central Bank of the Republic of Azerbaijan

is deducted from the amounts attributable to special reserve fund created on bad assets.

As per Article 2.4 of the Rules, amounts attributable to special reserve funds created in accordance with the quality criteria are not deducted from income in the following cases:

- ▶ on unsatisfactory assets:
- ▶ if the documents confirming the use of the loan for its intended purpose are not submitted;
- ▶ if there are significant delays in the schedule of performance of works determined in the loan agreement or business plan which is an integral part of the loan agreement;
- ▶ if the borrower has been operating at a loss for more than 1 (one) year;
- ▶ if the periodicity of interest payments under the terms of the contract is more than 90 (ninety) days;
- ▶ presence of overdue consumer loans within the last 6 (six) months.
- ▶ If the classification of assets based on delay period factor is satisfactory, the assets are classified according to the following quality criteria:[1]
- ▶ if negative circumstances in the borrower's solvency (twice in the last 6 months, each for more than 30 days) resulting from the changes in economic conditions (transition of the real GDP growth rate to the negative zone, as well as inflation at a higher level than aimed by the Central Bank of the Republic of Azerbaijan or more than twenty percent increase in unemployment compared to the figures for the previous year) are observed;
- ▶ if there is a need for additional sources of payment for repayment of the debt (for example, additional collateral, sale of property, attraction of additional funds by the borrower, etc.);
- ▶ if one or more of the other assets of a borrower or a group of related borrowers in the same bank are classified as non-standard assets. This criterion applies when the sum of non-standard assets of a borrower or a group of related borrowers is at least 20 (twenty) percent of its (their) total liabilities;
- ▶ if one of the companies with a significant share in the group of borrowers to which the borrower belongs goes bankrupt;
- ▶ on risky assets - in the absence of documents related to the credit assessment in the credit files;
- ▶ on bad assets - in case of termination of entrepreneurial activity of the individual.

[1] This paragraph (article 2.4.2 of the Rules) will enter into force on 1st January 2022.

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