

Emil and Ali's business: Legal Aspects of Starting Business

Emil is a young computer programmer. His friend Ali is a web designer. They live in Baku, Azerbaijan. The friends have a dream: they want to establish an IT company and grow it into a large company. But they know that starting and doing business requires complying with laws. They also want to attract investments in the future.

Emin and Ali approached Remells Law Firm for a legal advice. Remells has advised them about the following key issues relating to starting and running a business in Azerbaijan:

1. Establishing LLC: Remells recommended Emil and Ali establish a limited liability company, which they did. Emil and Ali established "XYZ" limited liability company (hereafter – XYZ LLC). Remells also has given them the following information:

Sole Entrepreneur

There are several ways of conducting business in Azerbaijan. One can do business as a sole entrepreneur. A person needs to register with the Azerbaijani tax authorities to obtain the status of a sole entrepreneur. The tax authority issues the entrepreneur a tax ID (Azerbaijani: *VOEN*) and the person fulfills his/her tax obligations using that tax ID.

There are, however, certain risks associated with being a sole entrepreneur. Sole entrepreneur's liability is not limited. For instance, assume Emil and Ali create a product and that product accidentally causes damage to third parties. As a result, Emil and Ali incur a financial liability in the amount of 100,000 manats. They can hardly avoid that liability and will most likely be required to pay even if they have to sell their personal property.

That's one of the key issues – sole entrepreneurship does not shield its participant's personal (non-business) property from liabilities that are business-related. Emil enjoys playing his guitars and if things in his business go wrong, Emil's business creditors (people whom he owes money in connection with the computer business) can force Emil to sell his guitars, although guitars had nothing to do with Emil's or Ali's business.

Limited Liability Company

Limited liability company (LLC) is one form of legal entity. In many cases LLC is the most optimal form of company for joint business activity in Azerbaijan. Emil and Ali are members of "XYZ" LLC. As opposed to being sole entrepreneurs, Emil and Ali's liabilities are limited as members (shareholders) of LLC. If the product created by Emil and Ali causes XYZ LLC to incur 100,000 manats liability, the worst that may happen is XYZ LLC may be forced to bankruptcy for not being able to pay its debts. Emil and Ali's personal property will not be affected.

Another reason why in most cases start-ups may prefer doing business through a legal entity is that it is generally easier to attract investment to a legal entity. Sophisticated investors prefer to make investments into legal entities.

Tax advantages of sole proprietorship/ entrepreneurship

Sole entrepreneur has some tax advantages. We've discussed it below in the part entitled *Dividend Tax*.

2. Emil and Ali's partnership: Emil and Ali are partners (even if they do business within one legal entity). To avoid any disputes between them in the future they should regulate their relationships. One way to do it would be through regulating governance in XYZ LLC in the entity's corporate charter. There are issues, however, which cannot be regulated by the corporate charter. Those issues are generally regulated by agreement between parties. They may be called shareholders agreement, or partnership agreement or some other similar agreement. Remells told to Emil and Ali over and over that they shouldn't underestimate the importance of or ignore this issue. People tend to argue over certain things.
3. Profit (Income) Tax: In so far as during the consecutive 12 months period (from the date the person is registered) XYZ LLC's taxable income does not exceed 200,000 manats, XYZ LLC can be a simplified taxpayer. The rate of simplified tax for Baku city is 4%. This tax will be calculated and deducted from the total revenue (without deduction of expenses) of the company.

For instance, assume XYZ LLC creates a website for its client and receives 1000 manats payments for its work. XYZ LLC will pay $1000 \times 0,04 = 40$ manats on that income. If XYZ LLC incurred 200 manat costs while working on the website, as a simplified taxpayer XYZ LLC will not be able to deduct those 200 manats from 1000 manats.

Emil asked Remells whether it is *always* better to start off as a simplified taxpayer?

In its response Remells told that it is up to a taxpayer whether it wants to start off as a simplified taxpayer or a regular taxpayer. Remells further noted that: "being a simplified taxpayer is generally reasonable for IT start-ups, because it minimizes taxpayer's administrative burdens and expenses. But if you anticipate that you will have large expenses at the beginning, then you should probably choose to be taxed as a regular taxpayer. This is because a simplified taxpayer is not able to take into account its expenses when calculating its tax liabilities". For instance, if Emil and Ali expect that during the next 1 year their monthly expenses will be 1000 manat and monthly income 500 manat, then, depending on the circumstances, it may be reasonable for them to be taxed as regular taxpayers.

The rate of regular business tax 20%, but this tax is paid from a net profit – income after deducting the relevant expenses.

Dividend Tax

A sole entrepreneur's income is taxed only once. For instance, Emil and Ali together earned 200 manats. Each has 50% of share in that income and each receives 100 manats. After 4% tax payment each of them will have 96 manats. They can freely use that money.

In Azerbaijan a legal entity's income (profit) is subject to "double taxation". A legal entity income is taxed twice: when it earns the income and when it distributes the income to its shareholders as a dividend. In Azerbaijan, the dividend tax rate is 10 percent. For instance, if XYZ LLC earns 200 manats it pays 4% tax from its corporate income and 192 manats remains in company's account. But Emil and Ali can't use those funds for personal purposes, as those funds are XYZ LLC's property, not its shareholders'.

XYZ LLC can distribute those funds to Emil and Ali as a dividend. Upon distribution 10% dividend tax will be applied on that distributed income: $196 - (196 \times 0.1) = 176.4$ manats. Assuming Emil and Ali hold equal shares (50x50) in the company, each will receive after tax income of 88.2 manat. This amount is 7.8 manats lesser

than those they can receive if they were sole entrepreneurs ($96-88.2=7.8$). If you find this amount too small then just add 5 or more zeros to it – for instance, 7800.

However this distinction doesn't decrease the importance of conducting business through a legal entity. There is a risk of unlimited liability when doing business as a sole entrepreneur. Additionally, even though XYZ LLC's income doesn't belong directly to Emin and Ali, they are the actual owners of that money. Given they are likely to reinvest those funds into the business, dividend distribution is not an important issue at that stage.

Other Simplified Taxes

Azerbaijani tax regulations allow trading business (those selling goods) and public service business (such as restaurants) to become simplified taxpayers, if their annual turnover exceeds 200,000 manats. In this case, the rate of simplified tax for trading business is 6 percent, while for public service business the rate is 8 percent.

The key about being a simplified taxpayer is that the tax is calculated from gross revenue (without any deductions or exclusions). The benefit most business may find in this is that it simplifies a taxpayer's record-keeping and accounting. A taxpayer does not have to keep track of its expenses for tax purposes.

The downside of being a simplified taxpayer is that whatever a business sells, its margin has to be more than the rate of a simplified tax (6 or 8%). If, for instance, it costs a business 100 manat to produce and bring to the market a product, it cannot sell the product below $100/0.94 = 106.4$ manat, so that after the simplified tax is deducted a business is left with 100.

4. Value Added Tax: A sale of a product or supply of a service in Azerbaijan is generally subject to value added tax (VAT) at the rate of 18%. This tax is calculated from the gross amount of a sale price or price of a service charged to a client. VAT is an indirect tax. A taxpayer can settle its VAT's paid with its VAT's due.
5. Social Security Payments: If XYZ LLC has an employee - person who works based on employment contract - XYZ LLC must pay social security payments. Generally, social security payments consist of 2 parts: (1) 22% percent of the employment salary fund and (2) 3% of each employee's salary. "Employment salary fund" means the total of all salaries. For instance, XYZ LLC has two employees – Emil and Ali. Emil's salary is 200 manats and Ali's is 100 manats. XYZ LLC's employment salary fund will be $200 + 100 = 300$ manats. Every month XYZ LLC will need to pay 22% of 300 manats ($300*0.22=66$ manat) to the Social Security Fund. Unlike the 3% social security payment, 66 manats (22%) cannot be deducted from 300 manats. Formally employer uses its own funds to pay that amount (*i.e.*, does not deduct from employee's wage).

The second part of social security (insurance) payment is 3%, which is deducted from the salary and paid to the Social Security Fund, *i.e.* 3% will be deducted from, let's say, Emil's 200 manats salary ($200*0.06=6$ manat) and remaining 194 manats will be paid to Emil.
6. Tax benefits: Azerbaijani tax laws provide for tax benefits for the businesses operating in high technology parks. Income (profit) of businesses registered in high tech parks are exempt from income (profit) tax for the consecutive 7 years from the date the business registers in the high-tech park. In order to benefit from this tax exemption the person should be resident of a high tech park created according to an order of the Azerbaijani President. Residency can be obtained through registration at those parks.

7. Employment Agreement: XYZ LLC should enter into an employment agreement with its employees. Employee is the person, who on a continuous basis performs employment duties, is typically present at work during standard work hours, has a workplace typically in the employer's premises *etc.* XYZ LLC must pay salary to an employee. The amount of salary should not be lower than the statutory minimum salary, which currently is set at 130 manats (this amount may change and usually upwards). If XYZ LLC's income is unstable, the part of wage can be paid as bonus in order to minimize the risks caused by that instability.

If there is no consistency in XYZ LLC's income and activities, and if, for instance, a person performs works based on specific projects, the person can perform his work anywhere or anytime he/she pleases, instead of an employment agreement, XYZ LLC may enter into service or other similar agreement with that person. In this case it is important to make sure that the person who provides services holds a tax ID. The service provider can be registered as simplified taxpayer and pay just 4% of the service fee. Social security payments also should be paid by the service provider. If there is no tax ID, XYZ LLC must withhold taxes from the source, *i.e.*, from the service fee. Subject to certain tax exemptions for very minimal payments, in the absence of tax ID, XYZ LLC will need to withhold at least 39% (14% income tax + 25% social security payments) from the service fee.

8. Intellectual Property: Most products created by IT companies are protected (may be protected) as intellectual property (IP) rights. Computer software including websites, programs in source codes and object codes, and other similar products are protected as copyrights. A person, who invents a product, must obtain a patent for the invention.

Remells advised XYZ LLC to enter into a relevant agreement when providing services or products to their clients. Those agreements are important in that, on one hand, they regulate XYZ LLC's relations with its clients (and create more certainty), and on the other hand, they confirm XYZ LLC's intellectual property rights to its products and services.

These agreements and confirmations of IP rights are also important in terms of attracting investment to the business. When deciding to invest funds into a company, investors look at a company's assets (valuable assets and rights) very carefully. If Emil and Ali are not able to show investors that the products or rights, which they claim belongs to XYZ LLC, does *legally* belong to XYZ LLC, an investor will not be willing to invest into the company.

Remells also recommends XYZ LLC to properly register its intellectual property rights at relevant state bodies. Trademarks and patents must be registered.

About Remells Law Firm

Remells Law Firm's lawyers have significant experience in Azerbaijan business law. Our lawyers are experienced in cross-border transactions and large scale litigations. We provide legal services and assist our clients on matters relating to corporate law, finance, oil & gas, IT, employment, tax and other areas of law.

Remells' lawyers hold law degrees from reputable US and European law schools.

Please visit our website www.remells.com for more information about Remells Law Firm.

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