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Taxation of loans granted to Iranian entities by foreign banks

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The taxation of income arising from the grant of foreign loan facilities has for some years been a contentious issue, the established position being that income earned therefrom was not subject to tax. A recent circular issued by the director-general of the Taxation Affairs Organisation, however, changed the position in that it provided, among other things:

“... given that the income earned by foreign entities in the form of interest and commission charges must be regarded as to include their activity in Iran and an instance of exploitation of capital in Iran, therefore, the grant of loan and credit facilities by foreign investors and banks who carry out their activity by means *other than* a permanent establishment, branch, representative office, agency and the like, shall be subject to taxation on income as the case may be in accordance with the provisions of the Direct Taxation Act.”

The language of the circular is clear and confirms that the income of foreign lending banks, being earned in Iran, will be made subject to tax. This could have significant repercussions on agreements entered into by foreign banks and Iranian borrowers.

Reasoning

The legality of the imposition of this tax is arguable. Given that Principal 51 of the Iranian Constitution unequivocally provides that “no tax shall be imposed unless by law”, the legality of any tax imposed on such income must be specifically provided for in a law enacted by Parliament. The Direct Taxation Act 1988, as amended (the DTA) is the only item of parliamentary legislation dealing with taxation. The only provision of the DTA imposing an obliga-

tion on foreign entities to pay tax is Article 107. The wording of the circular clearly relates to paragraph (c) of the Article, which provides:

“The taxable income of foreign legal entities and organisations domiciled outside of Iran shall be assessed in the following manner..

...(c) In the case of exploitation of capital and other activities that the legal entities and the said organisations perform in Iran *through* representation such as a branch, representative, agency and the like in accordance with Article 106 of this Law1.”

It would seem that the reasoning behind the circular is fundamentally flawed. Whereas the DTA provides for income derived *through* representation, etc, the circular seems to take a diametrically opposite view and speaks of income derived by means *other than* representation, etc.

A question of origin

Further, a previous decision made by the High Council of Taxation confirmed that:

“... pursuant to... Article 107(b) of the [DTA]... any non-Iranian person (whether real or legal) shall be subject to taxation in Iran on their income in Iran... but in the case of income earned from Iran, on the basis of the said authorities, the intention of the legislator was that this related solely to income derived from the transfer of licenses and other rights and/or the provision of training and technical assistance and/or film rights and apart from these, other income derived from Iran shall not form part of the matters mentioned, including profits related to credits and facilities granted by foreign credit institutions domiciled abroad who, having no operational activities in Iran, shall not be liable to pay tax to the government of the Islamic Republic of Iran.”

The decision confirms that income derived from the grant of loans and facilities by foreign banks, being income derived “from Iran” (as distinct from income earned “in Iran”), is not subject to tax, given the absence of specific provision for this in the DTA.

The decision is a confirmed interpretation of the DTA, and as the DTA is a higher form of law than a circular, it would seem likely that the contents of the circular may be found to be contrary to the DTA.

On the basis of the circular however, from the date of its issuance, the practice would be such that the income of foreign lending banks will be made subject to tax (deducted at source). This practice will continue until the circular is set aside as a result of judicial review.

It is the experience of the author that in all cases where financial facilities are granted by foreign banks to Iranian entities (which are almost invariably government companies in any case), the relevant facility agreement contains provisions whereby any payment made to the foreign bank shall be grossed up by the amount of tax attributable to it. Given this, it would seem that it will ultimately be the Iranian borrower who will suffer the consequences of the director-general’s circular.

Financial and corporate

Recommended firms

Tier 1

Atieh Associates
Tavakoli & Shahabi
Torossian Avanesian & Associates

Tier 2

Dr Akhlaghi & Associates
Dr Jamal Seifi & Associates

Tier 3

AA Atai & Associates
Adib Law Firm
Pars Associates

“Political troubles on the international stage have led to a dwindling in transactions,” according to one lawyer. Iran’s relationship with the West is strained at best. Since the President of

the US labelled Iran part of an “axis of evil” in 2002, numerous diplomatic incidents – including the capture of British sailors in March 2007 – have heightened tensions between the gulf state and the international community.

And Iranian lawyers have noted a downturn in the number of deals being started and completed, particularly in the energy sector. European companies with interests in oil, mining or electricity are simply staying away. In the wake of the sailors’ capture, one lawyer commented: “As a result of the international stand-off with Iran, many deals that were being negotiated have concluded without a result and some companies have also exited Iran fearing worsening international relations.”

The withdrawal of foreign investment is bad news for Iran’s legal market. An estimated 80% of Iranian business is owned by the state so the domestic market provides very little work for lawyers. But while investment from Europe and America has decreased, money is coming in from China, Japan and India as Asian investors seek to make the most of this opportunity.

“Investment in oil, gas and the petrochemicals sector continues,” said one lawyer, “and we are confident that this will continue as both the government and investors want it.” The latest spat between Iran and the West may have frightened some foreign investors away but companies from the Far East are enjoying the opportunities Western investors have abandoned.

Atieh Associates

“We have a very supportive relationship with them,” said one client of working with Atieh Associates. “They are very flexible, very open and we can go to them whenever we want, even at the weekend. Their advice is always suitable and beneficial.”

Clients also commended the firm’s commercial attitude and international approach: “They are much better than the lawyers in Germany. They are far more business-oriented and flexible which is what clients want.”

Foreign multinationals are certainly rushing to use the firm’s services. This year the firm has supported Danone on establishing a joint venture in Iran, has advised a foreign oil company on an upstream buyback and on liquefied natural gas (LNG) refining and transporting, and has counselled MTN on holding the second GSM licence in Iran.

Babak Namazi and senior associate Parisa Mazaheri worked on all these deals. One client commended their work saying: “We needed someone on our side that could bring their expertise to support us in the right way and they did this very well.”

Namazi was also singled out by fellow lawyers. One competitor remarked: “He is very world-oriented and easy to work with.” This

year Namazi advised European lenders on the secured financing of 12 Very Large Crude Carriers (VLCCs) worth a couple of hundred million dollars.

Other past clients include Borusan, Total, P&O Ports and Pepsi Cola.

Leading lawyers

Babak Namazi

Dr Akhlaghi & Associates

Behrooz Akhlaghi leads a team of 10 with expertise in matters such as finance, joint ventures and energy projects.

Akhlaghi draws on more than 35 years of experience as a professor of law at Tehran’s university to provide a high quality of service to domestic and international clients.

Legal counsel Mahnaz Mehrinfar worked at Iran Air for 25 years, experience that was put to use advising British Airways last year. In 2006 the firm also acted for a group of Asian companies on a second GSM licence and helped Persian Gold on a mining project.

Leading lawyers

Behrooz Akhlaghi

Dr Jamal Seifi & Associates

The “very knowledgeable” Jamal Seifi heads this team of six associates in Tehran. Although the firm has developed an international reputation for its arbitration work, it also represents both foreign and Iranian clients on corporate and commercial matters.

In 2006 the firm assisted a Dubai-based British company on its investment in Iran, counselled a Chinese company on the financing of an Iranian private mobile project and advised an Iranian private investment company – active in the car manufacturing and baby food sectors – on three projects. This year Seifi has worked for a French company looking to expand its activities in Iran.

One standout mandate looks set to keep the firm busy over the next year: in April 2007 the firm was appointed Iranian counsel on the financing of a multi-billion dollar LNG project.

Leading lawyers

Jamal Seifi

Tavakoli & Shahabi

Tavakoli & Shahabi has had a good year despite tensions between Iran and the international community. The firm has worked on a number of projects over the past 12 months, focusing its talent on advising foreign companies wishing to set up processing plants and factories in the country.

Named partner Mostafa Shahabi is well respected in the market. One peer commented: “He knows his job and is quite experienced in corporate and commercial work.” This year he led a team advising Oman Oil on establishing an ammonia and urea plant in Iran and counselled Tata Steel on setting up a steel plant.

Cyrus Shafizadeh, an English-qualified associate, supported on both these deals. Competitors highlighted him as one to watch in the future: “He is an up-and-coming lawyer. I have experience of his work and it is very impressive.”

The firm also advised Renault on constructing a car factory in Iran. Ahmad Ehtesham, “an old-timer and highly respected”, worked on this deal and assisted Legrand, the French electricals company, on an acquisition. Mehran Tavakoli was also present on this deal.

Clients have also had very positive encounters with the firm: “They have experience and seem to have a good understanding of what they’re talking about and they can express that in language we understand.”

Leading lawyers

Ahmad Ehtesham

Mostafa Shahabi

Mehran Tavakoli

Torossian Avanesian & Associates

Torossian Avanesian & Associates received praise this year from clients and competitors alike.

The firm is particularly expert in project finance with one client commenting: “They are very good. While Tavakoli & Shahabi are the shareholder lawyers, Torossian Avanesian & Associates are the project lawyers.” In March 2007 managing partner Vrej Torossian advised Al Ghurair Investment on a \$5.2 billion aluminium smelter project.

Finance is also an area of expertise. At the beginning of 2007 leading lawyer Aida Avanesian counselled DVB Bank on a \$100 million syndicated loan to finance ships and assisted National Bank of Dubai on an \$85 million syndicated facility for Iran Petrochemical Commercial Company.

In other financial work, the firm represented BEL on a \$12.8 million share purchase from Sahar Co.

Competitors rate the firm highly. One rival lawyer commented: “They are very good lawyers to work with; if I have a conflict I will refer the client to them.”

Leading lawyers

Aida Avanesian

Vrej Torossian