CHAPTER II

DETERMINATION OF TAXABLE INCOME

Article 12 – Article 20

Definitions

Article 12. Taxable Income is the total of all receipts of an individual, corporation, limited liability company, or other legal person less those exemptions and deductions authorized in this Law.

Exemptions are deductions from income of the taxpayer given in accordance with the provisions of this Law.

Deductions are expenses of production, collection, and preservation of income, which are allowed, by provisions of this Chapter, to be deducted from receipts.

Expenditures and costs not specifically defined as exemptions or deductions are not deductible.

Net Operating Loss is the amount that exceeds income after allowance of deductions prescribed in this Law.

12.1 Except as provided in the Income Tax Law, no expenditure may be subtracted from the income tax itself. Article 5 of the Income Tax Law provides for deduction of foreign income taxes paid on foreign income from the income tax due on such foreign income under the Income Tax Law of Afghanistan.

Except for foreign taxes, which are deductible from the tax itself, all other deductible expenses are deducted from income, and not from the Afghan income tax that is otherwise due.

12.2 Personal expenses are not deductible in computing taxable income.

Example 1: An Afghan resident operates a restaurant in Kabul. The Afghan resident chose not to form a corporation or limited liability company to own the restaurant. The resident employs a waiter, named Azizi, and a cook, named Asad. The Afghan resident pays each of Azizi and the cook Afs. 100 per day. The resident also pays his son, Farhiha, Afs. 80 per day. Farhiha occasionally visits the restaurant, but he does not wait tables or cook any food. The Afghan resident may only deduct Afs. 200 per day as wages expense. The Afs. 80 paid to Farhiha each day are not deductible expenses. Because Farhiha does not actually work at the restaurant, the amounts paid to him represent personal expenses that cannot be deducted.

Example 2: An Afghan resident operates an electrical supply store in Kabul which sells generators and switches and electrical adaptors. The Afghan resident decides to purchase a large electrical generator. The resident does not offer the large electrical generator for sale to the public. The resident does not use the generator as a backup generator to power the lights in his store. Instead, the resident uses the generator to power the lights and stoves in his house. The cost of the generator cannot be deducted against the income of the business. The amounts paid for the generator represent personal expenditures that cannot be deducted.

12.3 The Business Receipts Tax, Customs Duty, and any other tax (other than the Income Tax imposed under the Income Tax Law itself) can be deducted or added to the cost of an asset.

(a) A tax can qualify as a business expense that is deductible from gross receipts if the taxes were incurred pursuant to the conduct of a business and do not relate to the acquisition of a specific asset.

Example 1: An Afghan resident operates a restaurant through which he provides food and beverages for immediate consumption within his establishment. The Afghan resident generates 1,300,000 Afghanis of revenue in his first year of operation. Because the restaurant generated more than Afs. 100,000 of revenue per month, the Afghan resident is subject to the business receipts tax in Article 64(2) of the Income Tax Law. The applicable rate of business receipts tax for services is 10% under Article 65(1)6. The restaurant also incurred Afs. 700,000 of operating expenses during its first year of operation. The Afghan resident's taxable income is therefore calculated as follows:

Assessable Income	*1,300,000*
Less: Business Receipts Tax	*(130,000)*
Subtotal	*1,170,000*
Less: Deductible Expenses	*(700,000)*
Taxable Income:	*470,000*
Income Tax (20%)	*94,000*

Example 2: Azziz is an Afghan resident that owns all of the issued stock of an Afghan corporation. The Afghan corporation imports certain raw materials like screws, bolts, glue, and upholstery, that the Afghan corporation uses to produce furniture. The imports are subject to import duty. The Afghan corporation can deduct these import duties, because they were incurred in the course of conducting the Afghan corporation's business of manufacturing furniture.

Example 3: Azziz imports various DVDs and compact disks from Pakistan and India for his personal use. Azziz pays import duties on these imports. The duties are not deductible from gross receipts in computing Azziz's tax liability.

(b) If the tax was incurred to acquire an asset and the tax is not allowed to be claimed as a deduction, the tax must be added to the cost of acquiring the asset.

Example: Company A is an Afghan corporation that imports trucks which it uses in its transportation business in Afghanistan. Company A has to pay import duties with respect to the trucks. The import duties have to be added to the cost of the trucks. The import duties are not allowable as an income tax deduction. (But note a deduction by way of depreciation will be allowable under Article 18(1)7).

<u>Receipts Subject to Tax</u>

Article 13 (1) The following receipts are subject to income tax:

1. salaries, wages, fees and commissions,
2. all receipts derived from business and industry,
3. receipts from sale of movable and immovable property,
4. interest, dividends, rents, royalties, awards, prizes, winnings, bakhshishis (gratuities, bonus payments),
5. distributive shares of partnership gross income,
6. any other return from labor, capital, or economic activity,
7. income from other circumstances provided in this Law.
8. any other income which has not been provided in this Law.

(2) Dividends mean any distribution by a company in money or in property and any benefit provided to shareholders in their capacity as shareholders including:

(1) any tangible or intangible assets;

(2) shares in the company;

(3) discounts on any purchases from the company;

(4) loans to shareholders

(5) the use of any company property.

(3) Where a branch in Afghanistan of a non-resident person (as defined in Article 8 of this Law) pays or incurs an amount to the non-resident person or any person connected to the non-resident person, that amount will be treated as a dividend.

13.1 A receipt does not have to be in the form of currency, coin, or money to be subject to taxation. The fair market value of property in whatever form or kind received as compensation is taxable income to the recipient.

<u>Example 1</u>: An Afghan resident owns and operates an electrical supply store in Kabul. The store sells electrical generators, switches and basic appliances. Normally, the resident only accepts cash as payment. Once, however, the resident accepted a used car as payment for an electrical generator that typically sold for Afs. 60,000. Even though the resident did not receive cash, the resident is treated as having received the equivalent of Afs. 60,000.

<u>Example 2</u>: An Afghan resident operates a small carpet store in Kabul. The store sells a variety of carpets that are manufactured throughout

Afghanistan. The Afghan resident employs 10 people. One of the employees, Azziz, does a very good job during the year selling carpets and providing customer service. The Afghan resident decides to pay Azziz an Afs. 10,000 bonus, over and above his normal wages for the year to compensate him for his efforts. Even though the Afs. 10,000 bonus is a bakhshishi, Azziz must include the amount in his income during the year.

Example 3: *An Afghan resident operates a restaurant in Kabul City which provides Afghan cuisine to customers. One of the resident's waiters is Wahid. Wahid earns Afs. 100 per day working at the restaurant, but also receives tips and gratuities from the people that eat at the restaurant. Wahid must include the gratuities in his income during the year even though the amounts are in excess of his normal wages.*

13.2 When an Afghan resident receives a debt instrument, or note, in exchange for services or property, the face amount of the debt or note shall be presumed to equal its fair market value. Nevertheless, if the interest rate on the debt or note is substantially above or below market, the fair market value of the note shall be determined by looking at what the appropriate interest rate on the note should have been if the interest rate used were a market rate based on all of the relevant facts and circumstances. The rules under Article 102 may be used to determine what a market rate of interest is.

Example: *An Afghan resident ("Seller") sells a car to another Afghan resident ("Buyer") for a five-year note with a face amount of Afs. 1,000,000 and bearing an interest rate of 5%. The note has a payment schedule as follows:*

Year One	*Afs. 230,974.80*
Year Two	*Afs. 230,974.80*
Year Three	*Afs. 230,974.80*
Year Four	*Afs. 230,974.80*
Year Five	*Afs. 230,974.80*

The payments are amortized as follows:

Year	Payment	Interest	Principal	Balance
1	230,974.80	50,000	180,975	819,025
2	230,974.80	40,951	190,024	629,002
3	230,974.80	31,450	199,525	429,477
4	230,974.80	21,474	209,501	219,976
5	230,974.80	10,999	219,976	-0-
	1,154,874.00	154,874	1,000,000	

The Seller has a cost basis of Afs. 800,000 in the car. The Seller reports Afs. 200,000 of gain with respect to the car in year one, and has to recognize interest as shown in the above table, assuming the payments are made promptly on the note each year.

Upon audit, and based on a review of the facts and circumstances, the Afghanistan Revenue Department determines that a market rate for the note would have been only 2%. Because the true market rate of interest was lower than 5%, the actual value of the note was higher *than its face amount of Afs. 1,000,000. The true value of the note was really Afs. 1,088,690 and the note would amortize as follows:*

Year	*Payment*	*Interest*	*Principal*	*Balance*
1	*230,974.80*	*21,774*	*209,201*	*879,489*
2	*230,974.80*	*17,590*	*213,385*	*666,104*
3	*230,974.80*	*13,322*	*217,653*	*448,452*
4	*230,974.80*	*8,969*	*222,006*	*226,446*
5	*230,974.80*	*4,529*	*226,445*	*-0-*
	1,154,874.00	*66,184*	*1,088,690*	

As a result of the audit, the Seller would have to recognize gain of 288,690, an increase of Afs. 88,690 over what was reported on the Seller's tax return. This increase reflects the fact that the note was really worth more than what the Seller reported. The Seller would recognize interest income each year as set forth in the foregoing schedule assuming the payments are made promptly on the note each year.

13.3 Partners of a partnership must recognize the partnership's income or loss as it accrues under the partnership's method of accounting.

Example. *Azziz and Wahid are Afghan residents that are partners in a partnership. Azziz owns 60% of the partnership and Wahid owns 40% of the partnership. The partnership generates Afs. 1,000,000 of profit in its first year. Azziz must recognize Afs. 600,000 and Wahid must recognize Afs. 400,000 on their income tax returns.*

Remark: Unlike corporations and limited liability companies, partnerships are not required to use the accrual method of accounting. See Article 37 and guidance issued pursuant thereto. If, however, a partnership chooses to use the accrual method of accounting, the partners are required to recognize their distributive share of the partnership's income using the accrual method.

13.4 The receipt of cash or property by a legal entity in exchange for the issuance of equity interests in that entity is not considered taxable income to that entity.

a) If a corporation, limited liability company, or partnership issues stock or partnership interests to a person in exchange for property, the issuance of stock or partnership interests shall be neutral to the corporation, limited liability company or partnership that issued the stock or the interest. The person transferring the property, however, will have to recognize gain or loss unless the transferor's gain is excluded from income under Article 14.

b) If a corporation or limited liability company issues stock to an existing shareholder or partner as a dividend, the dividend shall be neutral to the issuing corporation or limited liability company. The recipient will not be taxed on the receipt of the dividend, but will have a zero cost basis in the shares or interest received. This basis must be aggregated with the basis in the shareholder or partner's existing shares in order to compute an average stock basis.

<u>Example 1:</u> *Two Afghan residents, Azziz and Wahid, own all of the issued stock of an Afghan corporation in equal shares. The corporation generated Afs. 100,000 of profit in the first year of operation. The corporation chooses to distribute Afs. 50,000 to Azziz, and 10 additional shares to Wahid in lieu of cash. The Afs. 50,000 received by Azziz is a taxable dividend. The 10 additional shares received by Wahid is not taxable, but Wahid takes the shares with a Afs. 0 cost basis. The earnings of the corporation are decreased by Afs. 50,000. There is no effect on the corporation from issuing the 10 additional shares.*

<u>Example 2:</u> *In 1384, an individual purchased 100 shares of stock in a corporation at a total cost of Afs. 3,600. In 1385 the corporation declared a stock dividend and the individual received 20 additional shares. His average cost is Afs. 30 per share. The additional shares do not constitute taxable income in 1385 unless the individual sells them in 1385. If he keeps all of the new shares in 1385 and sells some or all of the new shares in 1386, the proceeds from the sale must be declared as income in 1386. If he sells 50 shares for Afs. 40 a share and receives Afs. 2,000, his gain is Afs. 500 and is reportable as income.*

<u>Individual's Stock Record and Costs</u>

Purchased	1384	100	shares @ Afs. 36 per share	Afs.	3,600
Stock Dividend	1385	20	shares @ Afs. 0 per share	Afs.	0
120 shares @ average cost of Afs. 30 per share				Afs.	3,600
Sold 1386 50 shares @ Afs. 30 per share				Afs.	1,500
Remaining After Sale 70 shares @ avg. cost of Afs. 30 per share				Afs.	2,100

<u>Computation of Gain on Sale</u>

Sold	1386	50 shares @ Afs. 40 per share	Afs.	2,000
Cost		50 shares @ Afs. 30 per share	Afs.	- 1,500
Gain reportable as income			Afs.	500

c) If a corporation or limited liability company issues stock or partnership interests to an employee as compensation, the corporation, or limited liability company shall be entitled to a deduction equal to the value of the stock issued in the same year that the employee recognizes the value of the stock or partnership interest as a receipt. The employee will only recognize the value of the stock or partnership interest as a receipt in the year when the stock is not subject to a substantial risk of forfeiture. A share of stock is subject to a substantial risk of forfeiture if there are real and meaningful restrictions on the holder's ability to sell or transfer the stock.

<u>Example 1:</u> *Two Afghan residents, Azziz and Wahid, form an Afghan corporation to operate a farm. Azziz and Wahid each own 50 percent of the corporation. They agree to hire Adib to manage their farm for them. To compensate Adib, the corporation pays Afs. 100 per day of work and 10 shares of stock at the end of the harvest. The 10 shares of stock are unrestricted. Adib can sell the shares to whomever he wants. The shares are worth Afs. 10,000. Adib must recognize and report as receipts Afs. 100 per day that he works plus the value of the shares that he receives (Afs. 10,000) at the end of the year. The corporation is entitled to deduct the Afs. 100 per day that it pays Adib plus the value*

of the shares that it issues to Adib (Afs. 10,000).

<u>Example 2:</u> *The facts are the same as in Example 1, except that the shares that Adib receives are subject to a number of restrictions. Specifically, Adib cannot sell any of the shares for three years. Moreover, if Adib ceases to be an employee of the corporation at any time during the next three years (because his employment is terminated or because he quits) the shares will be forfeited and will revert to the corporation. In this case, Adib does not have to recognize the value of the shares in the year that they are issued. The corporation cannot claim a deduction for the value of the shares when they are issued. If, after three years, Adib remains an employee of the corporation and the restrictions are lifted, Adib will have to recognize the value of the shares at that time. Thus, if the shares are worth Afs. 12,000 in the third year, Adib must recognize Afs. 12,000. The corporation will be entitled to a deduction of Afs. 12,000 in the same year.*

13.5 The taxation of stock options differs depending on whether the stock option is issued as compensation for services or for property.

a) Stock options that are issued as compensation are not subject to tax unless or until they are exercised. The corporation that employs the individual is not permitted to claim a deduction unless or until the employee recognizes the income associated with the exercise of the stock option.

<u>Example</u>: *An officer of a corporation exercises a stock option privilege which, under the terms of his employment, allows him to purchase a specified number of shares of stock of the corporation each year at a favorable price. The difference between the market value of the stock on the day he acquired it and the amount which he paid for it must be declared as income. Thus, if the officer purchased 10 shares of stock at Afs. 500 per share, and the market price of the stock was Afs. 750 per share on the day he acquired the stock, he must report the difference (Afs. 7,500 – Afs. 5,000 = Afs. 2,500) as income in the year in which he acquired the stock. The corporation is entitled to a deduction of Afs. 2,500 in the same year.*

b) The tax consequences of stock options that are issued for property are held “open” until the option is exercised or lapses.

<u>Example 1</u>. *Azziz is an Afghan resident that owns a car which he purchased for Afs. 100,000 three years ago. Azziz now wants to sell the car. Wahid likes the car and wants to purchase the car, but he does not have the money at the present time. Azziz offers Wahid an option to purchase the car at any time during the next twelve months for a price of Afs. 80,000. Wahid pays Azziz Afs. 10,000 for this option. Six months later, Wahid exercises the option and pays Azziz Afs. 80,000. Wahid takes the car with a cost basis of Afs. 90,000. Azziz recognizes receipts of Afs. 90,000 (Afs. 80,000 price + Afs. 10,000 option premium). Azziz therefore has a 10,000 loss on the sale of his car (Afs. 100,000 cost base – Afs. 90,000 proceeds).*

<u>Example 2</u>. *The facts are the same as in Example 1, except that Wahid does not exercise the option. At the expiration of the option's term, Wahid has lost Afs. 10,000. Wahid may not deduct the Afs. 10,000 unless the Afs. 10,000 represent a business expense. See Articles 13 and 19. Azziz must recognize the Afs. 10,000 as income when the option lapses, because Azziz received Afs. 10,000 but was not required to transfer any cash or property in return when the option expired.*

13.6 A dividend may be taxable to the shareholders even though it is not formally declared. A dividend includes any benefit that a corporation confers on a shareholder to the extent that the corporation has sufficient earnings.

<u>Example 1</u>. *Naqibullah owns all of the issued stock of an Afghan corporation. The corporation has accumulated Afs. 10,000,000 in earnings. The corporation operates two car rental centers. One center is in Kabul and another is in Mazar-e-Sharif. The center in Mazar-e-Sharif allows Naqibullah's son, Azziz, to use its rental cars whenever he wants without paying for them. The manager of the Mazar-e-Sharif center estimates that the rents foregone equal Afs. 100,000 per year. Naqibullah will be considered to receive a deemed dividend from his Afghan corporation of Afs. 100,000.*

<u>Example 2</u>. *Naqibullah owns all of the issued stock of an Afghan corporation. The Afghan corporation purchases television sets from abroad and sells them to customers in Afghanistan. The television sets normally sell for Afs. 10,000 Occasionally, Naqibullah will purchase a set from one of his stores for Afs. 8,000. Every time that Naqibullah purchases a television set for Afs. 8,000, Naqibullah will be considered to have received a distribution of Afs. 2,000. If the corporation has sufficient earnings, the distribution will be considered a dividend. Otherwise, the distribution will be considered a tax-free return of invested capital or a capital gains distribution.*

<u>Remark</u>: See Article 43 and the regulations promulgated pursuant thereto for the consequences to a corporation that distributes appreciated property to its shareholders.

13.7 Any distribution by a company, whether in money or property or any other benefit, to a shareholder will be treated as a dividend. The distribution must be received by the shareholder in the person's capacity as a shareholder. If the distribution is provided for any other reason unrelated to the person's capacity as a shareholder, then the distribution will not be treated as a dividend.

<u>Example 1:</u> *Azeem is a shareholder of Kabul Construction Corporation. An earthquake damages the block of apartments where Azeem and other unrelated people live. As an act of charity, Kabul Construction Corporation agrees to repair the building for no cost. Even though Azeem has received a benefit ie the repair of his accommodation from Kabul Construction Corporation, he has not received that benefit because he is a shareholder in Kabul Construction Corporation. Rather, Azeem has received the benefit as a resident of the block of*

apartments. The value of the repairs to Azeem's apartment will not be deemed to be a dividend.

Where a benefit is provided to a shareholder in a form other than cash, the benefit will be treated as a dividend to the extent that the shareholder receives the benefit for less than its market value.

<u>*Example 2:*</u> *Bashir is a shareholder of Ace Electrical Company. The company sells electrical goods to the public. The shareholders are allowed to buy goods from the store for 25 percent of their market value (which is less that the cost of the goods). For the year 1385, Bashir buys goods with a market value of Afs 10,000 from the store and makes payment of Afs 2,500. Bashir has received tangible property from the company for less than market value because he is a shareholder of the company. Bashir therefore has received a dividend from the company. The amount of the dividend is the market value of the goods he has received less the amount he has paid. Therefore, Bashir will have received a dividend of Afs 7,500 in the 1385 year.*

This principle will apply to all forms of benefit received by a shareholder in their capacity as a shareholder for less than the market value to the public. Any tangible or intangible assets or shares in the company provided to a shareholder will be treated as a dividend to the extent that the shareholder has not paid market value. Loans by the company to shareholders will be treated as a dividend to the extent that the shareholders benefit from the conditions of the loan more concessional than loans provided by commercial banks to their customers.

<u>*Example 3:*</u> *Fayez is a shareholder of Hotel Safrini Corporation. Because he is a shareholder, he receives a loan of Afs 200,000. Fayez is required to repay Afs 202,000 after one year ie the amount of the loan plus 1 percent interest. If Fayez had taken the loan from a commercial bank, the amount to be repaid after one year would have been Afs 210,000 ie the amount of the loan plus 5 percent interest. Fayez has received a benefit less than market value. The benefit will be treated as a dividend. The amount of the dividend will be the amount of interest saved because of the favourable interest rate provided by the company. The amount treated as a dividend is the difference between the interest payable if the loan was taken with a commercial bank and the interest payable to the company ie Afs 8,000.*

If a shareholder is entitled to use company property on terms more favourable than available to the general public ie free of charge or at a discounted rate, then the use of the company property will be treated as a dividend to the extent of that favourable treatment.

<u>Example 4:</u> *Aref is a shareholder of Avid Car Rental Company. The company conducts the business of hiring cars to customers. Cars are available for hire at the rate of Afs 2,000 per day. Aref takes a car for five days to travel from Kabul to Jalalabad to visit his family. Because Aref is a shareholder, he pays Afs 1,000 per day for the hire of the car. Aref has received a benefit from the company in his capacity as shareholder of the company. The benefit is treated as a dividend. The value of the benefit is the difference between market value and the amount Aref paid ie Afs 2,000 less Afs1,000 equals Afs 1,000.a day. The value of the benefit for 5 days is Afs 5,000.*

13.8 When a non-resident person owns a branch in Afghanistan, and that branch pays or incurs an amount to the non-resident person or to a person that is "connected" (within the meaning of Article 102 of the Income Tax Law) to that non-resident person, the payment will be considered a distribution from the branch to that non-resident person. In making the determination of whether a payment has been made, due regard shall be given to the books and records of the branch. If a branch operation generates profits during the year, and those profits are not reflected as earnings on the balance sheet at the end of the tax year, a dividend will be deemed to have been distributed. This deemed dividend will be subject to all applicable withholding taxes.

<u>Example 1</u>. *Kashif is an individual resident of Pakistan that operates an import-export business within Afghanistan. Kashif has chosen to operate his import-export business as a branch, not a corporation. At the beginning of the year, the balance sheet for the branch is as follows:*

Assets:		***Liabilities:***	
Cash	*1,000,000*	*Accounts Payable*	*1,000,000*
Receivables	*8,000,000*		
Inventory	*10,000,000*	***Equity:***	
Office Furniture	*50,000*	*Equity Investment*	*10,000*
		Earnings	*18,040,000*

During the year, the corporation does not generate any earnings. The balance sheet for the branch at the end of the year is as follows:

Assets:		***Liabilities:***	
Cash	*2,000,000*	*Accounts Payable*	*1,000,000*
Receivables	*7,000,000*		
Inventory	*10,000,000*	***Equity:***	
Office Furniture	*50,000*	*Equity Investment*	*10,000*
		Earnings	*18,040,000*

Under these facts there has not been a deemed dividend from the branch. Instead, the books and records merely indicate that the branch has collected 1,000,000 of its accounts receivable. All of that cash is still on the books of the branch, however. Any interest on that cash will be taxed in Afghanistan. Hence, there has not been a distribution.

<u>Example 2</u>. *Kashif is a resident of Pakistan that operates an import-export business within Afghanistan. Kashif has chosen to operate his import-export business as a branch, not a corporation. At the beginning of the year, the balance sheet for the branch is as follows:*

Assets:		***Liabilities:***	
Cash	*1,000,000*	*Accounts Payable*	*1,000,000*
Receivables	*8,000,000*		
Inventory	*10,000,000*	***Equity:***	
Office Furniture	*50,000*	*Equity Investment*	*10,000*
		Earnings	*18,040,000*

During the year, the corporation generates Afs. 1,000,000 earnings. The balance sheet for the branch at the end of the year is as follows:

Assets:		***Liabilities:***	
Cash	*2,000,000*	*Accounts Payable*	*1,000,000*
Receivables	*8,000,000*		
Inventory	*10,000,000*	***Equity:***	
Office Furniture	*50,000*	*Equity Investment*	*10,000*
		Earnings	*19,040,000*

Under these facts there has not been any constructive dividend distribution. Although the branch generated an additional Afs. 1,000,000 of earnings during the year, the earnings continued to be reflected on the branch's balance sheet. As such, any interest accrued on the additional Afs. 1,000,000 held by the branch will be subject to tax in Afghanistan.

<u>Example 3</u>. *Kashif is a resident of Pakistan that operates an import-export business within Afghanistan. Kashif has chosen to operate his import-export business as a branch, not a corporation. At the beginning of the year, the balance sheet for the branch is as follows:*

Assets:		***Liabilities:***	
Cash	*1,000,000*	*Accounts Payable*	*1,000,000*
Receivables	*8,000,000*		
Inventory	*10,000,000*	***Equity:***	
Office Furniture	*50,000*	*Equity Investment*	*10,000*
		Earnings	*18,040,000*

During the year, the corporation generates Afs. 1,000,000 earnings. The balance sheet for the branch at the end of the year is as follows:

Assets:		***Liabilities:***	
Cash	*2,000,000*	*Accounts Payable*	*1,000,000*
Receivables	*7,000,000*		
Inventory	*10,000,000*	***Equity:***	
Office Furniture	*50,000*	*Equity Investment*	*10,000*
		Earnings	*18,040,000*

Under these facts there has been a constructive dividend distribution of Afs. 1,000,000. The branch generated an additional Afs. 1,000,000 of earnings during the year. The earnings were reflected in a Afs. 1,000,000 increase in the branch's cash balance. But the receivables decreased by a like amount. In the end, no amount was added to the branch's equity. Because Afs. 1,000,000 was earned by the branch, but the extra Afs. 1,000,000 were not reflected in the branch's equity, the branch is deemed to have distributed Afs. 1,000,000 to Kashif. As such, the dividend is subject to 20 percent income tax.

Remark: Because the purpose of the tax on the deemed dividends of a branch is to equalize the tax treatment of Afghan branches and corporations, the deemed dividends paid by the branch shall be deductible by the branch in computing the branch's taxable income.

13.9 The tax on the deemed dividends of a branch shall apply equally to non-residents that invest in Afghanistan through a partnership. It does not matter whether the partnership is domestic or foreign.

Example. USCO is a United States corporation. CANCO is a Canadian corporation. USCO and CANCO are partners in an Afghan partnership. USCO owns 60% of the partnership and CANCO owns 40% of the partnership. The opening balance sheet for the partnership at the beginning of the year is as follows:

Assets:		***Liabilities:***	
Cash	*1,000,000*	*Accounts Payable*	*1,000,000*
Receivables	*8,000,000*		
Inventory	*10,000,000*	***Equity:***	
Office Furniture	*50,000*	*Capital*	*10,000*
		Earnings	*18,040,000*

During the year, the corporation generates Afs. 1,000,000 earnings. The balance sheet for the branch at the end of the year is as follows:

Assets:		***Liabilities:***	
Cash	*2,000,000*	*Accounts Payable*	*1,000,000*
Receivables	*7,000,000*		
Inventory	*10,000,000*	***Equity:***	
Office Furniture	*50,000*	*Capital*	*10,000*
		Earnings	*18,040,000*

The additional 1,000,000 Afghanis of profit should have caused the partnership's earnings to increase by 1,000,000. Because the earnings did not increase by 1,000,000 Afghanis, there has been a constructive distribution of 1,000,000 Afghanis under these facts. There is a presumption that USCO received 600,000 of the distribution and CANCO received 400,000 of the distribution. The parties may rebut this presumption if they can prove that the distribution was shared in a different ratio.

13.10 "Receipts" in the case of taxpayers who account on an accrual basis (See Chapter V of the Income Tax Law), also means accrued sales, accrued interest income, accrued rental income, etc.

<u>Example</u>: *A limited liability company has cash sales in 1384 of Afs. 8,700,000. If Afs. 300,000 of the sales which were made in the last month of 1384, were not paid until the first month of the following year, 1385, the sales of Afs. 300,000 are included and accrued to the sales for 1384. Under the accrual system of accounting, sales are considered to be income at the time the sale is made rather than when the payment is received; therefore, the income for the taxable year for this company, which is required to use the accrual system, is Afs. 9,000,000 (the amount of sales) rather than Afs. 8,700,000 (the amount of payments actually received).*

<u>Non-Taxable Income</u>

Article 14. The following receipts are not subject to income tax and not included in returns of natural and legal persons:

1. grants, gifts, and awards of the State;

2. grants, gifts, and awards of foreign governments, international organizations, or nonprofit organizations for contributions to science, art, literature, social progress, and international understanding;

3. all scholarships, fellowships, and grants for professional and technical training;

4. health, accident, and unemployment insurance benefits;

5. life insurance paid on death;

6. compensation or damages for personal injuries or sickness or restitution of reputation;

7. proceeds of borrowing;

8. proceeds of issues of stocks and bonds by companies;

9. acquisition of property in connection with mergers of domestic corporations and other legal entities;

10. acquisition of movable or immovable property through expropriation of property of debtors by creditors

11. payments on principal received from debtors;

12. interest on deposits of individuals from State banks;

13. interest on bonds issued by the State and by municipalities; and

14. any other receipts according to the provisions of this Law.

14.1 Article 14 of the Income Tax Law covers receipts which are excluded from gross income. Receipts, unless specifically listed as excluded from income, are included in income.

14.2 "Grants, gifts, and awards of State" do not include payments made to employees for services performed in the ordinary course of duty. Grants, gifts, and awards are given in special circumstances or in recognition of issued or unusual service or accomplishment. They are associated with hardship, or recognition of accomplishment. Annual bonuses, overtime, back pay and other benefits given on a nonselective basis are part of the taxable income of the recipient.

<u>Example 1</u>: A family is struck by a calamity. This family receives Afs. 5,000 as a

gift from the State. This Afs. 5,000 is not taxable income of any of the members of the family.

<u>Remark</u>: *Amounts donated or granted by foreign and/or domestic institutions are also not taxable.*

<u>Example 2</u>: *A medical doctor devotes his life to building up medical clinics, facilities, and staff in several communities. The State honors him with an intangible recognition, and also with tangible material award. Such material gain is exempt from taxation.*

<u>Example 3</u>: *The receipt of a Nobel prize is an award of an international, nonprofit organization that is exempt from taxation.*

14.3 All of the money received in connection with a scholarship, fellowship, or grant for professional and technical training is exempt. This includes travel funds and living expense funds, as well as reimbursement for tuition, fees, cost of books and supplies, and other expenses.

<u>Example</u>: *A student receives a scholarship which covers his travel, hotel bills, lodging, tuition, fees, books, medical costs, etc., plus an allowance for clothing, food, and personal expenses of Afs. 5,000 per month. All of this is exempt from taxation.*

If the student receives a supplement from the State, this supplement is also exempt from taxation. If, however, as an employee of the State, he receives all or part of his salary from the State, this salary is subject to taxation.

14.4 Payment received from an insurance company as a result of loss, misfortune, sickness, etc. against which the recipient was insured is not taxable.

<u>Example 1</u>: *An individual insured himself against sickness and injury with an insurance company to which he paid monthly premiums. He was injured in an accident which resulted in lost income and medical expenses, and caused a disability. Under terms of his insurance policy he was paid Afs. 10,000,000 in settlement of his claim. This receipt is not taxable.*

<u>Example 2</u>: *An individual is injured while working at his job. His employer carries an insurance policy which covers all his employees. The insurance company pays the injured employee Afs. 10,000,000 in settlement of his claim. This receipt is exempt from taxation, though the injured employee did not even pay the premium for the insurance coverage.*

14.5 Payment received by a beneficiary from insurance upon the death of the insured person is not taxable income of the beneficiary.

<u>Example 1</u>: *An individual has purchased an insurance policy which provides, among other things, that his beneficiary shall be paid Afs. 2,000 per month upon death of the insured. This income is not taxable.*

<u>Remark</u>: *Regardless of whom the beneficiary is or how the insurance benefit is paid, the money paid by the*

insurance company is not subject to income tax.

Example 2: *An individual is killed in an accident while working on his job. His employer carries an insurance policy which covers all of his employees. The insurance company pays the amount of the death benefit specified by the policy to the beneficiary of the deceased. This receipt is exempt from taxation even though the deceased did not pay the premium for the insurance coverage.*

14.6 Compensation paid for personal injuries, sickness, or other harm inflicted on a person is not taxable.

Example 1: *A person struck and injured by an automobile receives Afs. 10,000 as compensation for the harm done. This receipt is not taxable.*

Example 2: *A person develops a disabling disease from his employment by a firm in an occupation exposing him to harmful chemicals. Upon order of a court, the firm pays the disabled person Afs. 2,000 per month for the period of his disability. This income is not taxable.*

14.7 Receipts which are proceeds of borrowing are not taxable.

Example: *An individual receives Afs. 25,000 from a bank in exchange for his promissory note. This receipt is not income and is not taxable.*

14.8 Receipts from the issue of stock or sale of bonds by a corporation is not taxable income.

Example 1: *A corporation increases its capital by issuing shares of stock at a par value of Afs. 1,000 per share. The corporation sells 10,000 shares at Afs. 1,000 each. The Afs. 10,000,000 received is not taxable.*

Example 2: *A corporation sells bonds redeemable in 10 years at Afs. 5,000 each with interest payable annually at a rate of five per cent. It sells 1,000 such bonds, receiving Afs. 5,000 for each bond. The proceeds, Afs. 5,000,000 are not taxable.*

Remark: *If, however, these bonds bring more than face value, the excess is subject to income tax. On the other hand, if bonds are sold for less than redeemable value, the discount in value is a deductible expense. The excess, called a premium, is in fact a reduction in interest over the term of the bond, while the discount is in fact additional interest over the term of the bond. Either shall be allocated over the term (period of years from date of issue to date of redemption) of the bond.*

14.9 Assets acquired through mergers are not taxable at the corporate or shareholder level if one of the following requirements are satisfied:

(a) The transaction qualifies as a “merger” under Afghanistan’s 1955 Commercial Code or any successor law to the extent that the shareholders exchange stock of the merged corporations for stock of the surviving corporation.

<u>Example 1</u>: *Corporation A merges with Corporation B to form a new corporation. In the process of this merger the new corporation acquires the cash, and other assets as well as the liabilities of Corporations A and B. The shareholders of Corporation A and B surrender their shares in exchange for shares in the new corporation. Neither Corporation A nor Corporation B recognizes income in this transaction. Because the shareholders of Corporation A and Corporation B exchange their shares for shares of the surviving corporation, they do not have to recognize income.*

<u>Example 2</u>: *Naqibullah owns all of the issued stock of Corporation A. Naqibullah has an Afs. 10,000 cost basis in his shares. Naqibullah's shares are worth Afs. 500,000. Wahid owns all of the issued stock of Corporation B. Wahid has an Afs. 20,000 cost basis in his shares. Wahid's shares are also worth Afs. 500,000. Naqibullah and Wahid decide that they should merge their two corporations. In the merger, Naqibullah receives 50 shares of the surviving corporation. Wahid receives 45 shares of the surviving corporation and Afs. 50,000. To the extent that Naqibullah receives shares in the merger, the transaction is tax-free to Naqibullah. Naqibullah therefore takes the 50 shares with a carryover basis of Afs. 10,000. Wahid's consideration consists of shares (90%) and cash (10%). The shares can be received tax-free. Wahid takes the shares with a carryover basis of Afs. 18,000. Wahid's receipt of cash is taxable. Wahid must recognize gain of Afs. 30,000 (Afs. 50,000 – Afs. 20,000 cost basis in 10% of shares). Neither Corporation A nor Corporation B recognizes gain or loss on the transaction.*

(b) An Afghan resident may transfer stock or other property to an Afghan corporation or limited liability company provided that, after the exchange, the Afghan resident owns 5% or more of the stock of the transferee. For this purpose, stock shall be measured by both voting power and value.

<u>Example 1</u>: *Naqibullah and Wahid are Afghan residents that want to form a corporation which will operate a clothing store in Kabul City. Naqibullah contributes Afs. 500,000 to the corporation in exchange for 50% of its shares. Wahid contributes clothing inventory that he has acquired to the corporation in exchange for 50% of its shares. Wahid had a cost basis of 200,000 Afghanis in the clothes that he contributed. Naqibullah cannot recognize gain or loss on the transfer of Afghan currency to the corporation. Because Wahid received shares representing more than 5% of the corporation, the transfer is considered tax-free. Wahid receives the shares of the corporation with a Afs. 200,000 cost basis. The corporation takes the clothing with a Afs. 200,000 cost basis.*

<u>Example 2</u>: *Naqibullah and Wahid are Afghan residents that together own all of the stock of an Afghan limited liability company. Naqibullah's cousin, Adib, has some useful equipment which he would like to contribute to the business in exchange for stock ownership in the*

business. Adib has a cost basis of Afs. 100,000 in the equipment. Naqibullah and Wahid agree to cause their corporation to issue stock to Adib in exchange for the equipment. The stock issued to Adib represents 7% of the value of the entire corporation, but does not possess any voting rights. The stock is worth approximately Afs. 175,000. Because Adib does not hold any voting rights in the corporation after the transfer, the transfer is not tax-free to Adib. Adib must therefore recognize gain of Afs. 75,000. The corporation takes the equipment with a fair market value cost basis of Afs. 175,000.

<u>Example 3</u>: *Naqibullah and Wahid are Afghan residents that together own all of the stock of an Afghan limited liability company. Naqibullah and Wahid decide that Naqibullah should transfer some appreciated land to the limited liability company. The two shareholders agree that Naqibullah should be entitled to receive an additional 2% interest in the voting power and value of the corporation in exchange for the contributed land. Thus, Naqibullah transfers the land to the limited liability company. After the transfer, Naqibullah owns 52% of the entity and Wahid owns 48% of the entity. Even though Naqibullah did not receive a 5% or greater interest in the limited liability company (measured by vote and value) in exchange for the transferred land, the transfer is considered tax-free because Naqibullah owns 5% or more of the voting power and value of the entity immediately after the transfer.*

14.10 Money received by the lender from the borrower in repayment of a loan is not income and is therefore not subject to income tax.

14.11 Interest received by individuals on their deposits in banks in Afghanistan is exempt from taxation.

<u>Example</u>: *A person deposits Afs. 100,000 in one of the banks operating in Afghanistan and receives Afs. 3,000 every six months as interest on this deposit. This person is not required to pay any tax on such interest income.*

<u>Remark</u>: *The nationality of the bank is not relevant. All that is relevant is that the bank have operations within Afghanistan and takes deposits from Afghan residents. Thus, if an Afghan resident deposits money with a bank that is based in Turkey, but has a branch within Afghanistan, the interest income the Afghan resident earns on the account will be exempt from tax.*

14.12 Interest received by limited liability companies and corporations on deposits in banks in Afghanistan is subject to taxation.

<u>Example</u>: *A limited liability company deposits Afs. 500,000 in a bank in Kabul and receives Afs. 15,000 every year as interest on this deposit. This receipt is subject to taxation and must be reported as income by the company.*

14.13 Interest received by partnerships is deemed to be received by the partners of the partnership for purposes of applying the rules in Article 14(12).

14.14 Interest on bonds issued by the State or by municipalities of Afghanistan is exempt, whether received by an individual (Afghan or alien), a corporation, or a limited liability company, (Afghan or foreign).

Example: *A limited liability company buys government bonds totaling Afs. 500,000. Every year the Treasury Department of the Ministry of Finance makes an interest payment to the company. Since this receipt is an interest on government bonds, it is not subject to the income tax, and is not reported by the company its income tax return.*

14.15 The value of property acquired by gift, bequest, devise, or inheritance is excluded from income, but the income from such property is includable in gross income.

<u>Food and Fuel Tax Exemption</u>

Article 15. Income represented by the value of food, fuel, and goods consumed or used by the producer of the same or by members of his household is excluded from income tax.

15.1 The "producer" is the person who made the item or article used by himself or his dependants.

<u>*Example*</u>*: An artisan owns a small carpentry shop where he makes furniture. During the year he makes a table and six chairs which he uses in his own home. He does not have to include the value of these items on this return.*

<u>*Remark*</u>*: In most cases, the producer will pay the fixed tax under Chapter XI of the Income Tax Law, which is in lieu of income taxes. In applying the provisions of Chapter XI, the amount of goods normally consumed by the taxpayer and his dependants is taken into account in arriving at the net income potential of his establishment.*

Taxes on Rent and Lease of Immovable Properties

Article 16 Rent received in money or otherwise from renting and leasing immovable property used for commercial, industrial and other economic purposes is subject to income tax. Taxation of agricultural lands, gardens, and livestock together with their income are taxed by separate laws.

16.1 Taxation of the yield from agriculture and animal husbandry is not subject to the Income Tax Law. The income of the farmer, the landowner, the herdsmen, or owner of livestock derived from agricultural or livestock production is not subject to income taxes.

a. The following examples are types of income excluded from income taxes by Article 16 of the Income Tax Law:

1. money received from the sale of grain by the person who produced the grain or by the person on whose land it was grown;

2. rent in money received by the landowner for land devoted to production of crops, fruit, timber, or used for pasture and grazing of animals;

3. money received from the sale of wool, skins, dairy products, meat, live animals, and other products of animal husbandry by the owner of the animals or by the person caring for the animals; and

4. money received by the owner of herds of livestock as his share of the income from such herds.

b. The following examples are types of income not excluded from taxation under the Income Tax Law:

1. income from industrial and commercial processing of agricultural or animal products;

2. income from trade in agricultural or animal products;

3. income from rental of land not devoted to agricultural production; and

4. income from sale of supplies, fertilizer, equipment, chemicals, etc. to landowners, farmers, and herdsmen, even if used in agricultural and livestock production.

Example 1: *Naqibullah owns and operates a farm on which he produces wheat. Naqibullah sells the wheat to Azziz who is in the business of purchasing wheat from farmers and reselling it to flour mills. Azziz sells the wheat that he purchased from Naqibullah to a flour mill in Kabul that is owned by Wahid. The flour mill grinds the wheat into flour and sells the flour to merchants in Kabul. Naqibullah is not subject to income tax. Azziz, Wahid, and the merchants that sell the flour are all* *subject to the Income Tax Law.*

Example 2: *Adib owns a farm. Adib uses a tractor on his farm. He also rents the tractor to other farmers when he is not using it. The rental income that Adib receives will be subject to income tax, even if Adib rents the tractor to other farmers.*

16.2 The owners of tangible property, primarily used for commercial, industrial, or other economic purposes, are subject to income tax on income received from renting and leasing such property.

Example 1: *The owners of commercial shops and sarais are subject to income tax on income received from the renting or leasing of such property.*

Example 2: *The owners of factories and compounds used for industrial purposes are subject to income tax on income received from renting and leasing such property.*

Example 3: *Adib owns a farm and uses a tractor on that farm. When he is not using the tractor for farming, Adib rents the tractor to contractors in the nearest city who use the tractor to haul bricks and mortar. The income that Adib earns from renting the tractor is included in taxable income, even though the tractor is used during a portion of the year in his farming operations.*

<u>Liability to Withholding Tax from Salary or Wages</u>

Article 17 (1) Ministries, agencies and other government organizations, enterprises, companies and charitable institutions are required to withhold taxes from the salary or wages of its employees when they are being paid and transfer the withheld amount to the government account.

(2) Pensions of government employees are exempt from income tax.

17.1 The process and procedure for complying with the wage withholding tax provisions are set forth in Ministry of Finance publications Guide 5 'Wage Withholding Tax' and Public Ruling titled 'Salary or Wages in Afghanistan'. Both publications are available at the Ministry of Finance's website at www.mof.gov.af/tax.

17.2 Only payments to "employees" are subject to withholding. Payments made to natural persons who are "independent contractors" are not subject to withholding. Instead, the independent contractor is responsible for paying annual income tax.

17.3 The following factors shall be considered in determining whether a person is an "employee" or an "independent contractor" under this Article 17 and Article 46. For this purpose, the "principal" shall be the person for whom services are performed and the "service provider" is the person that is performing the services for consideration.

(a) The degree of control that the principal has over the manner in which the service provider performs the services. In this regard, due consideration will be given to whether the principal controls the hours that the service provider must perform and the manner in which the work is done.

<u>Remark</u>: The foregoing factor will typically be the most significant factor in making the determination as to whether someone is an employee or an independent contractor.

(b) The degree to which the principal provides the service provider with the tools that the service provider uses to perform his or her services.

(c) Whether the principal engages a specific individual to perform services.

(d) The manner of payment (*e.g.*, pay by the hour vs. payment upon completion).

(e) Whether payment is fixed or contingent upon the occurrence of events.

(f) The typical arrangement in the marketplace – *i.e.*, are the providers of this particular type of service usually treated as employees or independent contractors?

(g) The manner in which the service providers are treated by the principal. Due consideration will be given to whether the service providers are referred to as "employees" by the principal.

Example 1: *The Ministry of Communications pays 5 individuals to fix transmission towers. The individuals earn a fixed amount of Afs. 20,500 per month. The Ministry instructs the individuals when the towers are to be fixed. The Ministry provides very detailed rules that have to be followed in terms of safety. The Ministry provides the individuals with trucks and tools. The individuals do not have to purchase their own equipment, but they do purchase their own uniforms for the job. Under these facts, the Ministry will be considered the "employer" and the 5 individuals will be considered "employees". The Ministry will have to withhold Afs. 800 per month (Afs. 20,500 – 12,500 = 8,000 x 10%).*

Deductible Expenses

Article 18. (1) Deduction of all ordinary and necessary expenses of the production, collection, and preservation of income of natural and legal persons is allowed and deductible as follows, provided that these expenses have been incurred during the taxable year, or one of the three previous years, in accordance with the provisions of this Law.

1. Any expense related to the cost of production or trade and business, such as insurance and freight expenses, etc.;

2. The cost of supplies, materials, fuel, electricity, water, and ordinary and necessary expenses used in the production of income, or in a trade or business;

3. Wages, salaries, commissions, and fees paid for services rendered by employees in trade or business;

4. Interest paid on business loans;

5. Rent paid on property necessary to and used in trade or business;

6. Cost of repairs and maintenance of properties and equipment necessary to and used for purposes of the business or trade;

7. Depreciation of movable and immovable property (except agricultural land) used in a trade or business or held by the producer for the production of income in accordance with the Income Tax Manual. The total of deductions for depreciation of any item of property over a period of years shall not exceed its cost to the taxpayer;

8. Any tax or charge that is necessary expense of doing business, holding property for income, or of producing income, if paid or accrued during the taxable year. Taxes imposed by this Law and taxes not qualifying as necessary business expense are not deductible, except as otherwise provided by this Law;

9. Damages to movable or immovable property caused by fire, earthquake, and by casualty or disaster of any kind, over a three year period, to the extent that the cost is determined and substantiated by records and the loss was not recovered by insurance;

10. Losses in business or trade from bad debts according to the Income Tax Manual;

11. Dividends paid in money by a legal entity organized under the laws of Afghanistan; and

12. Other expenses of doing business and of holding movable or immovable property for the production of income under relevant

laws.

(2) No deductions are allowed for the following expenses:

1. Expenses incurred to provide entertainment or advertising that are not connected to economic or commercial activities;

2. Dividends, interest, royalties, rents, commissions, wages, salaries and similar expenses from which legal persons are required under provisions of this Law to withhold tax but have failed to do so; and

3. In the case of a branch in Afghanistan of a non-resident person, any expenses paid or incurred to the non-resident person or any person connected to the non-resident person.

18.1 Expenses and costs ordinarily incurred in the production of income are deducted from profit or net income from that activity to determine the amount of taxable income. Article 18 of the Income Tax Law lists the ordinary and necessary costs and expenses that are deductible from receipts in determination of taxable income of any business activity of an individual, of a limited liability company, or of a corporation. Expenses and costs may be incurred which are <u>not</u> deductible for purposes of income taxation. Thus, the profit or net income of a business may be different according to the records of the owner than net income determined in accordance with the Law. Expenditures which are not ordinary and necessary expenses are not deductible.

Examples of non-deductible expenditures are:

a. gifts;

b. illegal expenditures;

c. donations;

d. income taxes;

e. additions to reserves that are not required by law or that cannot be justified from experience (See Article 19(2)2 of the Income Tax Law);

f. any excessive amount added to a reserve required by law, or justifiable from experience (See Article 19(2)2 and Article 56 of the Income Tax Law);

g. cost of goods purchased but used by the owners or employees for personal or household purposes and not sold;

h. cost of goods purchased but subsequently returned to supplier or manufacturer; and

i. cost and expense of providing benefits for the owners, officers, and management that are not necessary for the conduct of business.

Example 1: *An individual owns a factory. Out of the income from the factory, the factory purchases an automobile for the individual's family. Such expenditures are not deductible in determining the taxable income of the individual.*

Example 2: *An automobile dealer purchases 10 automobiles for resale at a cost of Afs. 160,000 each. He keeps two of these for his family's use and sells eight at an average price of Afs. 200,000. If all purchases were allowed as a deduction, profit would be understated:*

a. Sales receipt (8 x Afs. 200,000)	*Afs. 1,600,000*
b. Cost of purchase (l0 x Afs. l60,000)	*1,600.000*
c. Gross profit	*none*

Whereas the correct statement would be:

a. Sales receipt (8 x Afs. 200,000)	*Afs. 1,600,000*
b. Cost of purchase – less 2 automobiles for personal use (8 x Afs. 160,000)	*1,280.000*
c. Gross profit	*Afs. 320,000*

18.2 Interest paid on business debts is deductible, but interest paid on personal debts is not. A personal debt is one incurred for purchase of goods and services or property for personal consumption and use. A business debt is one incurred in purchase of land, buildings, equipment, goods, etc., for leasing, resale, production of goods and services, and other business purposes.

Example: *Azziz borrows money from his brother, Wahid, to purchase a computer. Wahid charges Azziz 2% interest per year. Azziz cannot deduct the interest that Azziz pays to Wahid.*

18.3 Depreciation and recovery of cost basis shall not be allowed unless the taxpayer has clearly established the cost of the property being depreciated or recovered. Any cost established for purposes of claiming depreciation expense is binding on the taxpayer for purposes of determining gain from sale of the same property.

Example 1: *Adib purchased a motorcycle for use in his business 3 years ago. Adib never kept the receipt from the purchase. Adib now sells the motorcycle for Afs. 30,000. Adib does not present any evidence about what the cost of the motorcycle was to him. Adib must recognize gain of Afs. 30,000.*

Example 2: *Adib purchased a motorcycle for use in his business 3 years ago. Adib never kept the receipt from the purchase. Adib now sells the motorcycle for Afs. 30,000. Adib is able to demonstrate that motorcycles of this type normally cost Afs. 50,000. The man who sold him the motorcycle confirms this. Adib will be permitted to deduct Afs. 20,000.*

18.4 If an owner of a building is not able to clearly establish his cost basis and depreciation, the Ministry of Finance may not allow any deductions. If the owner provides acceptable documents regarding his cost basis and depreciation, then in this case, the deduction for depreciation will be allowed.

18.5 In certain cases it will be unclear whether a transaction involves the loan of money secured by an interest in property or whether it involves the lease of property. In making this determination, the Ministry of Finance shall consider a number of relevant facts and circumstances. In making this determination, the primary factor shall be the ownership of legal title to the underlying property. If a transaction results in the legal owner of an item of property receiving payment for the use of that property, the transaction will presumed to be a "lease". If a transaction results in the transfer of legal ownership of underlying property in exchange for payment, the transaction will be presumed to be a "sale". Nevertheless, if the lease term exceeds twelve (12) months and one or more of the following factors exist, the presumption will be overcome and the transaction will be considered a "financing lease". The lessor in a financing lease shall be considered to have sold the property to the lessee. The lessee will be considered to have purchased the property in exchange for its obligation to repay the purchase price to the lessor. The lessee in this case will be entitled to depreciate the property and the lessee will have to separate each lease payment into its principal component (which is not deductible) and its interest component (which is deductible). The aforementioned factors are as follows:

(a) the lessee has an option to assume ownership of the underlying property at the end of the lease term;

(b) the lease term exceeds 80% of the useful life of the underlying asset;

(c) the lessee shall have the right to purchase the property at the end of the lease term at a price that is lower than the expected fair market value of the property measured on the date that the lease is entered into;

(d) the residual value of the underlying property at the end of the lease term is expected to be less than 20% of the value of the property at the beginning of the lease term; or

(e) the present value of the expected lease payments, measured using a reasonable discount rate, exceeds 90% of the value of the underlying property measured on the date the lease is entered into.

<u>Example</u>: *Wahid "leases" equipment to Azziz. Wahid retains legal title to the equipment during the lease term. The equipment has a useful life of 5 years. The lease term is for a period of 4.5 years. The lease provides that Azziz has the right to purchase the property at the end of the lease term for 1 Afghani. The parties believe, at the time they enter into the lease, that*

the value of the property will be in excess of 1 Afghani. Even though this transaction is labeled a "lease," the Ministry of Finance is entitled to treat this transaction as if Wahid sold the equipment to Azziz in exchange for a debt instrument issued by Azziz to Wahid. This debt instrument shall be deemed to bear a reasonable rate of interest considering all of the facts and circumstances. The lease payments will be treated as payments of principal and interest and the interest component will be allowed as a deduction to Aziz. Aziz will also be entitled to claim depreciation on the equipment.

Wahid will treat the 'lease' of the equipment as a sale. The interest component of the 'lease' payment will be assessable income to Wahid.

18.6 When the cost of depreciable business assets is determined from documentary evidence, the depreciation expense that may be deducted each year is subject to the following provisions:

a. All institutions and agencies are required to observe the following percentages and standards with respect to the depreciation of their buildings, machinery, and other supplies.

b. The percentage shall be based on the cost.

c. The percentages and standards shall be established by the Ministry of Finance in consultation with the Ministry of Mines and Industries at appropriate times and brought to the attention of institutions and agencies.

d. Depreciation is an annual allowance. If a taxpayer fails to deduct or deducts an understated amount for one taxable year, he may not deduct the depreciation omitted or the amount understated in another year.

No.	Kind of asset	Period of Useful Life (in years)	Percentage Allowed Each Year
l.	Brick or stone structures	50	2
2.	Loam structures	20	5
3.	Wooden structure	10	10
4.	Machinery and equipment not otherwise specified below	10	10
5.	Mining equipment	6.5	15
6.	Tools	4	25
7.	Printing equipment and machines	2	50
8.	Handicraft machines	3	33
9	Metallurgical machines	10	10
l0.	Carpets	10	10
ll.	Rugs and other furnishings	4	25
l2.	Chairs, seats, and sofas	4	25
l3.	Desks, tables, and cabinets	10	10
l4.	Office equipment (calculators, typewriters, telephones, etc.)	6.5	15
l5.	Bicycles	5	20
l6.	Trucks	2	50
l7.	Cars	4	25
l8.	Tires and tubes	2	50

l9.	Sacks	2	50
20.	Impure iron stoves and pipes	10	10
2l.	Iron stoves	2	50
22.	Carriages, animal carts, and handcarts	3	33
23.	Construction machines, rollers, and mixers	5	20
24.	Computers and computer related equipment	3	33
25.	Televisions, radios, cellular phones	3	33
26.	Telecommunications equipment / cell towers	7	14

18.7 "Wages" and "salaries" include such items as regular pay, bonuses, over time pay, retroactive increases, and other valuable considerations paid by the employer in money or other forms.

Example: *An employee works for a company for a monthly salary of Afs. 20,000. In Caus, he receives a promotion and his salary is increased to Afs. 24,000, effective as of Meezon 1. At the end of the year, the company pays each employee a bonus of five per cent of his salary. In reporting the salary paid to the employee, the company must include all of these items, and the employee must report them on his income tax return as follows:*

a.	*Salary (first 6 months) (6 x Afs. 20,000)*	*Afs. 120,000*
b.	*Salary (second 6 months) (6 x Afs. 24,000)*	*144,000*
c.	*Total 12 months' salary*	*Afs. 264,000*
d.	*Five per cent of yearly salary at the end of the year (5% of Afs. 264,000)*	*13,200*
e.	*Total income from the company*	*Afs. 277,200*

18.8 Payment by the employer of the personal income tax of his employee is payment of additional salary or wages to the employee and as such is subject to taxation.

18.9 The municipal tax on leased property is deductible from rental income.

Example: *A tax of Afs. 20,000 is paid to a municipality on commercial property leased to a tenant for Afs. 240,000 per year. This tax is deductible from rental income. If depreciation was Afs 20,000 and repairs were Afs 4,000 and no other deductible expenses were incurred, the net income from this property would be:*

a.	*Gross rent*		*Afs. 240,000*
b.	*Municipal tax*	*Afs. 20,000*	
	Depreciation and repairs (see Regulation 18.4)	*24,000*	*- 44,000*
c.	*Net income*		*196,000*

18.10 Net income taxes are not deductible in computing net income.

Example: *A corporation has a net income in the taxable year of Afs. 800,000. During the taxable year it paid income taxes of Afs. 120,000 on income received during the previous year. This amount is not deductible nor is the income tax for the current year deductible.*

18.11 An employer can deduct certain non-cash benefits that it provides to its employees, provided that the provision of the benefits is directly related to the employer's business.

<u>Example:</u> *A construction company which is building a dam some distance from any town finds that it must provide transportation between the nearest town and the construction site each day to induce laborers to work at the project site. This is a legitimate expense of doing business and the company may deduct the cost of providing such transportation.*

<u>*Remark*</u>*: If some of the employees drive their own cars to the project site, they cannot deduct the cost of traveling to and from work from their income when filing their individual income tax returns.*

18.12 Loss of property used for production, collection, or preservation of income caused by fire, wind, earthquake, casualty, or disaster of any kind may be deducted to the extent that such loss was not reimbursed by insurance. To claim such a deduction, the owner must have kept records which clearly show the value or cost of the property lost. One third of the loss may be claimed in the current year and each of the succeeding two years.

18.13 Premiums paid for insurance of property used for the production, collection, and preservation of income are a legitimate cost of doing business and are fully deductible. Receipts from an insurance company as the result of a loss are not taxable unless the amount of reimbursement exceeds the cost or depreciated value of the property lost. If the amount of reimbursement received exceeds the depreciated value of the property, the excess must be reported as income by the owner.

<u>Example</u>. *An individual operates a car dealership in Kabul. Due to a severe storm, two of the cars on the individual's lot are damaged. One car is a Toyota. The other car is a Mercedes. All of the cars are fully insured. The individual purchased the Mercedes for Afs. 1,000,000. The individual purchased the Toyota for Afs. 800,000. After filing an insurance claim for the damage, the individual receives Afs. 700,000 for the Mercedes and Afs. 850,000 for the Toyota. The individual is entitled to recognize a loss of Afs. 300,000 with respect to the Mercedes, but must recognize income of Afs. 50,000 with respect to the Toyota. The loss of Afs. 300,000 may be claimed over the course of three years. The first Afs. 100,000 loss may be claimed in the current year. An addition Afs. 100,000 may be deducted in each of the subsequent two years.*

18.14 A taxpayer will be allowed a deduction in a tax year for a bad debt if the following conditions are satisfied:

(a) the amount of the debt was previously included in the taxable income of the taxpayer;

(b) the debt is written off in the accounts of the taxpayer during the tax year; and

(c) the taxpayer has reasonable grounds for believing that the debt will not be recovered.

This requirement will not apply to a bank entitled to a deduction for additions to reserves against losses in accordance with Article 56 of this Law.

<u>Example</u>: *Ahmad Advertising Company provides advertising services for newspapers and radio. Ahmad Advertising Company has an arrangement with Shiraz Restaurant where Ahmad Advertising Company places advertisements each month in the newspaper and the radio and then sends an invoice for Afs 5,000 to Shiraz Restaurant for payment. One month, Shiraz does not make the payment. Ahmad Advertising Company cancels the arrangement. Ahmad Advertising Company, being required to account on the accruals basis and having provided the advertising services, has already included the amount of Afs 5,000 in its income. Ahmad Advertising Company makes attempts to collect the money. It makes phone calls and sends a letter to Shiraz Restaurant but no payment is received. Eventually, Shiraz Restaurant closes its business.*

Ahmad Advertising Company has reasonable grounds for believing that the debt will not be recovered. It may treat the amount as a bad debt and claim an income tax deduction for the amount not received.

<u>Remark:</u> If an amount is written off as a bad debt, but the debtor subsequently pays some or all of the amount written off, then this amount will be treated as income.

Non-Deductible Expenses

Article 19. (1) Personal expenses including the following expenses are not deductible:

1. payments paid to persons for his or his family's benefit and enjoyment;
2. expenses and costs of maintenance, repair, construction, improvement, furnishing, and other expenses of the taxpayer's or his family's house or residence or any property devoted to his own personal or family's use;
3. interest on personal loans;
4. costs of commuting to and from work and cost of travel for personal purposes;
5. cost of life, accident, health, and liability insurance for the protection of the taxpayer and his family; and
6. cost of insurance of any kind for the protection of property used for personal purposes.

(2) The following expenses are not deductible:

1. The cost of acquiring land, buildings, durable items such as machinery, equipment, fixtures, and furniture, or costs of additions or improvements to the same. Depreciation expense allowable under sub-paragraph 1(7) of Article 18 and the provisions of Chapter 3 of this Law are excepted from this paragraph;
2. Additions to reserves for contingencies, bad debts, and other similar purposes; and
3. Taxes paid to foreign countries by non-resident persons on income from sources within Afghanistan, except as provided by an existing treaty.

19.1 The expenses listed under Article 19(1) of the Income Tax Law are typical living expenses of an individual and his family that are specifically listed as not deductible to remove any uncertainty that could otherwise arise. No personal expenses are deductible. Examples of personal expenses are:

a. cost of food, supplies, clothing and shelter for taxpayer and his dependants;

b. costs of entertainment, recreation, books, and education for taxpayer and dependants;

c. medical and dental expenses of taxpayer and dependants;

d. contributions, gifts, and support given to unfortunates;

e. expenses of repair and maintenance of automobile used for personal and family purposes;

f. personal income taxes paid;

g. tax on a residence occupied by the owner, or taxes of any kind except those that are expenses of a business from which income is taxable;

h. fines paid for violations of law by the taxpayer or members of his family;

i. losses (except losses covered by Article 18(1)9 of the Income Tax Law) of property through misfortune, theft, carelessness, etc.; and

j. other costs and expenses that are not costs of doing business, producing income, etc.

19.2 Land is a fixed asset that is not depreciable for purposes of taxation. Unless destroyed by flood, landslide, etc., the land does not lose utility and value. Therefore, the cost of acquiring land is not deductible either at the time the land is purchased or as it is used. The cost of land is deducted from the price or value realized only when the land is sold or transferred (except by inheritance).

<u>*Example 1*</u>*:* *A corporation purchases a large tract of land as a site for a new factory. The cost of the land is not deductible from income nor can depreciation expense be claimed on the investment in land. The purchase price paid remains unchanged on the financial statement of the corporation until the land is sold in whole or in part.*

<u>*Example 2*</u>*:* *A corporation purchases a tract of land with an office building situated on the tract. The price paid for the entire property is Afs. 30,000,000. A division of this sum must be made on the books of the corporation between the cost of land and cost of improvements (buildings etc.). The cost allocated to land cannot be depreciated, but the cost allocated to improvements can be deducted in annual depreciation expense over the period of expected useful life of the improvements.*

19.3 An addition to a reserve is part of income set aside but not expended. If an amount is added to an already established reserve or is set aside to provide a new reserve which may be deemed necessary by the management, it is deductible if required by law.

<u>*Example l*</u>*:* *If the law requires a bank to maintain a reserve for losses on loans equal to 25 percent of loans issued and the reserve is less than that amount, any amount needed to bring the reserve up to 25 percent of loans outstanding, and not exceeding that, may be added to that reserve and deducted from income before taxes are calculated.*

Thus, if loans outstanding were Afs. 2,000,000,000 at the end of the year, and the reserve for losses on loans was Afs. 475,000,000, the maximum amount that can be added to this reserve, in addition to the Afs. 475,000,000, can be found as follows:

a.	25% of loans outstanding (25% of Afs. 2,000,000,000)	Afs. 500,000,000
b.	the amount of the existing reserve	- 475,000,000
c.	the amount by which the reserve is less than the legal reserve	Afs. 25,000,000

So, this reserve is thus Afs. 25,000,000 less than the amount required by law. Therefore, an amount up to Afs. 25,000,000 may be set aside and deducted from income before taxes are assessed. If net income were Afs. 25,000,000 or less, the entire income could be set aside, leaving no income subject to income tax.

Remark: *The business receipts tax would not be affected by reserve additions.*

Example 2: *If the bank had reserve of Afs. 500,000,000 and outstanding loans of Afs. 2,000,000 at the end of the year, an addition to this reserve would not be deductible because the amount of the reserve already equaled 25 per cent of the amount of loans outstanding. Thus, if net income was Afs. l00,000,000, and Afs. 25,000,000 of this was added to the reserve for losses on loans, increasing the reserve to Afs. 525,000,000, the taxable income (Afs. 100,000,000) would not be reduced. The amount added to the reserve cannot be deducted from income, because the reserve was already at the amount required by law (.25 x Afs. 2,000,000,000 = Afs. 500,000,000).*

Example 3: *Reserves for depreciation are not affected by Article 19 of the Income Tax Law. Allowable depreciation expenses may be deducted from the cost of the assets depreciated. (See Regulation l8.6 for allowable depreciation rates.)*

19.4 An expense that is not deductible may not be paid from a reserve built up out of tax-free income.

Example: *Since income taxes are not deductible from taxable income, charging income tax payments against tax-free reserves is essentially the same as deducting those taxes from income. If, on the other hand, the reserve for contingencies is not required by law and the reserve had been built up from income after taxes, the payment of income taxes may be charged against the reserve.*

19.5 Tax payments by aliens to foreign countries do not affect the taxes due to the State on income from sources in Afghanistan.

Example: *An alien may be subject to income taxes imposed by his own country on his income from sources in Afghanistan. The income from sources within Afghanistan is taxable by the Government of Afghanistan.*

Afghanistan has priority over taxation of such income and does not allow the taxes paid by the alien to his own country to affect (reduce) the tax due to the State. Therefore, such foreign tax paid cannot be deducted from taxable income or credited in computing the tax due under the Law. Thus, if an alien earns Afs. 500,000 from services performed by him in Afghanistan and in his country, regardless of how the tax due in his own country is calculated, the tax due in Afghanistan is unaffected.

<u>Income from Domestic Sources</u>

Article 20. (1) Income from sources within Afghanistan is as follows:

1. Interest from loans, deposits, investments, etc.;
2. Dividends received from resident companies doing business in Afghanistan;
3. Salaries, wages, self-employment income, etc., for services performed;
4. Rentals and royalties from any property (movable and immovable);
5. Gain from sale of immovable and movable property;
6. Commissions on sales of any kind including insurance;
7. Income from commercial activities within Afghanistan;
8. Gains from the sale or transfer of any movable property used in commercial or employment activities;
9. Royalties, a management fee, an annuity, or a commission paid by a resident of Afghanistan;
10. Income from exploitation of any interest in a right to explore for, or exploit, any mineral, petroleum, or any other resources; and
11. Income from other sources in Afghanistan which is subject to tax according to the provisions of this Law.

(2) For the purposes of this Law, apart from Articles 29 and 30, the term "immovable property" in subparagraph (5) of paragraph (1) of this Article includes any benefit in a company or other entity where the value of the assets of the company or entity results principally from ownership either directly or indirectly through other persons of –

1. immovable property in Afghanistan; or
2. benefits in immovable property in Afghanistan, including hydrocarbon contracts and mining licenses and mining authorizations as defined in Chapter XII.

(3) For the purposes of this Law, apart from Articles 29 and 30, exploitation of an interest described in subparagraph (10) of paragraph (1) of this Article includes any sale of or other dealing with an interest.

20.1 Interest on loans, deposits, investments, etc., within Afghanistan include:

a. interest on deposits of corporation and limited liability companies, but not of individuals, in banks in Afghanistan; and

b. interest on loans to individuals, companies, permanent establishments, and subsidiaries in Afghanistan.

20.2 Dividends paid by an Afghan corporation or limited liability company will be considered to have an Afghan source and therefore subject to Afghan withholding tax.

Example: *A foreign investor owns all of the issued stock of an Afghan corporation. The Afghan corporation has accumulated Afs. 1,000,000 of earnings. The Afghan corporation distributes Afs. 1,200,000 to its shareholder. Of the Afs. 1,200,000 distribution, only Afs. 1,000,000 is considered a dividend that has an Afghan source. The remainder of the distribution is considered a return of invested capital or a gain with respect to the investor's stock. Neither the return of capital nor the gain with respect to the stock is considered to have an Afghan source.*

20.3 Salaries, wages, self-employment income, etc. for services performed in Afghanistan are considered to have an Afghan source.

Example: *A non-resident individual is employed by a UK company to perform services inside and outside of Afghanistan. The non-resident employee spends approximately 80% of his time during the year in Afghanistan. Thus, 80% of the individual's salary during the year shall be considered to have an Afghan source. This income will be subject to Afghan income tax unless exempted by a treaty or an agreement with the State.*

20.4 Rentals and royalties from any property (moveable and immovable) used within Afghanistan shall be considered to have an Afghan source.

Example 1: *A Chinese company leases trucks to an Afghan corporation. The Afghan corporation, in turn, uses the trucks to make deliveries throughout Afghanistan. The lease payment from the Afghan corporation to the Chinese company is considered to have an Afghan source.*

Example 2: *A Chinese company leases trucks to an Afghan corporation. The Afghan corporation, in turn, uses the trucks to make deliveries throughout Afghanistan and Pakistan. The lease payment from the Afghan corporation to the Chinese company is considered to have an Afghan source only to the extent it relates to the use of trucks in Afghanistan. Thus, the lease payment from the Afghan corporation to the Chinese company must be allocated between payments for use of trucks within Afghanistan and the use of trucks in Pakistan based on a reasonable measure. Examples of reasonable measures would include* *the number of miles driven in each country, or a comparison of revenues from deliveries in each country.*

20.5 Gain from the sale of immovable and movable property that is physically situated in Afghanistan shall be considered to have an Afghan source. Such gains shall include:

a. income from the ownership or interest in any immovable property, mineral deposit, or natural resources in Afghanistan;

b. income from the ownership or interest in any franchise to do business in Afghanistan;

c. gain from the sale of an interest in a domestic or foreign partnership, to the extent the partnership owns assets in Afghanistan;

Example 1: *A foreign investor owns a 10% interest in the capital and profits of an Afghan partnership. The Afghan partnership owns real property in Afghanistan. If the investor sells his 10% interest in the Afghan partnership, the gain (if any) will be considered to have an Afghan source. The sale of the partnership interest will have the same source as the sale of the underlying property.*

Example 2: *A foreign investor owns a 10% interest in the capital and profits of a UK limited liability partnership. The partnership owns mining properties in Afghanistan. If the investor sells the UK partnership interest, the gain (if any) will be considered to have an Afghan source.*

Example 3: *A foreign investor owns a 10% interest in the capital and profits of an Afghan partnership. The Afghan partnership owns real property in India. The Afghan partnership does not own any Afghan assets. If the foreign investor sells his 10% interest in the partnership, the gain (if any) will not be considered to have an Afghan source.*

d) gain from the sale of stock of a corporation or limited liability company if the value of the assets of the company results principally from ownership either directly or indirectly through other persons of: (a) immovable property in Afghanistan; or (b) interest in immovable property in Afghanistan, including hydrocarbon contracts and mining licenses and mining authorizations as defined in Chapter XII.

Remark: For this purpose, the term "principally" shall mean more than fifty percent, measured by value.

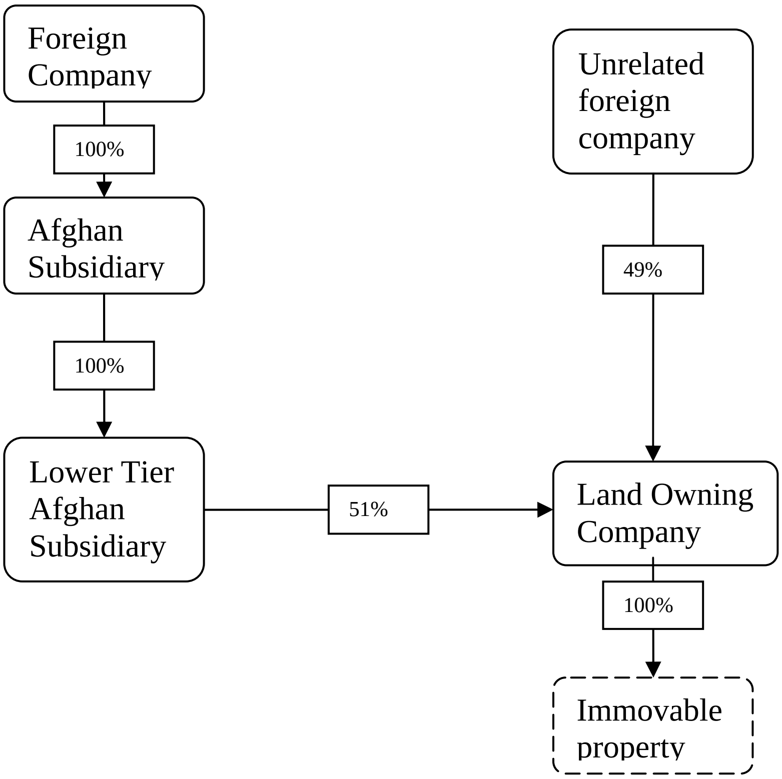
Remark: A corporation or limited liability company shall be considered to indirectly own those assets that are owned through lower-tier entities based on the value of the interest that the upper-tier entity owns in the lower-tier entity.

<u>Example 1:</u> *A foreign investor owns an interest in the stock of an Afghan corporation. The Afghan corporation leases some real property and owns equipment situated in Afghanistan. The Afghan corporation entered into the real property lease three years ago and the lease payments are somewhat below market. Thus, the leasehold interest is worth Afs. 300,000 to the Afghan corporation. The equipment is worth approximately Afs. 1,000,000. If the foreign investor sells the stock of the Afghan corporation at a gain, the gain will not be considered to have an Afghan source.*

<u>Example 2:</u> *A foreign investor owns an interest in an Afghan corporation ("A1"). A1 owns all of the issued stock of a second Afghan corporation ("A2"). A1's sole asset is the stock of A2. A2's sole asset consists of real property located in Bamiyan province. If the foreign investor sells the stock of A1, the gain will be considered to have an Afghan source, because A1's assets (owned indirectly) principally consist of real property located in Afghanistan.*

<u>Example 3:</u> *A foreign investor owns all of the issued stock of an Afghan corporation ("A1"). A1 owns stock of a lower-tier Afghan corporation ("A2") which represents 70% of the value of A2. A1 owns Afs. 1,000,000 that it has on deposit with Da Afghanistan Bank. A2 owns real property located in Afghanistan that is worth Afs. 2,000,000. The value of A1's property results principally from the indirect ownership of real property located in Afghanistan. This is because A1's assets consist of Afs. 1,000,000 of cash and Afs. 1,400,000 of real property (70% x Afs. 2,000,000). Thus, if the foreign investor sells the stock of A1 at a gain, the gain will be considered to have an Afghan source.*

Example 4:



The only assets owned by Afghan Subsidiary are shares in Lower Tier Afghan Subsidiary and the only assets owned by Lower Tier Afghan Subsidiary are shares in Land Owning Company and the only asset owned by Land Owning Company is immovable property eg a mining license for a site in Afghanistan.

If Foreign Company were to sell its shares in Afghan Subsidiary, Foreign Company would be treated as having sold immovable property in Afghanistan and the gain realised on the sale of shares in Afghan Subsidiary would be subject to income tax. This is because 100% of the value of Afghan Subsidiary is attributable to the immovable property further down the chain.

The same result would follow if Lower Tier Afghan Subsidiary owned 49% of Land Owning Company and Unrelated Foreign Company owned 51% of Land Owning Company. While Foreign Company now has an indirect interest in the immovable property of less than 50%, it is still the case that 100% of the value of Afghan Subsidiary is attributable to the ownership of immovable property. A sale of shares in Afghan Subsidiary in this case would be treated as a sale of immovable property.

> *Remark:* *The tracing mechanism through interposed entities will apply in the same manner to immovable property or to benefits in immovable property in Afghanistan, including hydrocarbon contracts and mining licenses and mining authorizations as defined in Chapter XII.*

20.6 Commissions on sales of any kind including insurance shall be considered to have an Afghan source to the extent the sales activities take place in Afghanistan. For this purpose, consideration will be given to all of the relevant facts and circumstances. The physical location where the contract is executed will be persuasive, but not definitive evidence of where the sales activities took place.

<u>Example</u>: *An insurance salesman from a foreign country is in Afghanistan 30 days selling insurance to aliens in Afghanistan, some of whom belong to the foreign diplomatic corps. All commissions earned by this salesman on sales made while in Afghanistan, including those received from sales of insurance to aliens exempt from taxes in Afghanistan, are subject to income tax. The foregoing is true even if the contracts (if any) happen to be signed outside of Afghanistan. The fact that the solicitation and negotiation occurred in Afghanistan is sufficient to subject the commissions to income tax within Afghanistan.*

20.7 Gains from the sale or transfer of any movable property used in commercial or employment activities within Afghanistan is considered to have an Afghan source. Whether property is "used" within Afghanistan is determined based on a facts and circumstances test with due regard for the amount of time the property was used in Afghanistan compared with the amount of time that it was used elsewhere, during the period that the owner used the property.

<u>*Example 1:*</u> *A Pakistani corporation owns a number of trucks that it uses to transport goods throughout Afghanistan. The Pakistani corporation has used one truck for three years within Afghanistan. At the beginning of the fourth year, the Pakistani corporation sells the truck to a third party at a gain. The gain is considered to have an Afghan source regardless whether the sale actually occurs in Afghanistan or not.*

<u>*Example 2:*</u> *A Pakistani corporation owns a number of trucks that it uses to transport goods between Pakistan and Afghanistan. The Pakistani corporation has used one truck for three years. More than half of the time the truck was owned, it was physically used within Pakistan, not Afghanistan. At the beginning of the fourth year, the Pakistani corporation sells the truck to a third party at a gain. The gain is not considered to have an Afghan source, because the truck was predominantly used outside of Afghanistan.*

20.8 A management fee, annuity, or commission paid by a resident of Afghanistan is considered to have an Afghan source.

<u>*Example 1:*</u> *A UK corporation owns all of the issued stock of an Afghan corporation. Certain executives from the UK corporation provide ongoing management advice to the Afghan corporation. In exchange for this advice, the Afghan corporation pays the UK corporation a management fee. The management fee is considered to have an*

Afghan source whether or not the advisory services are actually performed in Afghanistan.

20.9 Income from the exploitation of any interest in a right to explore for, or exploit, any mineral, petroleum, or any other resources physically situated in Afghanistan shall be considered income from Afghan sources. To the extent that any natural or legal person generates any income (including but not limited to exploration, extraction, and/or refining) with respect to the exploitation of Afghan minerals, petroleum or other resources, the income shall be considered to have an Afghan source.

CHAPTER II

DETERMINATION OF TAXABLE INCOME

Article 12 – Article 20