TAXING THE DIGITAL ECONOMY: AZERBAIJAN'S VAT RULES FOR ELECTRONICALLY SUPPLIED SERVICES



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The accelerating digitalization of economic activity has posed significant challenges for traditional Value Added Tax (VAT) systems, which were originally designed for transactions involving physical goods and location-bound services. Digital services raise complex issues of jurisdiction, place of supply, and enforceability, particularly in cross-border contexts.

This article examines the VAT treatment of digital services, with a focus on recent developments in the Republic of Azerbaijan. Azerbaijan, with its ongoing tax modernization effort, has begun to adapt its VAT system to the new realities of the global digital economy. This article explores the nature of digital services for VAT purposes, reviews international practice, examines Azerbaijan's evolving approach, identifies key strengths and analyzes structural weaknesses.

The digital economy has reshaped how services are produced, delivered, and consumed. Activities that historically required physical presence, such as entertainment, education, professional advice, and retail, are increasingly mediated by digital platforms and electronic networks. From a tax policy perspective, this transformation raises fundamental questions regarding the allocation of taxing rights and the practical administration of consumption taxes such as VAT.

VAT systems are premised on the principle of taxation at the point of consumption. Yet digital services are often supplied remotely by non-resident entities, to consumers who may not be readily identifiable, via platforms that operate globally. Traditional markers of tax nexus, such as physical presence, local establishment, or tangible infrastructure, provide limited guidance in digital environment.

In response, many jurisdictions have introduced specific rules for taxation of electronically supplied services. International organizations, notably the OECD and the EU, have long been working on building detailed frameworks for VAT treatment of digital services, including simplified regimes for non-resident suppliers.

Defining Digital and Electronically Supplied Services

Digital services, for VAT purposes, are typically understood as services delivered via the internet or other electronic networks, requiring minimal human intervention in their execution. International practice frequently refers to "electronically supplied services", encompassing:

- Streaming and downloadable content (audio, video, games, e-books);
- Software and apps, including software-as-a-service (SaaS);
- Cloud computing and hosting services;
- Online platforms and marketplaces;
- Digital advertising and data analytics;
- Online subscriptions, e-learning, and other automated digital content.

The key distinguishing feature is that the service is delivered electronically, and its performance is predominantly automated. This contrasts with online services where the core element remains human interaction (e.g., live consulting via video call), which may be treated differently under VAT rules.

Three interrelated VAT principles are particularly relevant to digital services:

1. **Destination Principle:** VAT should be levied in the jurisdiction where consumption occurs. For digital services, consumption is generally associated with the customer's location, either the place of establishment (B2B) or residence/habitual residence (B2C).
2. **Place of Supply Rules:** VAT legislation typically differentiates between B2B supplies, where the place of supply is the customer's place of business (often taxed via reverse charge) and B2C supplies, where the place of supply for digital services is increasingly defined as the consumer's location, requiring the supplier to collect and remit VAT in that jurisdiction.
3. **Collection and Enforcement Mechanisms:** Effective VAT collection in cross-border digital contexts often relies on mandatory registration of non-resident suppliers, simplified schemes to reduce compliance burdens and in some cases, obligations for platforms or intermediaries to act as deemed suppliers and VAT collectors.

These principles underpin global approaches and provide a benchmark against which national systems can be evaluated.

International Practice and Standards, approaches of OECD and EU

The OECD has articulated clear guidelines for VAT in the digital economy in OECD International VAT/GST Guidelines, in the report named "Addressing the Tax Challenges of the Digital Economy" that was issued as a part of the work carried out under the BEPS Action Plan:

- **Destination-based taxation:** VAT should accrue to the jurisdiction where the customer is located, thereby maintaining neutrality and reducing distortions in cross-border trade.
- **Tax neutrality and level playing field:** Similar consumption should face similar tax treatment, regardless of whether services are supplied domestically or cross-border, online or offline.
- **Simplified compliance for foreign suppliers:** Non-resident suppliers should have access to streamlined procedures for registration, filing, and payment, encouraging voluntary compliance.
- **Role of platforms:** In some cases, digital platforms may be treated as deemed suppliers, bearing primary responsibility for VAT collection.

These principles have influenced numerous countries, shaping reforms aimed at ensuring that digital services are effectively integrated into the VAT base.

The European Union represents one of the most advanced models of VAT regulation for digital services. Since 2015, telecommunications, broadcasting and electronically supplied services to consumers have been taxed in the member state of the consumer, regardless of the supplier's location. Central features of VAT taxation of digital services in EU include:

- Customer-location rules for B2C electronically supplied services;
- The Mini One Stop Shop (MOSS), expanded into the One Stop Shop (OSS), allowing non-resident suppliers to register in a single member state and report VAT due across the EU via one portal;
- Detailed evidentiary requirements to establish customer location (e.g., billing address, IP address, bank details).

VAT Taxation of Digital Services in Azerbaijan

Historically, Azerbaijan taxed crossborder digital services through a split system whereby B2B supplies were brought into the VAT net via reverse charge on resident business recipients, while B2C supplies were effectively taxed at the point of payment by charging VAT to customers' cards through local financial intermediaries (banks, the postal operator, and payment providers). In 2024, an optional registration mechanism started to apply to nonresident providers of B2C digital services, and, following the amendment to the Tax Code effective 23 August 2026, nonresident providers of digital services to persons not registered with the Azerbaijani tax authorities are obliged to register within 30 days once their calendaryear turnover from those supplies to customers in Azerbaijan exceeds the manat equivalent of USD 10,000, while registration remains voluntary below that threshold.

The Regulations expressly targets nonresident persons providing electronic commerce services via internet resources to residents of Azerbaijan. It covers a broad range of digital services, including (but not limited to):

- Downloads of digital content,
- Virtual games and software,
- Online advertising,
- Other services supplied through internet resources.

By design, the Regulation does not apply to nonresidents operating in Azerbaijan through a permanent establishment and such entities are instead governed by the general VAT rules under the Tax Code as resident taxpayers. Thus, the Regulation focuses squarely on the classic BEPS area for VAT, i.e. remote supplies by nonresident providers with no physical presence in Azerbaijan.

Conceptually, the Regulation adopts a destinationbased VAT model: digital supplies are taxed where the recipient is effectively located/consuming, rather than at the supplier's place of establishment.

Objective criteria are used to determine when a transaction is deemed to be supplied in Azerbaijan for VAT purposes. A nonresident must treat the supply as taxable in Azerbaijan and submit a VAT return if one or more of the following indicators are present in relation to the recipient of the digital service:

- **Payment channel nexus:** The recipient pays via a bank operating in Azerbaijan, the national postal operator, or another payment service provider established in Azerbaijan.
- **Physical presence:** The recipient is physically located in Azerbaijan at the time the digital service is acquired.
- **IP address test:** The IP address of the recipient's device (computer, phone, other equipment) used to access the digital service is located in Azerbaijan.
- **Mobile operator test:** The country code of the mobile operator whose network is used to purchase/access the service corresponds to Azerbaijan.

These conditions align closely with international practice (e.g., EU placeofsupply rules) by using multiple, technologybased proxies to determine the effective place of consumption.

The Regulation establishes a mandatory electronic VAT registration system for nonresident suppliers of digital services that meet the above nexus criteria.

Nonresidents are required to register via the online portal of the State Tax Service (STS). Once registered, nonresident suppliers must file VAT declarations electronically through the same online platform and pay VAT in the currency chosen at registration.

The Regulation explicitly provides for realtime electronic information exchange between the State Tax Service and local banks. This exchange serves two main functions:

- **Stopping VAT withholding once the nonresident registers (avoiding double taxation)**
  When a nonresident ecommerce provider registers with the STS, it declares its payment flows and relevant transactional data. STS then communicates this registration information to banks and other intermediaries in real time and instructs them to stop withholding VAT from card and other payments made to that registered nonresident. From that point, VAT on those transactions is no longer collected at the customer's payment instrument, instead, the registered nonresident is responsible for charging, declaring and paying VAT directly. This switch prevents the same VAT from being collected twice, first by the bank and then by the supplier.
- **Identifying unregistered nonresidents and monitoring compliance**
  Banks and payment providers must transmit transactional data on payments for digital services made to nonresident suppliers to STS. Using this data, STS can Identify nonresident suppliers with Azerbaijani customers and estimate the scale of their Azerbaijani turnover, spot nonresident suppliers that appear to meet the registration criteria but have not registered and also

compare declared turnover and VAT payments with actual payment flows, thereby monitoring compliance and enforcing VAT collection where discrepancies arise.

In this way, the realtime information exchange both operationalizes the transition from "VAT withheld at card" to "VAT paid by the nonresident supplier" after registration and provides the tax authorities with the data needed to bring unregistered nonresident suppliers into the system and oversee their ongoing compliance.

Azerbaijan's current approach to VAT taxation of digital services has several notable strengths that place it broadly in line with modern international practice.

One key strength is its strong alignment with the destination principle. The system relies on a set of multifactor nexus tests to determine whether consumption takes place in Azerbaijan. By embedding these objective indicators into its rules, Azerbaijan effectively ensures that VAT is levied where digital services are actually consumed.

A second strength is the electronic registration and filing system for nonresident suppliers. Nonresident providers of electroniccommerce services can register online, submit VAT returns, and pay VAT electronically. This is consistent with best practice in jurisdictions that have successfully integrated crossborder digital services into their VAT base and lowers practical barriers to compliance.

Third, the system's realtime data exchange with banks and payment service providers moves Azerbaijan beyond a purely declarative model into an evidencebased enforcement framework. Banks and other intermediaries share transactional data on payments for digital services made to nonresident suppliers, while the State Tax Service (STS) communicates registration status and instructions back to them. This is particularly important in the digital context, where traditional physical audits are difficult or impossible. The use of paymentflow data allows the authorities to identify relevant nonresident suppliers, estimate their Azerbaijani turnover, monitor whether they cross the registration threshold, and test the consistency of declared figures against actual transactions.

Despite these advances, the system has important weaknesses and challenges. Perhaps the most significant is the limited granularity in the treatment of complex digital business models. While the Regulation clearly defines which nonresidents must register and when supplies are deemed to be Azerbaijani, it does not offer detailed interpretative guidance on several key areas, such as:

- Multisided digital platforms (including when they should be treated as deemed suppliers rather than mere intermediaries);
- Bundled offerings that combine digital and nondigital elements (for example, subscriptions including content, services and support);
- Freemium models and inapp purchases, where monetization can be fragmented and incremental.

In the absence of detailed secondary guidance or practice notes, taxpayers face interpretive uncertainty. This increases the risk of inconsistent treatment, differing approaches by advisers and businesses, and potential disputes over the correct VAT characterization of complex models.

A second weakness relates to enforcement limits in the crossborder context. Although the Regulation creates a clear legal obligation for nonresident suppliers to register and pay VAT, Azerbaijan's ability to compel compliance by entities with no assets or presence in its territory is inherently constrained. The strongest sanction currently available to the authorities in the specific nonresident regime is effectively deregistration, while monetary sanctions are limited to late payment interest, there are no tailored fines or penalties specifically designed for nonresident noncompliance. Direct enforcement actions against nonresident entities are difficult in practice. Even though data from banks and payment providers can identify noncompliant suppliers and show that they have exceeded the registration threshold, converting that information into actual foreign registration and payment obligations depends largely on voluntary compliance and reputational considerations, rather than hard enforcement tools.

Overall Assessment

Taken together, Azerbaijan has a modern, coherent and internationally consistent framework for VAT taxation of digital services. The system:

- Clearly defines when nonresident digital supplies are taxable in Azerbaijan, using objective, technologybased nexus criteria;
- Establishes a dedicated electronic registration, filing and payment framework for nonresident ecommerce suppliers;
- Integrates realtime information exchange with banks and other financial intermediaries to support evidencebased monitoring and enforcement;
- Ensures a backup collection mechanism, mitigating the risk of complete nontaxation when nonresidents do not comply.

However, to fully realize the potential of this architecture, further refinement is needed. In particular, the system would benefit from:

- Detailed administrative guidance on the VAT treatment of complex digital business models, including platforms, bundles, freemium models and inapp purchases;
- More robust tax and nontax enforcement measures tailored to nonresident suppliers, moving beyond deregistration and latepayment interest to a more comprehensive sanction and incentive framework.

If these gaps are addressed, Azerbaijan's VAT regime for digital services could be a highly effective system, capable of handling the increasingly sophisticated forms of digital commerce that characterize the modern global economy.