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EDITION № 1

LT in Focus

Litigation Tracking

Court Practice

In the framework of Edition № 1 we will review the most interesting and noteworthy court cases for October and November:

- Exclusion of certain elements of differential in transfer pricing
- The dismissal of an administrative case for a VAT understatement in connection with the annulment of a notification
- Environmental emissions in the oil transportation industry without a valid permit
- The classification of operations with the share interests as social sphere activities
- The assessment of CDB on the revaluation of reserves. The inclusion of VAT to calculate the average selling price for TPMR purposes
- Challenging the pricing method and the exclusion of discounts from the differential transfer pricing

Tax and Legal
October - November 2015

Exclusion of certain elements of differential in transfer pricing

Resolution of the Supervisory Board for Civil and Administrative Cases of the Supreme Court of the Republic of Kazakhstan dated 7 October 2015 for case 3гп-521-15

CNPC International (Buzachi) Inc.

Resolution partially sustaining the taxpayer's claims

After the targeted transfer pricing audit of the branch of CNPC International (Buzachi) Inc. (the "Taxpayer") for the period between 1 January 2008 and 31 December 2012, the tax authorities assessed additional income on the Taxpayer due to its application of incorrect quality, insurance expense, banking expense and operator payment differentials on crude oil exports for the period in question.

The Taxpayer took legal action stating that the tax authorities had acted illegally and demanded that the results of the audit be annulled and moral damages be paid.

Court hearings established:

- the banking expenses in question do not influence the market value of exported oil and should be removed from the differential
- insurance expenses exceed the established market level
- the quality reduction and operator payments are not supported by primary documentation

History of the review of the taxpayer's appeal:

Time	Court	Result of consideration
January 2015	First instance court	Rejection of appeal
April 2015	Court of Appeal	Decision of Court of first instance left unchanged
July 2015	Court of Cassation	Resolution of the Court of Appeal left unchanged
October 2015	Supreme Court of the Republic of Kazakhstan	Partial sustaining of taxpayer's claim. Referral of the case for reconsideration to the court of appeal

Three Court instances supported the tax authorities' decision regarding the lack of sufficient grounds for the Taxpayer to apply the differential in question.

Position of the Supreme Court of the RK:

Supreme Court of Republic of Kazakhstan ("Supreme Court of the RK") established that the tax authorities had not stated how much the 2008 transaction had deviated from the market level. In relation to the Taxpayer's 2009-2012 export transactions, the tax authorities did not refer to the range of prices and the differential applied. The calculations used by the tax authorities in the audit act were never established.

Due to the absence of the required documents, the Supreme Court of the RK was unable to provide a legal assessment of the case and parties' conclusions. Supreme Court of RK concluded that Taxpayer's petition should be partially satisfied: the court acts recognising the actions of the tax authorities as legal should be annulled with the case sent for a new hearing in the court of appeal, according to the rules stipulated for the court of first instance. Court acts regarding the rejection of the taxpayer's demand for moral damages should not be disputed, are legal and justified.

Details: available in Russian only

Source: *«Directory of litigation cases of the unified automated information-analytical system of judicial bodies of the RK»*

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The dismissal of an administrative case for a VAT understatement in connection with the annulment of a notification

Resolution of the Supervisory Board for Civil and Administrative Cases of the Supreme Court of the RK dated 7 October 2015 for case 3на-74-15

PetroKazakhstan Oil Products LLP

Resolution on termination of proceedings related to administrative vilotaion

The tax authorities carried out a targeted tax audit of the accuracy of the assessment and timeliness of the payment of VAT between 2005 and 2010 by PetroKazakhstan Oil Products LLP ("Company"). The audit resulted in notification of the accrual of VAT on goods produced, work performed and services provided in the RK. VAT was accrued because the tax authorities included excise duties in the Company's taxable turnover from the processing of tolling materials. A fine was also imposed for understating VAT in tax reporting.

The Company disputed the tax authorities' notification based on the results of the tax audit and won a favourable resolution: the Courts concluded that the transfer of products created from tolling materials is not a sale of goods, as the taxpayer did not own the new product; oil refining is not an excisable activity; the section of the notification on accrual of VAT on excise duties is not lawful.

History of the review of the taxpayer's appeal:

Time	Court	Result of consideration
February 2013	First instance court	Imposition of administrative liability in the form of a fine
March 2013	Court of Appeal	Decision of the court of first instance (imposition of an administrative fine) upheld
July 2014	Supreme Court of RK	Courts' acts overturned (on the case on disputing the notification of the of tax authorities) and the case remitted to the Court of Appeal for new consideration
October 2014	Court of Appeal	The section of the notification related to the VAT accrual on produced goods and performed works and services held to be unlawful
December 2014	Court of Cassation	Decision of the Court of Appeal upheld
October 2015	Supreme Court of the RK	Court of First Instance and Court of Appeal 2013 decisions overturned; protest of the Deputy General Prosecutor upheld; Administrative violation case terminated

Position of the Supreme Court of the RK:

Subpoint 2) of part 1 of article 580 of the CoAV states that an administrative violation case cannot be instigated, and the case that had been instigated would have to be terminated due to the absence of necessary elements of administrative violation.

As the judicial acts for the civil case established the illegality of tax accruals and late payment interest by the tax authorities, the disputed court acts should be annulled and case proceedings terminated due to the absence of an administrative violation.

Thus, the Supervisory Court Board of the Supreme Court of the RK issued a resolution terminating proceedings in the case of an administrative violation (part 1 of article 209 of the CoAV - understatement of tax) due to the absence of an administrative violation.

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Environmental emissions in the oil transportation industry without a valid permit

Resolution of the Supervisory Board for Civil and Administrative Cases of the Supreme Court of the RK dated 21 October 2015 for case 3гп-541-15

Kazakhstan-China Pipeline LLP

Decision taken in favour of the tax authority

The tax authorities carried out a targeted audit of Kazakhstan-China Pipeline LLP ("Taxpayer") for tax liabilities for 2010, which resulted in notification of a charge for environmental emissions of KZT 39 million and late payment interest of KZT 24 million.

The basis for the notification was the pollution and contamination of soil as a result of the escape of oil from a pipeline, which spread without the required permit.

The tax authorities referred to the Waste Classifier approved by a Ministry of Ecology Order and determined that soil soaked by oil or fuel oil relates to oil production and oil refining waste, for which the environmental charge (for the disposal of production and consumer waste; "amber list") is 4 times the monthly calculation index per tonne.

Based on point 3 of article 492 of the Tax Code, environmental emissions made without a permit are treated as excess emissions, except for pollutant emissions from mobile sources.

In accordance with point 10 of article 495 of the Tax Code (2010 version), excess emissions are subject to a 10x charge.

History of the review of the taxpayer's appeal:

Time	Court	Result of consideration
August 2014	First instance court	Rejection of claim
October 2014	Court of Appeal	Decision of court of first instance left unchanged
May 2015	Court of Cassation	Resolution of court of first instance and appeal court annulled; Taxpayer petition upheld
October 2015	Supreme Court of the RK	Resolution of court of cassation annulled, resolution of court of appeal left in force

Position of the Supreme Court of the RK:

The Supreme Court of the RK supports the tax authorities' position. Case proceedings established that the soil had been polluted and contaminated. The tax authorities also proved that the Taxpayer had disposed of waste without a permit to do so. At the same time, it was also noted that the Taxpayer may be covered by insurance, as according to ecological law, pipeline operation to transport gas, oil or chemicals should be insured.

Based on the above, the court board left the resolution of the appeal court in force and upheld the petition of the Kyzylorda Oblast State Revenue Department.

Details: available in Russian only

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The classification of operations with the share interests as social sphere activities

Resolution of the Supervisory Board for Civil and Administrative Cases of the Supreme Court of the RK dated 28 October 2015 for case 3гп-554-15

"KazAgroInnovaciya" JSC

Decision taken in favour of the tax authority

In 2009, "KazAgroInnovaciya" joint stock company (the "Company"), certified to perform scientific and technical activities using state funds, transferred assets to subsidiaries as charter capital contributions, which until that moment it had treated as fixed assets depreciable for CIT purposes. At the same time, the fair (market) value of the assets significantly exceeded their depreciable value in tax accounting at the moment of transfer, as a result of which the Company generated income from the disposal of the fixed assets of KZT 3,050 million.

The Company qualified the above as income from social sphere operations (science based activities), for which article 135 of the Tax Code provides a CIT exemption.

The Company also applied a reduced property rate of 0.1% on the assets in accordance with point 3 of article 398 of the Tax Code.

According to the tax authorities, article 135 of the Tax Code does not treat the transfer of assets to subsidiaries' charter capital as social sphere activities, and for that reason, they categorised it as the result of operations not related to science-related activities. According to the tax authorities, in 2009 the share of the Company's income not related to social sphere activities exceeded 10%, which is why the CIT exemption stipulated by article 135 of the Tax Code was not applicable to the Company in the tax period under review.

Based on this argument, the tax authorities refused to allow the Company to apply the reduced property tax rate of 0.1% on the assets transferred to subsidiaries as charter capital contributions.

History of the review of the taxpayer's appeal:

Time	Court	Result of consideration
February 2014	First instance court	Rejection of claim
April 2014	Court of Appeal	Rejection of appeal
July 2014	Court of Cassation	Resolutions of the Court of First Instance and Court of Appeal overturned, decision fully in favour of the Company
October 2014	Supreme Court of the RK	Resolution the Court of Cassation overturned, reinstatement of the original decision by the court of first instance

Position of the Supreme Court of the RK:

The Supreme Court of the RK upholds the "Astana city Tax authority of Almatinskiy district of" State Authority ("SA") in full. Income from the disposal of fixed assets should have been attributed to the Company's non-core social sphere activities. Furthermore, the Company's income not related to social sphere activities exceeded 10%. Given this, the Company was subject to CIT in accordance with the generally established Tax Code procedure.

As the Company failed to meet the conditions stipulated by article 135 of the Tax Code, it cannot be eligible for point 3 of article 398 of the Tax Code, and consequently the Company's recalculation of property tax using the 1.5% rate on the average annual value of objects of taxation was incorrect.

Position and recommendations of "Deloitte"

We recommend to companies operating in the social sphere and applying tax breaks, analyse closely whether their income, taking into account income from assets received free of charge and deposit interest income, accounts for 90% of comprehensive annual income, to establish whether they comply with the conditions for operating in the social sphere.

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The assessment of CDB on the revaluation of reserves. The inclusion of VAT to calculate the average selling price for TPMR purposes

Resolution of the Supervisory Board for Civil and Administrative Cases of the Supreme Court of the RK dated 11 November 2015 for case 3гп-583-15

JSC “Mangistaumunaigas”

Decision on case referral for reconsideration

The tax authorities carried out a complex audit of JSC “Mangistaumunaigas” (“Taxpayer”) for the question of accuracy of calculation and timeliness of fulfilment the tax liabilities for the period of 2009 – 2011. This resulted in notification of a charge for additional assessments: Commercial Discovery Bonus (“CDB”) of KZT 314,532 thousand (exclusive of late payment interest of KZT 143 588 thousand), tax on the production of mineral resources (“TPMR”) of KZT 5,689 thousand (exclusive of late payment interest of KZT 838 thousand).

CDB: The tax authorities insist that CDB should be taxed on the physical volume of mineral resources extracted. The assessment was made because initially approved reserves increased.

TPMR**:** The tax authorities believes it is incorrect to calculate TPMR liabilities using the value of natural gas sold domestically and applying the average weighted sales price, exclusive of VAT.

History of the review of the taxpayer’s appeal:

Time	Court	Result of consideration
August 2014	First instance court	TPMR section of the notification annulled. CDB section left unchanged
December 2014	Court of Appeal	First instance court decision left unchanged
February 2015	Court of Cassation	Resolutions of the court of first instance and Court of Appeal left unchanged
July 2015	Court of Cassation	CDB section of the notification annulled
November 2015	Supreme Court of the RK	Referral of the case for reconsideration to the Court of Appeal

Position of the Supreme Court of the RK:

CDB: The court resolved that the previous court instances had been premature in their conclusions, not having correctly considered the reason for the increase in reserves and not establishing whether a commercial discovery had taken place. The case was returned to the court appeal board for civil and administrative cases with different members of the board.

TPMR: In accordance with point 1 of article 332 and subpoints 1) of point 5 of article 334 of the Tax Code, the object of taxation for TPMR is the physical volume of crude oil, gas condensate and natural gas produced by a subsoil user during the tax period.

TPMR is calculated using the value of natural gas sold by subsoil users domestically, which, in turn, is determined on the bases of the weighted average sales price generated for the tax period, determined in accordance with the procedure prescribed by point 2 of article 341 of the Tax Code.

Point 1 of article 86 of the Tax Code states that sales income is the value of goods, work and services sold, apart from income included in comprehensive annual income is determined in accordance with articles 87-98 of the Tax Code, and the income referred to in point 2 of article 111 of the Tax Code, where it does not exceed the expenses shown in point 1 of article 111 of the Tax Code, unless otherwise stipulated by transfer pricing law.

The value of goods, work and services sold does not include value added tax and excise duties.

From case materials it is clear that the company sold natural gas in Kazakhstan and for that reason TPMR should have been based on the weighted average sales price for the tax period, exclusive of VAT, while on the other hand the tax authorities assessed additional TPMR for natural gas sales in Kazakhstan based on total value inclusive of VAT.

As TPMR was additionally assess without legal grounds, the court's resolution to annul the section of the resolution dealing with it was correct.

Position and recommendations of "Deloitte"

CDB: We have seen cases before where CDB has been paid on increases in previously approved volumes of mineral resources created as a result of revaluations and recounts. In the cases we are aware of, the taxpayers paid CDB either voluntarily or based on court resolutions issued as a result of a tax dispute resolved in favour of the tax authorities. In the case under review, however, the interesting aspect is that the court requested that the company ask experts from the authorised body for their opinion on the actual reasons for the increases in reserves and whether they were related to a commercial discovery.

TPMR: The Supreme Court's conclusions on this case contradict the clarifications provided by the Ministry of Finance and Ministry of Economic Development and Trade, according to which the price used to calculate the TPMR case should include VAT. Thus, the remove of VAT from the average sales price for mineral resources to calculate TPMR based on the Supreme Court resolution does not guarantee the absence of potential disputes with the tax authorities during future tax audits.

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Challenging the pricing method and the exclusion of discounts from the differential transfer pricing

Resolution of the Supervisory Board for Civil and Administrative Cases of the Supreme Court of the RK dated 11 November 2015 with respect to case 3гп-588-15

Nelson Petroleum Buzachi BV

Decision on partial settlement of taxpayer claims

In accordance with a tax audit of Nelson Petroleum Buzachi BV ("Taxpayer") for the period between 1 January 2009 and 31 December 2012, the tax authorities assessed additional taxable income in connection with the Taxpayer's application of the incorrect transfer pricing method in relation to oil exports for the period in question.

History of the review of the taxpayer's appeal:

Time	Court	Result of consideration
February 2015	First instance court	Partial settlement of taxpayer claims
April 2015	Court of Appeal	First instance decision was annuled
June 2015	Court of Cassation	First instance court decision and court of appeal resolution left unchanged
November 2015	Supreme Court of the RK	Resolution on partial settlement of taxpayer claims

Position of the Supreme Court of the RK:

A resolution was issued partially in favour of the Taxpayer, recognising the previous court resolutions and that of the tax authorities as invalid. All remaining court acts were left unchanged. The Court considered the following in relation to transfer pricing issues:

Applicable quotations

The taxpayer used the mean average quotation for three days from the transfer of ownership as published in an official source to determine the market price, while the tax authorities used the average price. The supervisory board resolved that the tax authorities had unlawfully adjusted income based on an average price instead of the minimum price, referencing a range of prices which resulted in an increase in income and, subsequently, additional taxes and late payment interest.

Quality discount

The tax authorities excluded quality discount, in particular the buyer's expenses to blend oil, from the differential due to the absence of supporting documentation. The supervisory board resolved that the Argus Media research provided by the taxpayer as support for the quality discount was not sufficient and removed the reduction from the differential.

Discount for the registration of bills of lading

The tax authorities removed the discount for the registration of bills of lading from the

differential because of a lack of supporting documentation. At the same time, the supervisory board accepted the taxpayer's conclusions and established that expenses to register bills of lading had been supported by documentation.

Oil transfer expenses

The tax authorities removed oil transfer expenses incurred based on an agreement with a transportation agent that paid for transportation services from the differential. The agreements provided were recognised as third party documents that do not support contractual relations between the taxpayer and customer. The supervisory board established that oil transfer expenses had been supported and correspond to the market equivalent published in official data sources.

Inspection expenses

The tax authorities removed inspection expenses from the differential, as it could not be seen from the invoices provided whether services to inspect oil in Aktau port had been permitted in relation to the Company's resources. The supervisory board resolved in favour of the tax authorities with respect to this reduction.

Freight insurance expenses

The tax authorities reduced freight insurance expenses in the differential, as they did not correspond to the market equivalent published in official data sources. The supervisory board established that the tax authorities had acted unlawfully to adjust income as Argus Media research allocated 0.03% of the value of freight to the Novorossiysk-Augusta route only, while the object of the review is the Aktau-Makhachkala-Novorossiysk differential component, for which the taxpayer provided supporting documentation.

Oil resale discount

The tax authorities removed oil resale discount (compensation of end buyer expenses to transport oil from the port of discharge to the refinery) from the differential, as they do not correspond to the comparable uncontrolled price method and are accounted for using the subsequent sale method. The supervisory board's resolution in relation to this reduction was in favour of the tax authorities.

Financing discount (banking expenses)

The tax authorities removed the financing discount from the differential because market prices are not affected by the form of payment, while payment conditions do not affect market prices. The supervisory board established that the financing reduction was justified as it had been given in connection with buyer expenses to open and manage a letter of credit. At the same time, an agreement to open and manage a letter of credit is treated as a payment that affects a pricing deviation from a market price according to the transfer pricing law, which is confirmed by breakdowns and other documentation.

Operating margin

The tax authorities removed operator's 2009-2012 margin at the Aktau-Makhachkala site from the differential. The supervisory board did not rule in favour of the taxpayer as ownership to oil transferred from the seller to the buyer at the Novorossiysk port, and not at the Aktau-Makhachkala site.

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Contacts:

Almaty/Astana

Vladimir Kononenko
Tel.: +7(727) 258 13 40
Fax: +7(727) 258 13 41
Email: vkononenko@deloitte.kz

Agaisha Ibrasheva
Tel.: +7(727) 258 13 40
Fax: +7(727) 258 13 41
Email: aibrasheva@deloitte.kz

Yelena Ryzhkova
Tel.: +7(727) 258 13 40
Fax: +7(727) 258 13 41
Email: yryzhkova@deloitte.kz

Atyrau/Aktau

Anthony Mahon
Tel.: +7(727) 258 13 40
Fax: +7(727) 258 13 41
Email: anmahon@deloitte.kz

deloitte.kz

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