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LT in Focus

Recent court developments on unjustified tax benefits

The unjustified tax benefit principle, as outlined in Resolution No. 53 of the Plenary Session of the Russian Supreme Commercial Court of 12 October 2006, remains relevant to taxpayers as legal disputes relating to its application form a rather significant portion of all tax disputes.

The number of such disputes is rising steadily, with tax authorities often trying to further elaborate on the approaches developed by the Plenary Session of the Russian Supreme Commercial Court and come up with new arguments to substantiate their position.

In view of the above, we recommend that taxpayers undertake an additional review of their business plans and dealings with contracting parties in the context of the existing court practice to identify possible claims from tax authorities and prepare to defend their position when negotiating a settlement or in court.

In this edition we present the most notable cases that reflect the court developments on unjustified tax benefits.

Confirming suppliers act in good faith

The existing court practices show that merely presenting documents such as abstracts from the Unified State Register of Legal Entities and the Unified State Register of Taxpayers as well as certificates of incorporation and registration with the tax authorities is not sufficient to prove that a taxpayer's suppliers act in good faith.

To provide evidence of their due care in dealings with contractors, companies must carefully analyse the reputation of their contracting parties.

In particular, the circumstances listed below (considered in their entirety) may indicate a lack of due care, according to court practice (see case No. A40-13039/16):

- A lack of personal interaction between the supplier and customer management in the course of negotiating the terms of delivery and signing contracts;
- A lack of documentary evidence of the authority of the contractor's CEO and representatives, no copies of their proof of identity;
- A lack of information about the physical address of the contractor's offices and warehouse/production/sales facilities;
- A lack of information regarding the means of obtaining information about the contractor (no media advertisements, no references from partners, no website).

The court noted that the adverse consequences of the failure to exercise due care when doing business were to be borne by the entity that had entered into the respective transaction and not by the federal budget by way of reducing the entity's tax liabilities or granting unjustified refunds.

Courts stress that merely presenting the minimum set of documents is not sufficient to prove that a taxpayer exercises due care. Taxpayers must perform a more detailed analysis of their contractors' background to minimise possible tax risks.

At the same time, extensive documentary evidence of a taxpayer's due care cannot, as such, guarantee that the tax authorities will not have any claims.

For example, in case No. A40-87379/2014 a taxpayer presented a comprehensive set of documents, including both basic documents (i.e. abstracts from the Unified State Register of Legal Entities and the Unified State Register of Taxpayers, a certificate of incorporation, a certificate of registration with the tax authorities, minutes of the shareholders' meetings, and CEO appointment orders) and additional documents (balance sheets, copies of passports of the authorised representatives, rental agreements and letters from the contractor's CEO confirming that the relationships with the taxpayer are genuine and long-standing, the documents are signed in person and goods are delivered on a recurring basis).

However, the court ruled in favour of the tax authorities, having concluded that the availability of the above-mentioned documents and the fact that the taxpayer chose first-tier suppliers performing genuine economic activities did not indicate that the taxpayer had acted with due care, but rather that the taxpayer **had given the appearance** of acting with due care.

The court made this conclusion based on other circumstances in the case, such as the bad faith operations of the second- and lower tier suppliers, inconsistencies in documents, and on finding facts that cast doubt on whether the capacity to perform the business transactions in question actually existed.

Documents evidencing a taxpayer's due care cannot, as such, guarantee that the taxpayer will be relieved of responsibility if the tax authorities prove that the taxpayer and its contracting party conducted no genuine economic activities and the transactions were aimed exclusively at obtaining unjustified tax benefits.

Bad faith second- and lower tier suppliers

If second- and lower tier contractors act in bad faith, it may lead to the conclusion that a taxpayer has received an unjustified tax benefit.

For example, in case No. A40-6272/2016, a dispute had arisen as a result of a taxpayer purchasing raw materials from third-party suppliers through an affiliated company (trade company).

In the course of a desk audit, the tax authorities identified all of the components in the supply chain and found that the second- and lower tier suppliers had demonstrated bad faith. In view of this, the tax authorities concluded that the taxpayer had received an unjustified tax benefit.

The tax authorities believed that the documents presented by the taxpayer (waybills, invoices, quality certificates) contained incomplete or inaccurate information, which hindered the identification of the names, quantities and cost of the goods, and raised questions with respect to the actual existence of the goods.

In addition, the tax authorities proved that the taxpayer did not conduct supplier due diligence procedures.

The court upheld the position of the tax authorities, noting that the source documents were not prepared properly and could not therefore be used to prove the authenticity of the respective transactions.

Indications of bad faith with respect to second- and lower level suppliers may result in challenges from the tax authorities.

Another noteworthy tax dispute is case No. A40-13039/2016 on interacting with bad faith suppliers in purchasing advertising services through an agent.

The courts ruled in favour of the tax authorities, concluding that the taxpayer had not exercised due care in choosing a contractor and had recorded the details of third-party invoices and source accounting documents without thorough preliminary analysis, which is why the taxpayer itself was to bear the risks associated with such inaction.

Implications for dealings with bad faith suppliers where the authenticity of business transactions is not challenged

In proving that suppliers act in bad faith, the tax authorities may decide that a taxpayer has received an unjustified tax benefit even if the substance of the respective transaction is not challenged.

For example, in case No. A40-179707/2015 the tax authorities challenged the recovery of VAT and recognition of expenses relating to contracts with parties that were found to act in bad faith.

The courts supported the position of the taxpayer in view of the following circumstances:

- The tax authorities had not challenged the actual performance of the construction work;
- The assumption of the tax authorities that the work had been performed by the taxpayer itself was not evidenced by the facts of the case;

- Questioning of the taxpayer's personnel, which had revealed that they did not know the subcontractor engaged by the taxpayer, could not be used as evidence of the taxpayer's bad faith since a customer is unable and is not obliged to be aware of all subcontractors that perform work on the construction site;
- The taxpayer had performed all the required due diligence procedures available to them in accordance with their rights and obligations set out in the tax and civil laws of the Russian Federation.

However, the court of cassation canceled the decisions of the courts of lower instances and remanded the matter for a new trial, pointing to the need to assess the evidence presented by the tax authorities.

Genuine transactions may also be challenged should a tax authorities find any indications that the suppliers in such transactions might act in bad faith.

One more example worth mentioning is case No. A60-50249/2015. The tax authorities concluded that the taxpayer had obtained an unjustified tax benefit with respect to part of the supplies from its contracting party, which had been found to be acting in bad faith, even though the tax authorities did not challenge the authenticity of the transactions as such.

The tax authorities' conclusion that the contractor acted in bad faith was based on, *inter alia*, the findings of tax audits and court practice with respect to other taxpayers, where disputable contractors were found to be acting in bad faith.

The court of cassation decided in favour of the taxpayer. The court concluded that court practice for other companies where disputable contractors had been found to be acting in bad faith cannot be used as sufficient grounds to conclude that a taxpayer does not exercise due care.

Overstatement/understatement of the cost of goods, work or services

Recently, the tax authorities have often tried to prove in courts that taxpayers overstated/understated the price of transactions with an intent to obtain unjustified tax benefits.

In particular, in case No. A40-71974/2015 the tax authorities challenged the deduction of VAT on the purchase of a land plot and the buildings that occupied it.

The tax authorities found that the taxpayer had received an unjustified tax benefit by artificially overstating of the cost of the buildings purchased while understating the cost of the land plot, which resulted in an overstated deduction of input VAT.

The courts supported the view of the tax authorities. The court's arguments were as follows:

- Having reviewed the documentary confirmation of the construction costs associated with the buildings purchased, the tax authorities found that the cost of certain materials and work was overstated by two to three times. The tax authorities compared the estimated cost of the materials/work performed under the contract with the principal contractor using the available information about the prices of actual suppliers of materials/contractors of work, as well as publicly available information about the prices of such materials/work);
- Cash remitted to the principal contractor was forwarded to a foreign entity, which in turn distributed it as dividends to the owner registered in an offshore jurisdiction (the British Virgin Islands (BVI));
- Based on the tax accounts of the transacting parties involved in the construction and purchase of the said real properties, the tax authorities found that they paid minimum VAT. This means that the taxpayer had essentially not calculated and paid any of the VAT it claimed for deduction and there was no source for such a deduction.

Thus, the value of the land plot, the sale of which is not subject to VAT, was understated by a comparable amount to that by which the purchase price of the buildings and, in turn, the input VAT were overstated.

Another case worth addressing is case No. A40-197337/2015, which is particularly interesting, *inter alia*, because the tax authorities did not raise the matter of the justification of the purchase price as regards the transfer pricing rules even though the taxpayer was involved in transactions with related parties.

The tax authorities challenged a portion of the expenses on goods purchased in view of the unjustified overstatement of their cost through the creation of an artificial supply chain that comprised related Russian and legal entities.

The tax authority undertook tax control measures, such as handwriting examinations, questioning of the taxpayer's personnel, questioning of vendors, analysis of cash flows, requests for information from foreign tax authorities, analysis of IP addresses, etc. As a result, the tax authorities found that foreign contractors, importers, suppliers and cash flow-contributing entities had neither the autonomy to select the terms or define the subject matter of contracts, determine the price of goods or deadlines for the fulfillment of contractual obligations, nor the capacity to control or hold the respective information about the physical flow of goods. The sole function of these entities was to produce documentary evidence in the course of the flow of goods and cash and to minimise the tax burden at all stages of the delivery of goods.

Additionally, the court dismissed the taxpayer's arguments that they acted with due care as supported by a set of vendor-related documents, including abstracts from the Unified State Register of Legal Entities, charters, certificates of incorporation and registration with the tax authorities, balance sheets, profit and loss statements, and copies of passports. Notably, the court specified that, with due regard for the evidence presented in the case, the taxpayer had been found to have intentionally selected particular vendors of equipment while being aware that those vendors were 'pass through entities' conducting no genuine economic activities and having no physical capacity to supply the goods on their own.

The additional amount of tax was assessed based on the difference between the cost of purchasing goods from the bad faith vendors in question and their customs cost.

There is a high risk that the tax authorities may charge additional amounts of tax if the court ascertains that the cost of goods, work or services was overstated/understated with an intent of obtaining unjustified tax benefits.

In regard to unjustified tax benefits obtained as a result of overstating/understating transaction prices, special emphasis should also be placed on the correlation between the unjustified tax benefit principle and the restrictions of the powers of territorial tax authorities to review prices in the transactions outlined in the transfer pricing rules of the Russian Tax Code.

Please note, the Supreme Court of the Russian Federation has concluded that territorial tax authorities are not allowed to review the correspondence of ~~a~~ transaction prices to the market level unless they prove that the manipulation of prices has resulted in unjustified tax benefits for the parties to the transaction. For more details, please refer to LT in Focus of 22 July 2016.

Unjustified tax benefits received through the use of 'pass through' companies

Recently, the tax authorities have been demonstrating intense interest in major structured transactions with shares and share capital contributions involving 'pass through' companies.

For example, according to case No. A13-5850/2014, a tax authorities charged profit tax in view of a taxpayer's receipt of an unjustified tax benefit in the form of the evasion of withholding tax when transferring shares of a Russian company to offshore companies (residents of the BVI) using 'pass through' companies registered in Cyprus.

The taxpayer transferred shares of a large Russian metal company to Cypriot companies (first tier) as a contribution to their share capitals. The Cypriot companies subsequently transferred the said shares as a contribution to the share capital and property of two other Cypriot companies (second tier), which were 50 percent owned by companies registered in the BVI.

Having applied the unjustified tax benefit principle, the tax authorities found that the true purpose of the above transactions was to make a gratuitous transfer of the shares to the offshore companies, therefore the taxpayer, as a tax agent, was obliged to withold a tax on those transactions. The offshore companies' gains were determined based on the market value of the shares, taking into account the stakes held by these offshore companies (50 percent).

The courts supported the position of the tax office, concluding that the tax scheme created for the gratuitous transfer of the shares to the offshore companies (residents of the the BVI) had resulted in obtaining a tax benefit in the form of the non-payment of withholding tax. When making their judgments, the courts took into account the following circumstances:

- All of the companies involved in the transactions with the shares were related companies controlled by the same individual;
- The time interval between the share transfers transactions was short;
- The Cypriot companies did not conduct genuine commercial activities. Notably, their books had a record of only one transaction relating to the receipt and transfer of shares;
- Since their founding dates, the Cypriot companies had not incurred any office maintenance or payroll expenses and had a negative equity balance as of the transaction date;
- The value of the shares received by the taxpayer from the Cypriot companies and the value of the metal company shares transfered in exchange for those shares were not consistent. Specifically, in exchange for 100 shares of one Cypriot company with a par value of EUR 1 each, the taxpayer transferred shares in the metal company with a total value of nearly USD 85 million, and in exchange for 1,000 shares of the other Cypriot company with a par value of EUR 1 each, the taxpayer transferred shares in the metal company with a total value of nearly USD 437 million;
- The contribution of the said shares to the charter capital was aimed not at investing, but at deriving profit or other economic benefits;
- The BVI-resident companies were the effective beneficiaries of the income as they gained the right to dispose of the shares of the Russian entity and to derive profit from owning these shares;

- The fact that the shares were transferred free of charge to the second-tier Cypriot companies controlled by the BVI-resident companies (through 50 percent stakes) was ascertained based on the analysis performed.

It is notable that the courts dismissed the argument that the shares were transferred to the Cypriot companies to strengthen the legal protection of the rights to the shares against the risk of seizure by bad faith parties.

Moreover, the court did not take into consideration that the shares were not actually given to the BVI-resident companies to hold (the shares were held by the second-tier companies). In particular, the court noted that in redistributing the assets and capital between the group of affiliated entities involving companies that are non-residents of the Russian Federation, the beneficiaries acted not so much with the aim of physically transferring the property (property rights) in the form of shareholdings, as with the aim of obtaining tax benefits from the transaction by way of abusing the law and taking the opportunity to evade taxation by applying international legislation.

In addition, in pointing out that the taxpayer had obtained an unjustified tax benefit, the courts did not specify the precise nature of the tax benefit even though the courts had ascertained the fact that all the entities, including Russian, Cypriot and those in the BVI, were controlled by the same individual, i.e. there was no change of beneficiary that could have indicated a disguised sale of shares and the corresponding need to charge profit tax.

The tax authorities may have questions for a company if there are no indications of a reasonable business purpose with respect to a sale/purchase of ownership interests involving affiliated parties that bear signs of being 'pass through' companies registered in low tax jurisdictions.

It is also worth noting case No. A40-229779/2015, where the tax authorities challenged the sale price of marketable shares.

A taxpayer purchased shares from its Russian affiliate and sold those shares to its offshore affiliate (resident of the BVI) on the same date at the same price, i.e. with zero profit or loss. The offshore company subsequently sold the shares to a third-party legal entity (UK) at a price nearly twice as high as their original purchase price.

The court ruled in favour of the tax authorities, having pointed out that the chain of transactions used by the taxpayer gave them an opportunity to sell the shares to an offshore company at a non-market price and to transfer the speculative profits resulting from the sale to a low-tax jurisdiction company with the aim of avoiding taxation on this transaction in Russia.

In case No. A40-206055/2015 the tax authorities challenged the recognition of losses that resulted from the taxpayer's expenses on ownership interests in subsidiaries, which exceeded the actual value of these interests as determined upon the withdrawal of participants.

The court upheld the tax authorities' position, pointing out that the taxpayer's investments in the charter capital of its subsidiaries were fictitious and aimed solely at obtaining an unjustified tax benefit.

Business splitting schemes

Business splitting is a fairly popular way to avoid taxes. However, it may result in challenges from the tax authorities.

For example in case No. A12-24270/2014, a tax authorities found that a taxpayer created a scheme to avoid taxation by entering into mutual contracts with an individual entrepreneur applying the UTII (unified tax on imputed income) regime. In accordance with the contracts, the taxpayer and the individual entrepreneur could, acting on behalf of each other, perform the sale and purchase of transactions with customers, which created an opportunity to distribute the resulting profit between the taxpayer and the individual entrepreneur with the intent to minimise tax liabilities and obtain unjustified tax benefits.

Engaging in transactions with related parties that are subject to special taxation treatment may be viewed by the tax authorities as splitting the business with the aim of evading taxes.

Having considered the below circumstances, the courts eventually upheld the position of the tax authorities:

- The sales premises rented by the individual entrepreneur to perform their operations were not separate from the premises occupied by the taxpayer and did not represent autonomous sales outlets with their own trading system and cash desks;
- The individual entrepreneur did not have any other sales outlets apart from those in the taxpayer's stores;

- The goods bought from the taxpayer and the individual entrepreneurs were paid for using the same cash desks;
- The customers were presented with cash register receipts containing the same information about the owner of each of the goods;
- The revenue received by the taxpayer and the individual entrepreneur was recorded using a unified point-of-sale system;
- The cash earned was collected by the taxpayer and the individual entrepreneur together;
- The same employees worked for both the taxpayer and the individual entrepreneur. Certain employees who were initially hired by the individual entrepreneur later took jobs at the taxpayer's company. Moreover, questioning of certain employees showed that they perceived the taxpayer and the individual entrepreneur as a single business;
- The taxpayer and the individual entrepreneur bought their goods from the same vendors, whose aim was to work with the taxpayer and sell their goods through the taxpayer's stores (this information was ascertained in the course of questioning of the vendors' representatives);
- The goods were delivered, unloaded and stored by the taxpayer as the individual entrepreneur did not have the necessary resources;
- The taxpayer served as the single source of income and business for the individual entrepreneur, which indicates that the individual entrepreneur was indirectly controlled by the taxpayer.

At the same time, the tax authorities are not always successful in proving that business splitting schemes are used with the sole purpose of obtaining unjustified tax benefits (see cases No. A27-16576/2015 and A27-19625/2014 in which the courts decided in favour of the taxpayers).

Overall, we may conclude that there is an ongoing trend in court practice whereby tax disputes are resolved in favour of the tax authorities, which means that good faith taxpayers bear the responsibility for offenses committed by third parties.

In view of the above, we encourage companies to carefully consider their tax risk areas, especially where there is suspicion that their contracting parties might act in bad faith, and to prepare in advance for any possible challenges from the tax authorities.

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We hope that you find the information in this edition interesting and informative. Should you have any questions on this subject, please do not hesitate to contact us.

Best regards,

Deloitte CIS partners

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