

New Rules on Unjustified Tax Benefit

Newsletter

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Starting from the early 2000s, the Russian tax authorities have been pursuing the following concept: even unless the law explicitly allows some activities, they can result in violation of law and subsequent additional charge of tax. The classic example is business operations involving shell companies.

The issue in question was first regulated in the Resolution of the Plenum of the Supreme Commercial Court of the Russian Federation dated 12 October, 2006 No. 53 *“On Assessment by State Commercial Courts of Validity of Taxpayers’ Gaining Tax Benefit”* (hereinafter – the Resolution). It particularly provided a definition of tax benefit, distributed the burden of proof in the judicial proceedings and gave criteria of unjustified tax benefit. This resolution of the Plenum set the direction for the court practice development.

In **August 2017, new amendments to the Tax Code came into force**. They prohibit actions aimed at circumvention of tax law, and set the frames of lawful conduct. Prior to the changes in the law, the Federal Tax Service issued several letters, where it covered particular issues on unjustified tax benefit, for example, the Letter dated 23 March 2017 No. ED-5-9/547@, the Letter dated 16 August 2017 No. SA-4-7/16152@.

The essence of the amendments is that the legislator designated particular actions of a taxpayer that are deemed to be abuse of right as well as the conditions to be fulfilled so that the tax benefit was justified. Generally the anti-abuse novelties of the Tax Code are aimed at those taxpayers who continue to transfer assets to shell companies for the purposes of expenses increase, tax base decrease and subsequent tax cuts.

Para. 1 of the new Article 54.1 of the Tax Code directly prohibits accounting misrepresentation for the purpose of tax evasion, provided that the tax authorities prove the taxpayer’s unlawful intent. As the Federal Tax Service explained in its Letter dated 16 August 2017 No. SA-4-7/16152@¹, the tax authorities will have to provide evidence that a company was making efforts to evade taxes, which may take the following forms:

- ▶ economic or legal control between the taxpayer and its contractors;
- ▶ transit operations between interdependent or affiliated parties of linked economic transactions (in particular through intermediaries) by means of special forms and due dates of payment;
- ▶ circumstances indicating collusion between business entities.

In case of correct accounting records, a taxpayer is entitled to reduce the tax base or the amount of the due tax. The new article of the Tax Code introduces two criteria of a lawful transaction to be met

in the aggregate:

1. Non-payment (underpayment) of taxes or set-off (recovery) of taxes **does not constitute the main objective** of the transaction;
2. The contractual obligation is fulfilled by a party to the contract or by another person, who the obligation was transferred to, if so provided in the contract or statute.

At the same time the following criteria separately do not evidence that the tax benefit was unjustified and cannot serve as a basis for claims from the tax authorities (para. 3 of Article 54.1 of the Tax Code):

- ▶ Supporting primary documents are signed by an unidentified or unauthorized person;
- ▶ The counterparty has violated the tax law;
- ▶ The taxpayer could arrive at the same result of economic activity in the course of other transactions not prohibited by law.

These criteria alone cannot entail claims from the tax authorities. However, if an unidentified person signs the supporting primary documents, provided that the counterparty does not pay taxes and cannot carry out business activity due to lack of staff etc., the tax authorities are likely to assess the circumstances in the aggregate, and therefore will be able to submit claims against the taxpayer.

One more key criterion to be met so that the taxpayers were entitled to the tax benefit is providing evidence that the transaction was **real**. It means that if a contract was fulfilled by a company that lacked resources for this purpose, such a company is likely to be considered a shell corporation. The Letter of the Federal Tax Service dated 23 March 2017 No. ED-5-9/547@ "*Concerning the Determination of the Circumstances of an Unjustified Tax Benefit*" gives the tax authorities an instruction to carefully check whether the taxpayer took sufficient and reasonable measures to exercise the due diligence of the contractor.

MOSGO & PARTNERS LAW FIRM

Tel.: +7 (495) 228 48 78
info@mosgolaw.com
www.mosgolaw.com

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¹ Letter of the Federal Tax Service dated 16 August 2017 No. SA-4-7/16152@ "*Concerning the Application of the Provisions of Federal Law No. 163-FZ of 18 July 2017 "Concerning the Introduction of Amendments to Part One of the Tax Code of the Russian Federation"*.