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Pepeliaev Group has successfully defended a major foreign bank in a case concerning the deduction of expenses relating to futures transactions for profit tax purposes

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At the end of November 2015, a tax authority handed down a decision based on the results of a field tax audit of a foreign bank. The authority went back on a point that had previously been demonstrated in terms of expenses relating to futures transactions being legitimately deducted from the tax base for profit tax. Including fines, the amount claimed was more than RUB 300 million.

Pepeliaev Group represented the taxpayer through senior partner **Ivan Khamenushko** PhD and senior associate **Lyudmila Merkulova** PhD.

The taxpayer was a major British provider of banking and other financial services. Over many years, it has regularly performed various types of forex and futures transactions on the foreign currency market with a range of counterparties. The business purpose behind the transactions was to manage the company's liquidity and to temporarily place free liabilities with a view to generating a profit. With regard to the term, there was a mix of short- and long-term transactions. In view of this, both positive and negative exchange rate differences arose for the company and these were taken into account for profit tax purposes. The company took account of the results of all transactions in its overall tax base for profit tax.

At the stage of the administrative challenge to the tax authority's decisions, Pepeliaev Group's client successfully put forward a number of arguments to substantiate its position that the expenses were deducted legitimately and to justify the procedure by which it had accounted for the futures transactions. Thus, the fact that parties to a transaction are related is not in itself a reason to challenge whether expenses under the transaction are economically justified. It is only one of the grounds for control over prices. Moreover, the conclusions of the tax inspectors were based on their substituting a challenge as to whether transactions were genuine in place of checking whether they were economically justified (what the business purpose was). Further, the tax authority also wrongly concluded that completed transactions were inefficient or economically unjustified. This was because, when the tax inspectors determined the final financial result, they failed to take into consideration a substantial part of the income the company generated in the form of an unrealised exchange rate difference. The Russian Central Bank has confirmed that this may be taken into account.

Previous cases show that it is not uncommon for the tax authorities to come to erroneous conclusions because they have misunderstood the actual circumstances of a case and have not read documents correctly (for example, regarding simultaneous entry into many transactions that are being challenged, the legal structure of transactions, and the implications of payment netting being applied). This means that transactions aimed at generating a profit are wrongly classified and their actual purpose is wrongly determined.

"It is noteworthy that at the stage of objections and additional measures, a tax inspectorate has overcome its own formal approach to assessing the circumstances of the case," comments Pepeliaev Group senior partner **Ivan Khamenushko**, "and has agreed with the explanations of the taxpayer, who revealed the economic sense of transactions with a related party, assessing them both in isolation and taken as a whole with other transactions of the bank. It is to be hoped that we have managed to avert the formation of a whole trend from being formed in the practice of bringing claims against banks."

Pepeliaev Group senior associate **Lyudmila Merkulova**, who acted for the company, explains that the tax dispute related to proving the business purpose of currency swap transactions. There was a need to refute the tax authority's assertion that the transactions were ostensibly loss-making (the tax authorities, among other things, took account of the result of the transactions based on the Central Bank exchange rate against their real, actual profitability). One of the particular features of the case was the difficulty of analysing and proving the time at which the transactions were actually concluded and whether prices under them were of market value.

"In winning the case, we showed once again the value of sticking to one's guns at the administrative stage of challenging tax authorities' decisions," said Ms Merkulova. "This can be an effective tool for challenging decisions, and companies should not assume that it is just a formality. We have extensive experience of this, and have seen over the past year that there have been far more successful challenges at the pre-trial stage than there were in previous periods."

Pepeliaev Group is a leading Russian law firm offering the full range of legal services in all regions of Russia, most former Soviet countries and abroad. Over 160 lawyers in Moscow, St Petersburg, Krasnoyarsk, Yuzhno-Sakhalinsk, Vladivostok, Beijing, Shanghai, Guangzhou and Seoul provide legal assistance to over 1,500 companies operating in various industries. 50% of these are international corporations implementing long-term investment projects in Russia.