Russian Supreme Court rules against formalistic approach to assessment of VAT offset grounds

Russia · 09.07.2020

Available languages: RU

On 14 May 2020, the Russian Supreme Court issued a decision* in favour of a Russian taxpayer (the "**Decision**"), which contains detailed guidelines on how to assess the good-faith conduct of Russian taxpayers claiming VAT offset.

The Decision, which was issued in an online format, contains a careful and detailed digest of the positions and arguments that should be taken into account when justifying the VAT offset claimed.

In particular, the Decision switched the courts' focus from the formalistic approach normally applied by the Russian tax authorities to the reality and commercial grounding of the operations giving rise to a VAT offset.

As a result, the Decision could set a precedent for resolving similar court cases on the recently codified concept of unjustified tax benefit in Russia. The arguments presented in the Decision may be instrumental for taxpayers attempting to prove their positions in court.

The facts

Russian tax authorities challenged the VAT offset claimed by a Russian joint-stock company "Specialised Production and Technology Base "Zvezdochka" (the "**Taxpayer**") regarding the acquisition of construction tools and materials from a Russian limited liability company "SK-Logistic" (the "**Supplier**").

Russian courts in three instances supported the position of the tax authorities. They stated that the Taxpayer had not performed with due diligence the "know your counterparty" ("**KYC**") procedures in respect to the Supplier and had not requested sufficient documentation proving the reality of the economic activity or business reputation of the Supplier. They also stated that the Taxpayer had not checked the authority of the persons signing documents in the name of the Supplier.

The courts specifically indicated that immaterial tax payments made by the Supplier did not constitute a sufficient **economic source** for VAT offset by the Taxpayer in the Russian budget.

After an in-depth analysis of the arguments presented by the tax authorities and the Taxpayer, the Supreme Court held that the facts and legal grounds behind the decisions rendered by the lower courts had been misinterpreted, and the case has been sent back for a new investigation on these grounds.

The Decision

In its Decision, the Supreme Court presented its interpretation of the criteria that should be taken into consideration when assessing the economic justification of VAT offset claimed by Russian taxpayers.

The Supreme Court confirmed that account should be taken as to whether a sufficient **economic source** for VAT offset in the Russian budget is available for VAT offset justification purposes, given the specifics of indirect tax withdrawal procedures.

However, if such an **economic source** in the budget is insufficient, this will not as such predetermine the outcome of the VAT offset claimed. Instead, this consideration, along with other arguments proving the intention of both parties to perform the operations with the sole or main aim of optimising taxes, should be considered.

In this context, a taxpayer claiming the VAT offset will not automatically be held liable for the tax misconduct of its counterparties. In fact, the opposite approach supported by the Russian courts results in a taxpayer being financially liable for the actions of other companies, which the taxpayer claiming the VAT offset usually does not control.

The Supreme Court stated that the following key circumstances should be analysed by the courts, as determined by a precedential resolution* of the Plenum of the Russian Supreme Commercial Court in 2006:

- whether the operations behind the VAT offset claimed are real; and
- whether the taxpayer claiming the VAT offset intends to evade tax or is negligent.

The Decision stated that, in terms of normal commercial activity, entrepreneurs usually assess the business reputation, resources and experience of their counterparties together with the commercial terms of any specific transactions.

In this context, taxpayers may be reasonably expected to conduct certain due diligence procedures on their counterparties before entering into commercial transactions, checking in particular whether the counterparties concerned have fulfilled their tax obligations.

However, the level and form of KYC procedures performed by a taxpayer should depend on **the materiality and nature of the transaction involved**, and following this logic may be limited to the reasonable efforts normally made by entrepreneurs in the context of their commercial activity.

When a taxpayer claiming VAT offset receives sufficient justification of its counterparty's ability to properly fulfil its obligations under the analysed transaction, the burden of proof is shifted to the tax authorities challenging the VAT offset.

According to the Decision, the fact that a counterparty involved third parties to perform some obligations of the analysed transactions should not as such jeopardise the VAT offset.

Finally, tax authorities should base their conclusions on specific circumstances proving that the investigated counterparty intentionally underpaid taxes. In their analysis, they should not rely solely on formalistic criteria, such as the ratio between input and output VAT or the proportion of costs to revenues, resulting in small amounts of tax to be payable to the Russian budget.

CMS comments

The Decision tries to align KYC procedures in a tax context with those normally conducted by businesses as part of their ordinary commercial activity. Currently, tax authorities frequently expect taxpayers to conduct burdensome and formalistic procedures when checking their counterparties, which not only go beyond those reasonably required for commercial purposes, but may in the end interfere with the timely and proper fulfilment of contractual obligations on both sides.

The Decision also contains important statements, which would allow taxpayers claiming VAT offset to be released from liability for their counterparties' tax misconduct to the extent that they could not reasonably anticipate such misconduct based on the data normally requested and provided in KYC procedures.

However, having a good KYC policy in place together with documents proving the fulfilment of KYC procedures remains the centrepiece for taxpayers claiming VAT offset to justify their good faith. It is hoped that the arguments provided in the Decision will reduce the formalities and corresponding administrative burden associated with KYC compliance in the tax context, and avoid the shifting of tax liability to good-faith taxpayers.

For more information on this eAlert, please contact CMS Russia experts Dominique Tissot, **Maria Kabanova** or your regular contact at CMS Russia.

* *In Russian*

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