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'Unscrupulous' Counterparties Revisited: Arbitration Court Practice in 2011

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One would think that after the Presidium of the Supreme Arbitration Court of the Russian Federation rendered two decrees in 2010 that were imparted the weight of judicial precedent (Decrees of the Presidium of the Supreme Arbitration Court of the RF No. 18162/09, dated April 20, 2010, and No. 17684/09, dated June 8, 2010), disputes between taxpayers and the tax authorities involving transactions with counterparties considered unscrupulous by the tax authorities should be heard without any particular problems. According to those judicial acts, in cases where:

- there is proof that the taxpayer actually performed business operations involving the purchase of goods (or works or services);
- there is proof that the taxpayer acted with due care and circumspection in performing the business operations with the "unscrupulous" counterparties;
- there is no evidence that the taxpayer was aware, or ought to have been aware, of the suppliers' failure to discharge their tax obligations,

then the fact that the counterparty was "unscrupulous" and the transaction documentation and invoices were signed by persons who did not have the proper authority to do so (or by persons whose identity is unknown) does not itself necessarily mean that the taxpayer obtained an unjustified tax benefit in the form of a lower VAT base (as a result of the expenses under such agreements being included among the counterparty's total expenses for the purposes of offsetting VAT).

From an analysis of such court cases in 2011 it is clear that for most taxpayers proving the legitimacy of a tax benefit obtained under transactions with "unscrupulous" counterparties remains a pressing issue. But the precedential character of the Presidium's decrees mentioned above has not affected the tax authorities' treatment of such transactions. As before, when conducting tax audits they tend to ignore the Supreme Arbitration Court's

legal position and to exclude any sums paid to counterparties they consider unscrupulous from claimed expenses and set-offs. What is more, the tax authorities do not hesitate to spend time and public money collecting evidence they know will be disregarded by the courts when assessing whether or not a tax benefit obtained by a taxpayer was justified. Tax inspectors will interview the founders and senior management of counterparties, arrange expert handwriting analyses to ascertain the validly of signatures on transaction documents, investigate whether or not a counterparty is actually located at the address specified in its foundation documents, etc.

One should bear in mind that the Presidium of the Supreme Arbitration Court took this legal position in relation to cases involving goods supplied by "unscrupulous" counterparties. As a rule, when taxpayers purchase goods from suppliers in relation to whom tax inspectorates have provided evidence of unscrupulousness, the taxpayers have no problems proving that a tax benefit was justified. That said, from time to time the tax authorities do manage to prove in court the absence of actual delivery of goods or the absence of due care and circumspection on the part of a taxpayer. For example, in one case a tax inspectorate proved that at the time when payment was made in cash for goods, the supplier had been deregistered from the Unified State Register of Legal Entities (Decree of the Federal Arbitration Court of the Moscow Circuit No. KA-A40-15685/11, dated Feb. 2, 2012).

Some such cases are still before the Presidium of the Supreme Arbitration Court. In a number of similar cases the Presidium set aside judicial acts of the lower courts and denied taxpayers' claims because they had purchased goods from an entity whose taxpayer identification number differed from the number contained in the Unified State Register of Legal Entities, and therefore, the court ruled, the taxpayers had not exercised a due level of care and circumspection (Decrees of the Presidium of the Supreme Arbitration Court of the RF No. 10230/10, dated Feb. 1, 2011, and No. 10096/11, dated Oct. 20, 2011). Another taxpayer purchased goods from an entity in relation to which there was no information whatsoever in the Unified State Register of Legal Entities. In that case, too, the Presidium set aside the decisions of the lower courts under which the taxpayer's claim had been awarded (Decree of the Presidium of the Supreme Arbitration Court of the RF No. 17649/10 dated 31 May 2011).

Yet these arbitration court cases are essentially curiosities, given that the courts at all three levels have ruled the tax authorities' decisions unlawful.

More complicated are disputes involving works and services, when the tax authorities submit evidence of bad faith on the part of a taxpayer's counterparties.

In May 2010, the Presidium of the Supreme Arbitration Court remanded a case involving OJSC Koksokhimmontazh-Tagil to be heard in new proceedings (Decree of the Presidium of the Supreme Arbitration Court of the RF No. 15658/09, dated May 25, 2010). The Presidium ruled that the lower courts had not properly weighed all of the circumstances identified by the tax authority in their entirety and in concert, specifically:

- the retention of subcontractors had not been coordinated with the project owners as was required under the terms of the general contractor agreements;
- the taxpayer had not proved that the subcontractors' personnel were present at the project owner's construction sites, and one of the project owners maintained that

the subcontractors that were considered unscrupulous did not do any work at its site;
- the subcontractors did not have a permit issued by Rostekhnadzor authorizing them to carry out hazardous works, nor did they possess a certificate confirming their knowledge of industrial safety procedures;
- the licenses submitted by the subcontractors had in fact not been issued by the licensing authority.

Analysis of arbitration court cases in recent years (2011-2012) shows that the courts generally tend to deny taxpayers' claims for invalidation of tax authorities' decisions if the underlying transactions entailed the performance of works by "unscrupulous" contractors or subcontractors. Decisions in disputes over services agreements also tend to go against taxpayers.

The position of the courts in such cases is based on, among other things, the findings of the Presidium of the Supreme Arbitration Court in the OJSC Koksokhimmontazh-Tagil case, as well as the Presidium's findings set out in its decrees of April 20, 2010, and June 8, 2010. That position may be summarized as follows: The onus is on the taxpayer to prove that business operations are real and that it exercised due care and circumspection in selecting a counterparty and performing the transaction. Obviously, proving that work was performed or services were rendered is much more difficult than proving that goods were delivered. Taxpayers often find themselves unable to prove such business operations really occurred, which inevitably leads to denial of their claims.

Taxpayers should also bear in mind Article 71 of the Russian Arbitration Procedure Code, which stipulates that a court is to weigh evidence according to its own internal conviction.

And finally, the courts are highly unlikely to rule in a taxpayer's favor if the tax authority proves that the taxpayer was aware, or ought to have been aware, that its counterparty failed to discharge its tax obligations deriving from affiliation, other corporate relations or other grounds.

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