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Iterative Tax Audits: New Approach

Recent history demonstrates that in times of economic recession tax control procedures are significantly tightened. The reasons for this are quite apparent: while companies' incomes and, consequently, tax payments are considerably decreased¹, the tax authorities try to achieve their tax collection plan at any cost. As a result, tax authorities pay more attention to documentation justifying the deductibility of input VAT, incurred expenses or the right to apply a tax exemption and seek new possibilities of conducting more information inspections and verifications as well as of carrying out of iterative, cross and additional tax audits. However, two recent widely debated Decrees of the Russian Supreme Arbitration Court that express an official viewpoint and consider the grounds and legal consequences of iterative tax audits seem to improve the position of taxpayers in relation to the tax authorities.

Legal context

According to article 89 (10) of the Russian Tax Code (Part I No. 146-FZ dated 31 July 1998) an iterative tax audit is defined as an on-site tax audit² held in respect of the same taxes and for the same period. Within the framework of an iterative tax audit only a 3-year calendar period preceding the year of adoption of the relevant decision on the iterative tax audit is considered.

An iterative tax audit may be held **only** in the following two cases:

- where a tax authority has previously held an initial tax audit, and a decision is made by the head of such tax authority, where a company files an adjusted tax return indicating a smaller amount of tax due than the amount stated in the first tax return; and
- by a superior tax authority supervising the activities of the tax authority that held the primary audit.

However, as the rules and the grounds of iterative tax audits are formulated rather generally and no concrete details are provided for by tax law, taxpayers often come across rather severe approaches taken by the tax authorities. As a result, companies are often afraid, for instance, to file adjusted tax returns as they are concerned about possible supplementary verifications and are not willing to conduct the additional preparations necessary and to present new supporting documents.

New court decision on iterative tax audits where a taxpayer files an adjusted tax return

As discussed above, the tax authorities are generally entitled to make iterative tax audits if a company files an adjusted tax return with reduced tax liabilities. However, as Russian tax law does not specify the scope of such iterative audits and in the absence of adequate clarifications of this legal rule, tax authorities often hold an iterative tax audit inspecting not only the information related to the actual tax (taxes) set out in the adjusted tax return, but all information and all taxes. In this context, any correction of the tax return, including correction of an obvious elementary error, may lead to a full-scale tax audit with the relevant consequences.

The case of the company "Dirol Cadbury"³ tends to modify this hands-on approach. The company challenged a decision of the tax authorities on an iterative on-site tax audit in connection with the filing of an adjusted profits tax return, according to which losses of the company were substantially increased. The relevant adjusted return was filed after the primary tax audit was completed, but before a decision was given on its results.

According to the position of the Russian Supreme Arbitration Court (the "Court") in the *Decision No. VAS-8163/09 dated 25 January 2010* supported by the final Decree of the Presidium of the Court delivered on 16 March 2010, such iterative audit is possible under the rules stipulated by the Tax Code however it may not have a "global" character. This means that **only the data, the modification of which led to the decrease in the company's tax liabilities, may be the subject of the iterative audit**. Accordingly, data and information which were not amended by the taxpayer, as well as data the modification of which does not lead to a decrease in tax liabilities, may not be iteratively audited.

¹ According to the Federal Tax Service (www.nalog.ru), profits tax proceeds to the federal budget in January-February 2010 have narrowed by 2,6 times as compared with January-February 2009.

² According to the articles 88-89 of the Russian Tax Code, tax audits are divided into two main groups: in-house (*камеральная*) and on-site (*выездная*). We note that the notion of "iterative" (*повторные*) tax audits relates to on-site primary audits only.

³ This case No. A44-23/2009 was examined in the first instance by the Arbitration court of the Novgorod region (Decision dated 24 April 2009).

Moreover, the Court referred to the *Decree of the Constitutional Court of the Russian Federation No. 5-P dated 17 March 2009* (the “**Constitutional Court Decree No. 5-P**”) which confirmed that an iterative tax audit is not acceptable if its results may potentially contradict the actual conditions established earlier by competent courts and the existing proofs and evidences taken into account in the relevant court decisions which are in force. In that particular case, the Court specified that where a court decision on challenging the results of the initial tax audit had been adopted before the iterative tax audit, such audit may not review the court’s conclusions made in the court case. Consequently, the tax authority, having held an iterative audit, would not be entitled to make a decision that would give rise to legal consequences for the taxpayer different to those determined by the court, either by contesting the legal nature of the transaction as determined by the court or reviewing the court’s interpretation of actual conditions and circumstances.

Official statistics show that many companies are obliged to file adjusted tax returns on a regular basis, even every month. This may be due, for instance, to the poor work of contractors who do not present necessary supporting documentation in a timely manner. Consequently, we believe that notwithstanding the rather conservative approach of the Court (which did not in any way limit the **right** of tax authorities to conduct iterative tax audits), its new position on limiting the **scope** of such audits represents an important step forward for taxpayers and may substantially simplify their ability to recover VAT, offset tax payments etc.

New court decision on iterative tax audits held by superior tax authorities

Another significant case, is that involving the state-owned company “Titan”⁴. This case concerned the grounds for a tax audit conducted by the superior tax authorities in order to control and supervise the activities of the tax inspectorates that held the primary on-site tax audits.

According to the case facts, a primary on-site tax audit with respect to the company “Titan” was carried out by a tax inspectorate who’s territorial jurisdiction did not cover the location of the company in question. Consequently, it was not entitled to conduct the audit. This breach of legal regulations was confirmed by a competent court, and the results of the primary tax audit were invalidated. However, the superior tax authority decided to carry out an iterative tax audit with the intention of controlling the activities of the local tax inspectorate.

It was stated in the final Decree of the Presidium of the Court delivered on 16 March 2010 (rendered further to a *Decision of the Court No. VAS-14585/09 dated 29 December 2009* on the transfer of the case to the Presidium) that **the iterative tax audit may lead to the adoption of a decision defining the rights and obligations of the taxpayer in respect of the same taxes and for the same fiscal period, differing from those decisions made by the inferior tax inspectorate**. However, the **conduct of an iterative tax audit** by a superior tax authority **supposes the presence of results and conclusions of a primary tax audit**. Consequently, if the results of the primary tax audit have been recognised as invalid by a competent court, the superior tax authority is not entitled to conduct an iterative audit.

In addition, the Court also reiterated the legal position expressed in the Constitutional Court Decree No. 5-P (discussed above) and stipulated that it is necessary to determine in every single case whether the results of the iterative on-site tax audit may potentially contradict the actual conditions established earlier by the competent courts and the existing proofs and evidences taken into account in the relevant court decisions in force.

Finally, we note that neither the Decree of the Presidium of the Court in the “Dirol Cadbury” case rendered on 16 March 2010, nor the relevant Decree in the “Titan” case of the same date, have yet been officially published. Consequently, the conclusions set out in this Tax Outlook are primarily based on the Decisions of the Court rendering the relevant judgments for the examination of the Presidium and explaining the legal position of the Court and on the existing comments of the officials of the Court.

Moreover, according to current Russian legislation, the interpretations of Russian laws by the Court are not considered to be legally binding. They are, however, deemed obligatory for all courts of the Russian Federation and this leads us to believe that both tax and judicial authorities will now apply these new approaches regarding the scope of iterative tax audits: a positive change for taxpayers.

⁴ This case No. A12-681/2009 was examined in the first instance by the Arbitration court of the Volgograd region (Decision dated 20 February 2009).

CMS can offer you the following assistance:

- Assistance in negotiation with the Russian tax authorities, to achieve early tax settlements and resolution of pending issues
- Preparation and selection of documentation requested by tax inspectorates
- Representation of your company in disputes with tax authorities and/or contracting parties
- Auditing of your existing tax claims/receivables in order to determine appropriate procedures/strategies to speed up the refund of tax amounts previously paid to the budget (recovery/offsetting of tax payments, export VAT recovery, etc.)
- High-level due diligence of companies
- Auditing of existing structures with a view to tax optimisation (i.e. cost reduction) of profits tax and VAT through proper structuring
- Auditing of existing or contemplated expenses (operating and capital expenses) with a view to tax planning

If you have any questions on the matters referred to in this **RUSSIA TAX OUTLOOK**, please do not hesitate to contact Dominique Tissot, Partner, and Anastasia Prozor, Associate, or your regular contact at CMS, Russia.

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