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LT in Focus

Tax Disputes and Litigation Review: Issue №1/2019

April 2019

Introduction

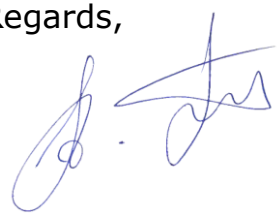
We keep our finger on the pulse of your business

Dear friends

We are happy to offer this latest overview of court practices around Kazakhstan court **tax and customs** disputes. In it we have considered the most interesting and significant cases that may have the potential to impact any aspect of your business.

Should you be interested, we would be happy to have a more detailed discussion on any of the cases considered in this **LT in Focus**, or any question you may have on the latest tax court practices, including investment disputes.

Regards,



Dispute Resolution Group

Tax Disputes

Appeal of tax officials' actions

Supreme Court Resolution dated 5 February 2019 on a claim from JSC A

Appeal of tax officials' actions and recognition of transactions as valid

A JSC (the "**Taxpayer**") took the Almaty State Revenue Department (the "**Department**") to court to appeal the actions of its officials, who had recognised 117 transactions of the Taxpayer and its counterparties as invalid and indicated the same in tax audit act No.1181, which it used as grounds to accrue corporate income tax. The Taxpayer also asked the court to have the transactions recognised as valid.

The Taxpayer believes that the officials were wrong to recognise the transactions as invalid and record this in the audit act, as the counterparties' registration had not been recognised as invalid, and none of them had been recognised as unreliable taxpayers. All the transactions had been correctly executed.

The Taxpayer also pointed out that all the required accounting documents had been issued, and taxes paid on the transactions.

The Taxpayer provided a number of relevant agreements, invoices and certificates of completion to confirm this. Moreover, the officials failed to mention in the audit act what documentation they had used as the grounds for deeming the transactions invalid.

The Taxpayer believes that the officials unlawfully assumed court powers to recognise the transactions as invalid.

The Department, in turn, believes that its conclusion that the Taxpayer's transactions are invalid, as indicated in the audit act, is legitimate, whereas the Taxpayer's arguments are unfounded. However, the Department does not justify its position, only points out violations in how transaction accounting documents were issued.

Period	Instance	Decision
June 2018	Court of first instance	In the part of appealing the actions of the Department – in favour of the Taxpayer. Proceedings were terminated with respect to the recognition of the transactions as valid.
August 2018	Court of appeal	Court of first instance decision upheld.
February 2019	Supreme Court	Court of first instance decision canceled. Issued a new decision in favour of the Department.

Appeal of tax officials' actions

Position of the court of first instance:

The court considered the actions of the officials as illegal, and terminated proceedings regarding the recognition of the transactions as valid because:

- The Taxpayer's violations regarding its issuance of transaction accounting documents cannot be grounds for the latter to be recognised as invalid
- The officials' conclusion on the invalidity of the transactions has no basis, since the court was not provided with any substantial and relevant evidence
- Moreover, by law tax officials are not entitled to recognise transactions as invalid, which makes the officials' action unlawful
- At the same time, proceedings to recognise the transactions as valid should be terminated, due to a lack of grounds to do so. The transaction parties are not disputing their legality.

Position of the court of appeal:

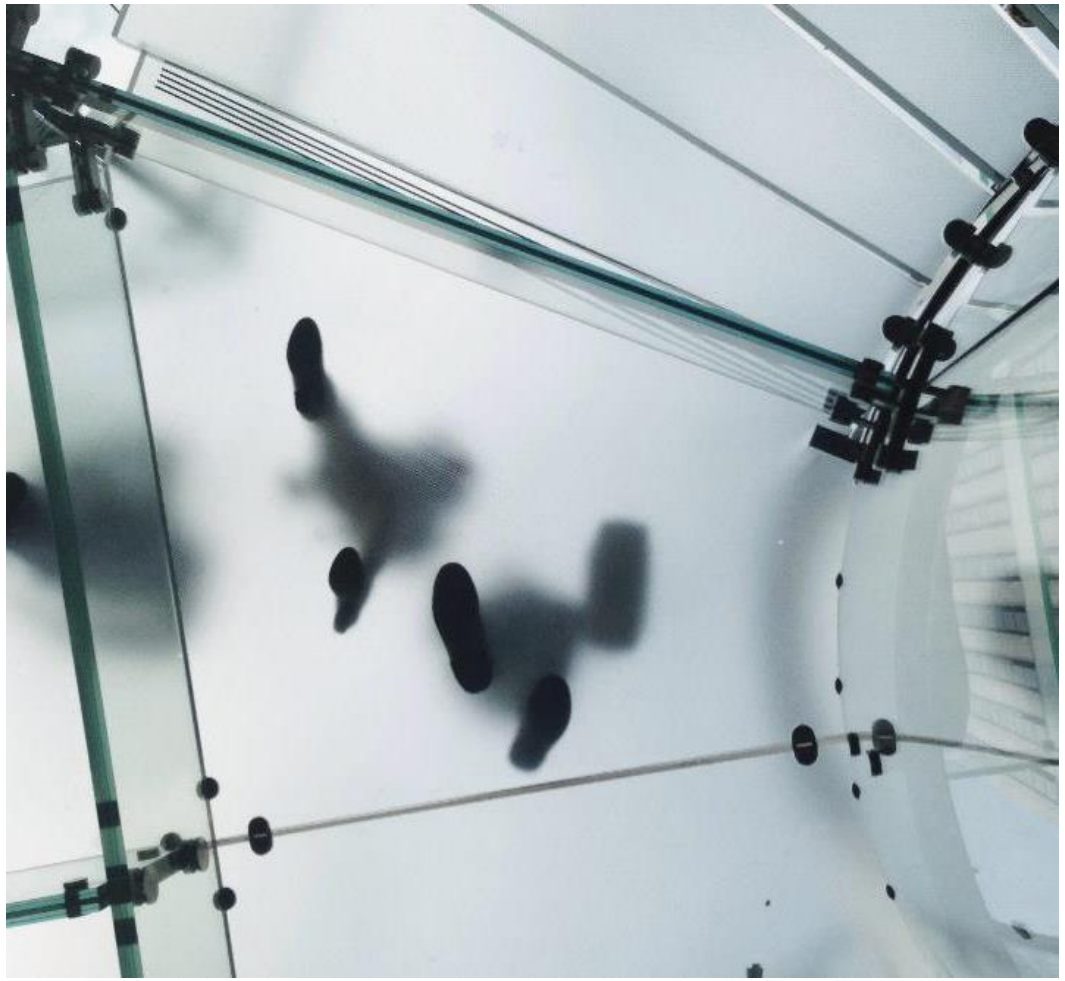
- The court of appeal upheld the court of first instance's decision.

Position of the Supreme Court:

The court cancelled the lower court acts and decided in favour of the Department, because:

- Since the tax audit was conducted within the framework of an ongoing criminal investigation, a notification will be issued only after the investigation is completed
- If the Taxpayer does not agree with tax accrual, it should appeal the notification after its receipt.

More details



Tax audit appeals 1/2

Supreme Court Resolution dated 21 June 2018 on a claim from B LLP

Recognition of notification of tax audit results as illegal and its cancellation

B LLP (the "**Taxpayer**") applied to court to have notification No.85 dated 10 August 2017 of the Almaty State Revenue Department (the "**Department**") recognised as illegal and cancelled (partly). The Department had accrued corporate income tax ("**CIT**") of KZT 75,026,984, value added tax ("**VAT**") of KZT 44,072,788 and charged interest.

The Taxpayer believes that the notification is unlawful, which it explained by the following. During 2012-2015, the Taxpayer paid bonuses for achieving purchase targets and paying bills on time to its distributors. Since the tax accounting of bonuses for CIT and VAT purposes is not regulated by tax law, and bonuses are used as discounts, they were accounted for by adjusting aggregate annual income and taxable turnover by issuing additional (negative) invoices.

The additional invoices could not be linked to units of products sold because of their huge volume, and also since the bonuses were provided for a certain number of products and not for each unit.

The Taxpayer also believes that the distributors were not obliged to issue invoices and acts of work performed, because the provision of bonuses is not a service or work provided by the distributors for a fee. Moreover, distribution agreements do not oblige the distributors to perform counter actions or services for the bonuses.

The Department, in turn, believes that the distributors' receipt of the bonuses is not a price discount nor product sales discount, since the bonus system does not actually change the initial price of the products sold.

Moreover, the Taxpayer issued the additional invoices in violation of the statutory procedure, as they do not contain the name, quantity of goods or discount amount. They only indicate the bonus reduction amount.

In this regard, the Department believes that the Taxpayer unreasonably adjusted and reduced its aggregate annual income and taxable turnover for CIT and VAT purposes, respectively.

Period	Instance	Decision
March 2018	Court of first instance	In favour of the Department
June 2018	Court of appeal	Court of first instance decision upheld.

Tax audit appeals 1/2

Position of the court of first instance:

The court considered the notification as legal because:

- the Taxpayer's provision of bonuses through additional invoices under distribution agreements does not constitute a price discount or sales discount of product, since the initial price of the sold products did not change through using the bonus system
- In this regard, the Taxpayer's adjustment of aggregate annual income and taxable turnover for CIT and VAT purposes is unlawful
- Since the Taxpayer did not provide the Department with properly executed documents confirming operating costs with distributors, but provided additional invoices that do not meet legal requirements or confirm expenses incurred, the Taxpayer had no reason to recognise the bonuses as deductible expenses
- Moreover, the court also considered that the bonuses should be treated as taxable turnover by the distributors, and for that reason they are obliged to issue invoices to the Taxpayer.

Position of the court of appeal:

The court of appeal upheld the decision of the court of first instance.

More details

Tax audit appeals 2/2

Supreme Court Resolution dated 28 May 2018 on a claim from Central C LLP

Recognition of the notification of tax audit results as illegal and its cancellation

C LLP (the "**Taxpayer**") took the Astana State Revenue Department (the "**Department**") to court to have notification No.680 dated 31 March 2016 recognised as illegal and cancelled (partly). The Department had accrued corporate income tax ("**CIT**") of KZT 144,312,745, value added tax ("**VAT**") of KZT 68,375,461, non-resident VAT of KZT 20,781,036 and charged interest of KZT 116,492,472.

The Taxpayer believes that the notification is unlawful because on 9 November 2010, a customer and the Taxpayer concluded an agreement to supply, among other items, 27 rail retarders.

To execute this agreement, the Taxpayer entered into another agreement to supply the rail retarders with the supplier, Almatau Kurylys LLP ("**Almatau**").

Almatau supplied the goods to the Taxpayer, as evidenced by accounting documents. The Taxpayer, in turn, supplied the goods to the customer, which is also confirmed by accounting documents and the absence of any complaints from the customer.

However, the Department disallowed VAT offset on the Taxpayer's payments to Almatau, and disallowed certain Taxpayer expenses from CIT deductions. Since the Taxpayer provided all documentation supporting the validity of the transactions and related payments, the Taxpayer believes that the Department's actions are unlawful.

The Department, in turn, believes that the accrual is legal, as a counter tax audit of Almatau failed to confirm the supply of the goods. Moreover, the Almatau suppliers - Sary-Arka Invest Astana LLP and Astana Umit Stroy LLP - are unreliable enterprises.

The position of the court of first instance:

The court considered the notification illegal because:

- The Taxpayer provided accounting documents in respect of both the purchase of the goods from Almatau and their further supply to the customer
- During the tax audit, the Department did not find any discrepancy between Taxpayer's tax return data and its accounting documents
- Tax law does not stipulate grounds for disallowing VAT offset, and excluding CIT deductions in transactions with companies whose suppliers are unreliable enterprises, if the supply of goods has been confirmed
- The above explains why the notification is unlawful and should be cancelled

Tax audit appeals 2/2

The final position of the court of appeal:

- The court of appeal partly upheld the court decision, agreeing that the accrual of CIT, VAT and interest related to 11 rail retarders supplied by Astana Umit Stroy LLP to Almatau and then to the Taxpayer be cancelled and explaining that tax and accounting documents with respect to the given supply chain had been drafted and issued legally.
- At the same time, the court of appeal agreed with the accrual of CIT, VAT and interest related to the remaining rail retarders supplied by Sary-Arka Invest Astana LLP to Almatau and then to the Taxpayer, because Sary-Arka Invest Astana LLP and Almatau tax returns with respect to the given supply chain do not reflect these supplies.
- Due to this, the court of appeal ruled that the court decision should be cancelled in the part of cancelling the accrual of CIT, VAT and interest related to the rail retarders supplied by Sary-Arka Invest Astana LLP. In the rest part, the court decision should be upheld.

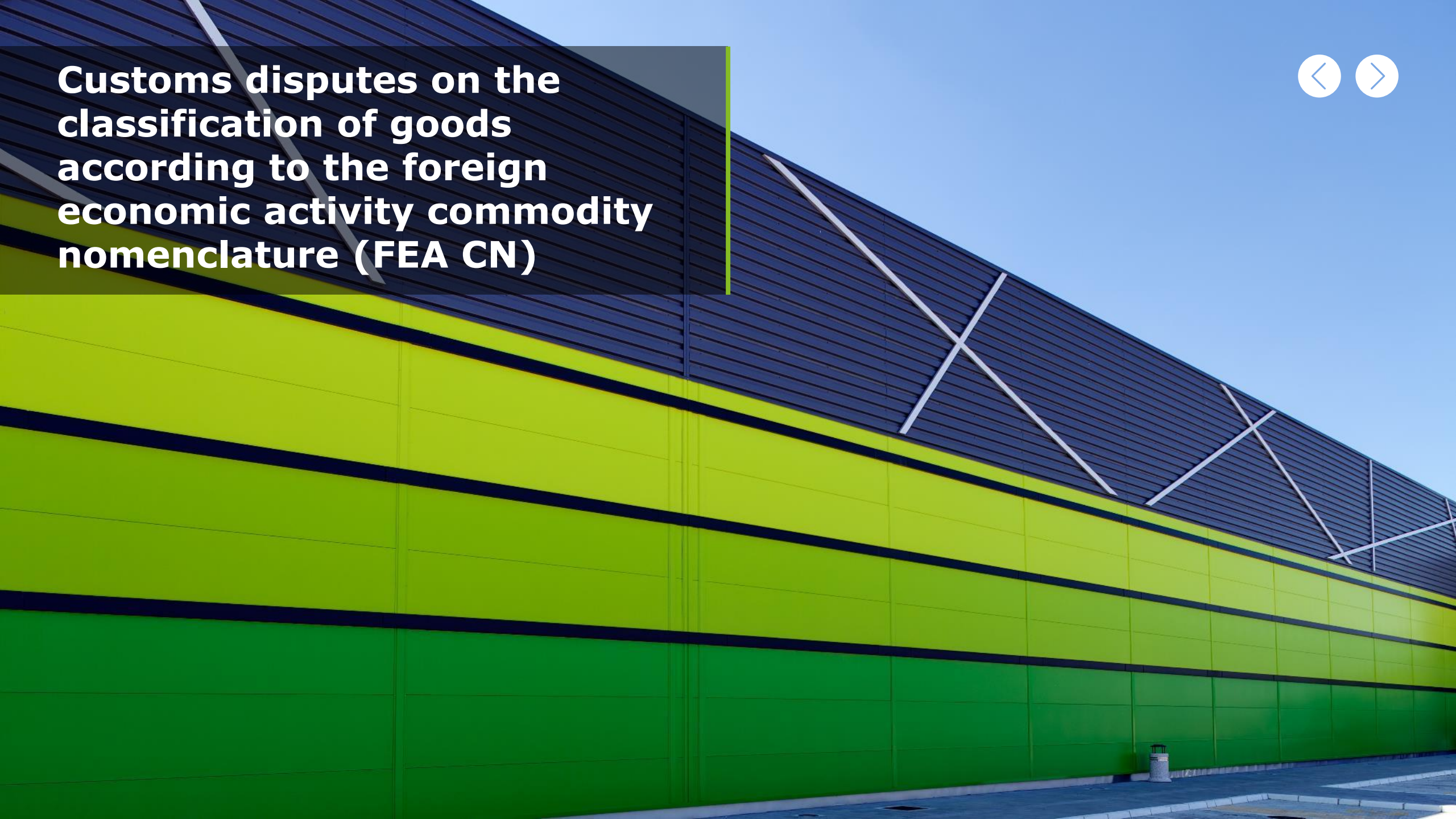
Tax audit appeals 2/2

Case history

Period	Instance	Ruling
June 2017	Court of first instance	In favour of the Taxpayer.
August 2017	Court of appeal	Court of first instance decision cancelled. A new decision issued rejecting the Taxpayer's claim.
September 2017	Court of appeal	Court of appeal decision cancelled. A new decosion issued in favour of the Taxpayer.
January 2018	Supreme Court	Court acts cancelled. The case is submitted for reconsideration.
March 2018	Court of appeal	Initial court decision changed. The Taxpayer's claim is partially upheld.
May 2018	Supreme Court	The latest court act is upheld.

More details

Customs disputes on the classification of goods according to the foreign economic activity commodity nomenclature (FEA CN)



Classification of imported goods (1/3)

Karaganda Oblast Court Resolution dated 3 October 2018 on a claim from D LLP

D LLP (the "**Company**") imported "ApilakGrindeks" (the "**Product**") into Kazakhstan, indicating the FEA CN code 3004 90 000 2 (medicines) in its customs declaration.

State Revenue Department position: After an in-house customs audit, the Karaganda Oblast State Revenue Department reclassified the Product from FEA CN code 3004 90 000 2 (pharmaceutical products) as specified in the customs declaration to FEA CN code 2106 90 920 0 (food products not elsewhere specified or included).

Company position: Disagreeing with the new classification, the Company took the State Revenue Department to court to have it recognised as incorrect and cancelled.

Court rulings:

- The first instance court upheld the Company's claims and recognised the State Revenue Department's classification as incorrect
- The court of appeal cancelled the court decision and replaced it with a new one, which rejected the Company's claims.

The hearings established that:

- The Product had been registered in Kazakhstan as a drug between 12 November 2010 and 12 November 2015, so it was classified as medicine during that period
- The Product's instructions for use state that it is a biologically active additive and a mixture of biologically active substances
- Based on its function, and according to General Interpretation Rules 1 and 6, the Product falls under FEA CN heading 2106 "Food Products ..."
- According to the Integrated FEA CN Explanatory Notes, FEA CN heading 3004 does not include food supplements containing vitamins or mineral salts prepared for health purposes, and any such products should be included in heading 2106 or FEA CN group 22
- FEA CN code 2106 90 920 0 is not in the list of drugs exempt from 12% VAT
- Even if the product is registered as a drug, based on its functional purpose according to the FEA CV General Interpretation and Explanation Rules, it should be included in the "Food Products" heading, as it is intended to provide essential vitamins and not to treat and prevent disease. Therefore, the State Revenue Department's classification is correct.

Classification of imported goods (1/3)

Our recommendations for classifying goods, based on case facts:

- Use General FEA CN interpretation rules and explanations
- For goods subject to import VAT exemptions, obtain a preliminary ruling on their classification, which should help to avoid additional VAT after a customs inspection

More details

Classification of imported goods (2/3)

Supreme Court Resolution dated 20 November 2018 on a claim from E LLP

E LLP (the "**Company**") imported "UCRETE" product consisted of four types of construction goods into Kazakhstan, and gave each of them different FEA CN codes.

State Revenue Department position: After customs control, the Astana State Revenue Department reclassified the imports, giving all four the same FEA CN code - 3925 90 800 1 (other construction items made of polyurethane, not elsewhere specified or included).

Company position: The Company believes that each item is a separate product, has its own number and packaging, and can be imported both individually and as one lot. Given it's composition, it can also be used in other construction industries. Based on these arguments and disagreeing with the reclassification, the Company took the State Revenue Department to court to have the decisions on reclassification declared illegal and cancelled.

Court rulings:

- The court disagreed with the Company's arguments and rejected its claims
- The court of appeal upheld the court decision
- The court of cassation cancelled the court decision and the terminated case proceedings.

The hearings established that:

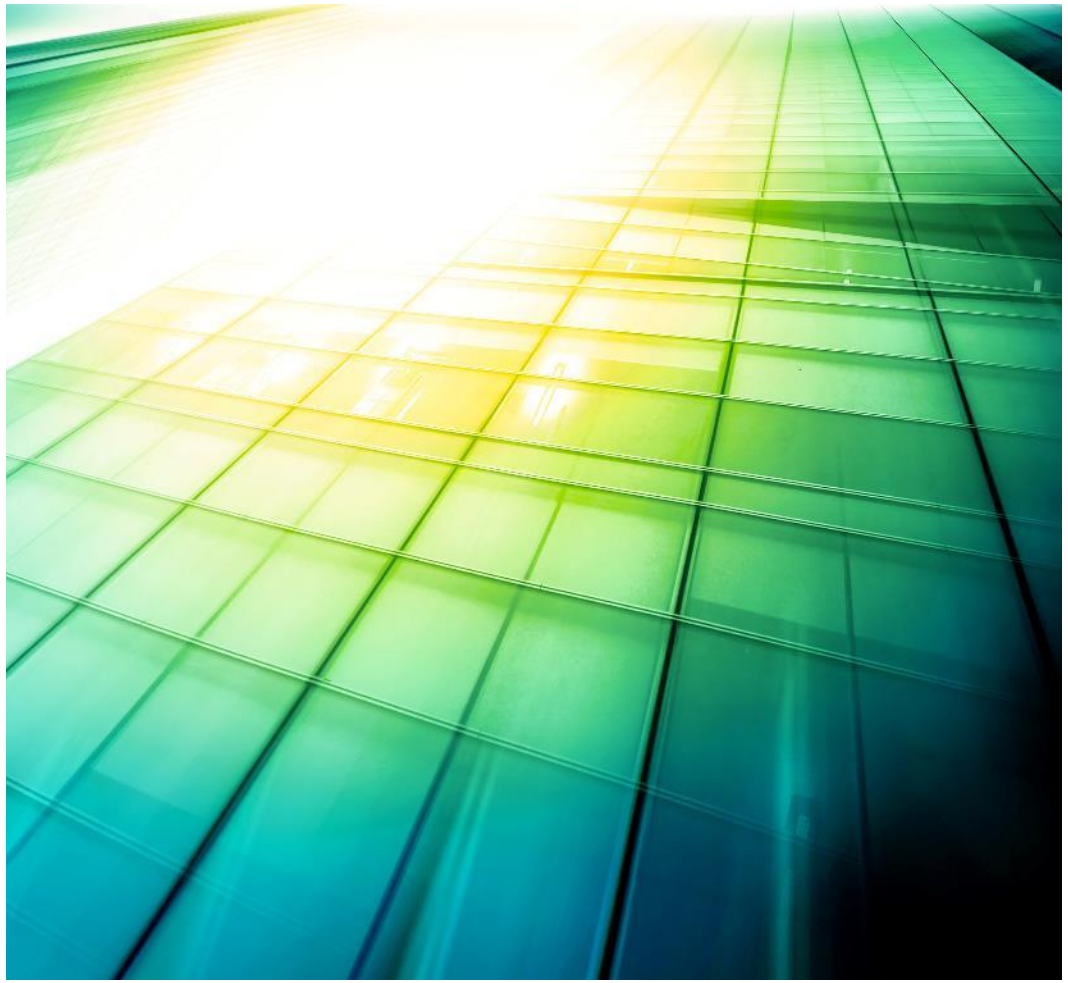
- According to customs experts, mixing the components creates polymeric flooring. If the mixing ratio is not maintained or if one of the components is missing, UCRETE polyurethane cannot be used as intended. Non-compliance with application rules leads to a change in the physical and chemical properties of the components
- Thus, the State Revenue Department classified the goods based on the main criteria of their function (floor covering) and the material from which they are made (which includes polyurethane)
- At the same time, a repeat customs expertize showed that the components and the product of their mixing are not construction materials nor items, and are a self-levelling component to be added to a floor surface
- Based on the results of the above, the State Revenue Department cancelled the disputed decisions unilaterally, classifying the goods under FEA CN code 3214 90 000 9 (Glass and garden filler, resin cement, packing components and other pastes…)
- As the disputed decisions have been cancelled, the court terminated proceedings.

Classification of imported goods (2/3)

Our recommendations for classifying goods, based on case facts:

- To classify goods, it is important to use the General Rules for the Interpretation of Goods correctly. Specifically, Rule 1 states that for legal purposes goods are classified in the FEA CN based on commodity item texts and the corresponding notes to sections or groups.

More details



Classification of imported goods (3/3)

Supreme Court Resolution dated 4 July 2017 on a claim from F LLP

F LLP (the "**Company**") imported children's diapers into Kazakhstan under FEA CN code 9619 00 210 0 (children's diapers made from paper, cellulose cotton).

State Revenue Department position: After an in-house customs audit, the South-Kazakhstan Oblast State Revenue Department classified the goods under FEA CN code 9619 00 900 1 (children's diapers made from other materials), and issued notifications requiring to eliminate violations and repay customs payments, taxes and interest.

Company position: The Company believes that the State Revenue Department classified the goods incorrectly, as the diapers' main absorbent component is cellulose, and asked the court to declare the above classification and notifications unlawful and cancelled.

Courts rulings:

- Court of first instance – ruled partially in favour of the Company
- Court of appeal – the court decision upheld
- The court of cassation – ruled fully in favour of the Company.

The hearings established that:

- The declarant, using FEA CN code 9619 00 210 0 according to GRI 3 **(b),** believed that cellulose gives the diaper its main property – liquid absorption. The State Revenue Department, in turn, indicated that sodium polyacrylate is the main material (gelling granular filler), and applied GRI **3 (c)**
- Russian national standards – GOST R 52557-2011 "Paper diapers. General technical conditions" are used for this type of goods and state that the liquid is absorbed by cellulose (fibre, cotton or canvas)
- The Company submitted certificates of compliance and other evidence confirming that the goods meet GOST R 52557-2006 requirements, where their absorbent layer always contains cellulose, but not necessarily a superabsorbent. A video of studies on the absorbing properties of children's diapers conducted by German Innovation Centre experts, explanations of the same, and court decisions on similar cases were provided
- Based on the above, the court decided that the classification and notifications of the State Revenue Department are unlawful and should be cancelled.

Our recommendations for classifying goods, based on case facts:

- To classify goods, it is important to use the General Rules for the Interpretation of Goods correctly

More details

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