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LT in Focus

Review of desktop audit practices

February 2021

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Keeping our finger on the pulse of your business

Dear friends,

Recently, as it has been impossible to conduct field tax audits, we have been seeing the authorities carrying out more and more desktop audits. As the practice has progressed, we have noticed a number of trends have been catching the attention of the tax authorities, which we would like to share with you in this issue of LT in Focus.

The aim of LT in Focus is to provide an overview of office practices that could potentially impact many of the aspects of your business. We will be happy to discuss with you in more detail any of the issues discussed in this issue of LT in Focus or any of the latest trends in judicial practice on tax and other issues, including investment disputes.

Kind regards,

Dispute Resolution Group

Tax disputes

Recognition of a non-resident’s permanent establishment

Permanent establishment created by the presence of personnel

In a desktop audit, the tax authorities revealed that a non-resident legal entity had unlawfully applied a full withholding tax exemption on income generated (“CIT at source”) in violation of point 4 of article 212 of the Tax Code (after revealing that the non-resident had created a permanent establishment or “PE” in Kazakhstan). According to current practices, the tax authorities approve the existence of a PE based on the presence of non-resident personnel on projects in Kazakhstan for a period in excess of 183 days.

Oilfield service companies, which, among others services, supply and install equipment and train personnel, often find themselves in this situation, which can be avoided by recruiting personnel through secondment agreements.

Decision of the Astana Specialised Interdistrict Economic Court dated 8 May 2019

The Yesil District State Revenue Department in Nur-Sultan (Astana) issued Company “N” with a notice to correct violations identified in a desktop audit.

When paying income to Company "M", Company "N" failed to withhold Kazakhstan corporate income tax, believing that in accordance with the provisions of the Double Tax Treaty from 18 October 1996 between Kazakhstan and Russia, the income was taxable in Russia.

As a result of a ruling by the East Kazakhstan region tax authorities on 23 January 2013, the activities of the non-resident Company "M" created a PE in Kazakhstan. According to the Yesil District State Revenue Department, it was incorrect in exempting its income from withholding tax, in violation of point 4 of article 212 of the version of the Tax Code from 10 December 2008, that is, after a non-resident creates a PE in Kazakhstan. The violation affects the Russian resident Company "M". According to verbal information from the Yesil District State Revenue Department, Company "M" performed contract work for Company "B" in 2008-2012 in East Kazakhstan Region over a period that exceeded 12 months.

Given the above, the Yesil District State Revenue Department believed that Company “M” was ineligible for Double tax Treaty relief for all projects in Kazakhstan.

In its ruling, the court was guided by point 1 of article 191 of the Tax Code, which states that when services are provided or work performed in Kazakhstan, the place where the services are provided or work performed through employees or other personnel hired by a non-resident for that purpose are recognised as a PE, if the related activities continue in Kazakhstan for over 183 calendar days during any consecutive 12-month period from the date operations within the framework of a project or related projects start.

After considering the dispute, the court ruled in favour of the Yesil District State Revenue Department.

Distribution of dividends

New practice

Additional CIT on the difference between income subject to CIT and income on which dividends are paid

The tax authorities have recently begun to calculate the understated income of non-residents based on taxable income less corporate income tax in accordance with CIT returns (form 100.00).

Potential understatements of withholding tax at the source are calculated at 15%.

According to point 1 of article 1 of the Tax Code, "dividends" are defined as the distribution of a company's net income or part of it among its partners. According to article 40 of the Limited and Additional Liability Partnerships Law, dividends are accrued and paid on net income based on a founder decision.

Kazakhstan law does not provide a definition of “net income”, which is why we need to rely on the generally accepted interpretation of net income from entrepreneurial activity as profit after expenses associated with that activities, as well as tax payments and other liabilities.

According to article 190 of the Tax Code, tax accounting is maintained in accordance with statutory accounting. However, tax accounting data may differ significantly from statutory accounting data due to the Tax Code (for example, the Tax Code provides for a number of tax exemptions and a procedure for maintaining tax accounting that differs from statutory accounting).

As such, taxpayers may record significant differences between net income in their CIT return and financial statements, and any such discrepancies do not affect CIT liabilities at the source of payment for dividends. Thus, there is no statutory connection between a taxpayer’s net income and taxable income, on which income tax is paid at the source of payment.

In this regard, given how the Tax Code determines net income, any taxable income (or net income) recorded in a CIT return is not recognised as grounds for determining potential CIT at the source of payment for non-resident dividend income.

In its letter No. 03-19 / 233 dated 18 January 2021, the Ministry of the National Economy states that as tax accounting is based on statutory accounting data (point 3 of article 190 of the Tax Code), the "net income" concept applied in statutory accounting should be applied.

Moreover, the Ministry was asked about an additional condition regarding the mandatory taxation of income payable for the purpose of applying a withholding tax exemption that came into force only from 1 January 2021.

A Law dated 10 December2020 amending the Tax Code and the Law enacting the Tax Code entered into force on 1 January 2021, with certain exceptions provided for in article 2.

At the same time, article 645 of the Tax Code was amended from 1 January 2021.

In addition, in accordance with article 43 of the Law On Legal Acts, legal acts that introduce new obligations on individuals or worsen their situation cannot be retroactive.

Based on the above, the Ministry of the National Economy rules that the amendments to article 645 of the Tax Code in the law from 10 December 2020 could not be applied until 2021.

Explanations in response to notices based on desktop audit results

New provisions in point 4 of article 96 of the Tax Code

Law enforcement practices

Under 2 of article 96 of the Tax Code, the submission of explanations is recognised as the execution of notice to correct violations identified by a desktop audit.

Since 1 January 2020, in accordance with point 4 of article 96 of the Tax Code, the tax authorities are entitled to recognise a notice to correct violations identified by them in a desktop audit as not having been executed.

Also, from 1 January 2021, taxpayers are entitled to appeal any such decision within 10 working days from the date it is issued or received, with a higher tax authority and/or authorised body or court.

The amendment was introduced to provide taxpayers with the opportunity to appeal tax authority rulings, which were previously treated as internal tax authority document, before their bank accounts are blocked.

Until 2021, the appeal deadline was 5 working days, which in practice was too short and could easily expire before the court accepted a case for consideration, since the consideration process was also 5 working days.

We have also seen cases where 10-day deadline for appealing a decision has been missed and taxpayers have no longer been able to apply chapter 29 of the Civil Procedural Code to appeal tax authority actions or inactions, which allows any such appeal within three months of the day rights, freedoms and legitimate interests were violated.

Thus, when taxpayers disagree with desktop audit results, they should pay special attention to the timing of their appeal.

Ruling of the East Kazakhstan Region Specialised Interdistrict Economic Court dated 10 February 2020

The Ust-Kamenogorsk State Revenue Department (the “Department”) sent a notice dated 18 November 2019 to Company "P" to correct violations identified by it in a desktop audit.

On 21 November 2020, Company “P” provided a written explanation stating that it believed it had complied with the notice. However, on 5 December 2019, the Department dismissed the explanation, ruling that it was not sufficient as grounds for executing the notification.

Company "P" filed a lawsuit demanding that the notice be declared illegal and the decision declaring the notification unexecuted be cancelled.

The court followed point 4-1 of article 96 of the Tax Code, according to which appeals against decisions to recognise a notice as unexecuted should be made within five working days of the date it is delivered or received. Company "P" stated that the ruling was received on 5 December 2019 and appealed to the court on 23 December 2019 only, i.e. after the deadline. At the same time, it did not ask for the term to be reset or provide the court with a valid reason for missing the deadline. For this reason, the court rejected the claim without examining the evidence of the arguments.

Explanations in response to notices based on desktop audit results

Resolution of the Almaty City Court Judicial Board for Civil Cases

The Almaty Medeu District State Revenue Authority (SRA) issued Company “D” with a notice to correct violations identified by a desktop audit, to which Company "D" provided explanations within the deadline, despite which on 13 August 2020, the SRA issued declared the notice unexecuted. Company "D" appealed the notice with a higher tax authority, but the ruling remained unchanged. Company "D" then went to court to have the SRA rulings recognised as invalid.

The court of first instance, in its rejection of the appeal, referred to point 19 of Supreme Court Normative Resolution No. 4 dated 29 June 2017 *On Court Practices in the Application of Tax Law* and stated that the SRA had used the Tax Code correctly to recognise the notices as unexecuted, since the taxpayer's explanations were not based on law, and for that reason the notices were recognised as not having been executed and the court did not establish that the defendant had violated the rights and legitimate interests of the plaintiff.

Company "D" disagreed with the court of first instance ruling and appealed it with the court of appeal. In January 2021, the Almaty City Court Judicial Board for Civil Cases considered the case at the request of Company “D” and concluded that “the applicant had executed the notices in full compliance with Tax Code requirements. In these circumstances, **the SRA is not entitled to recognise a notice as not having been executed, if explanations that comply with tax law requirements have been provided in good time."**

Thus, the court of appeal recognised the unlawful nature of the SRA rulings and cancelled the ruling of the court of first instance.

Resolution of the Supreme Court

The SRA issued Company “T” with a notice to correct violations identified by a desktop audit. Even though Company "T" provided explanations on time, the SRA recognised the notice as not having been executed. After the pre-trial resolution stage failed, Company “T” went to court to restore its violated rights.

The Almaty Specialised Interdistrict Economic Court issued a ruling in February 2020 upholding the claims in full. The rulings declaring the notices as not having been executed were declared unlawful and cancelled.

The Almaty City Court Judicial Board for Civil Cases issued a resolution in June 2020 leaving the court ruling and decision unchanged.

Further, the SRA then appealed to the Supreme Court to cancel the ruling of the court of first instance and court of appeal, citing violations of substantive and procedural law. In December 2020, the Supreme Court adopted a Resolution on the Company "T“ case allowing the SRA to only assess the taxpayer's explanation in the form stipulated in subpoint 2) of point 2 of article 96 of the Tax Code.

> “The court of first instance and court of appeal, by applying subpoint 2) of point 2 of article 96 of the Tax Code, point 19 of Supreme Court Regulatory Resolution On Court Practices in the Application of Tax Law No. 4 dated 29 June 2017 to the dispute, were correct in upholding the Partnership’s lawsuit, having concluded that the SRA was not authorised to recognise the notice as not having been executed, if an explanation has been provided in good time that complies with tax law requirements. In addition, the SRA is not authorised to rule on the legality of the reasoning in the plaintiff's explanation without conducting an unscheduled targeted tax audit. "

In its consideration of the case, the Senior Prosecutor upheld the position of Company "T", explaining that the justification of explanations should be verified during a tax audit, and not within the framework of a desktop audit, and for that reason upheld the position of Company "T" and recognised the unlawful nature of the tax authority’s actions.

Explanations in response to notices based on desktop audit results

Resolution of the Almaty City Court Judicial Board for Civil Cases

In December 2019, the Almaty Bostandyk District State Revenue Authority (the “SRA”) issued Company “B” with a notice to correct violations, and then a ruling declaring the notice as not having been executed, despite explanations being provided on time and the format prescribed by the Tax Code.

The deadline stipulated in point 2 of article 96 of the Tax Code for submitting explanations passed on 10 February 2020. Accordingly, a ruling, subject to legal justification, should have been issued by 17 February 2020. However, the SRA issued the contested ruling only on 10 March 2020.

Thus, the above actions of the SRA and the ruling itself did not comply with the Tax Code.

In a Resolution from July 2020, with the participation of Company "B", based on article 96 of the Tax Code and point 19 of the Supreme Court Normative Resolution dated 29 June 2017 *On Court Practices in the Application of Tax Law*, the Almaty City Court stated that the SRA did not have the authority to recognise a notice to correct violations identified by a desktop audit as not having been executed because Company "B" had provided the appropriate explanations within the statutory deadline, and no unscheduled targeted tax no audit had been performed in relation to the taxpayer.

The court of first instance and the court of appeal ruled in favour of Company “B”.

Ruling of the Almaty City Specialised Interdistrict Economic Court

The Almaty Almali State Revenue Authority (the “SRA”) issued a notice to Company “O” dated 22 July 2019 to correct violations identified by a desktop audit for the period between 1 January 2018 and 31 December 2018.

On 29 August 2019, Company "O" filed additional tax returns, and explanations with the SRA on 3 September 2019 in relation to the notice, expressing its disagreement with the notice due to having filed an additional tax return once the identified errors had been corrected together with reconciliation statements.

Despite this, on 20 September 2019, the SRA recognised the notice as not having been executed. To restore its rights, Company "O" went to court requesting the SRA ruling be recognised as illegal and cancelled.

In a ruling from February 2020, the Almaty Specialised Interdistrict Economic Court notes that “interpreting the Tax Code literally the SRA is authorised to recognise a notice to correct violations identified by a desktop audit as not having been executed only if the taxpayer fails to provide an explanation or misses the deadline to so and the explanation does not comply with Tax Code requirement, or if it files an additional return that violates tax law. The above grounds are exhaustive and are not subject to wider interpretation.

For this reason, the SRA ruling was declared unlawful and cancelled in court.

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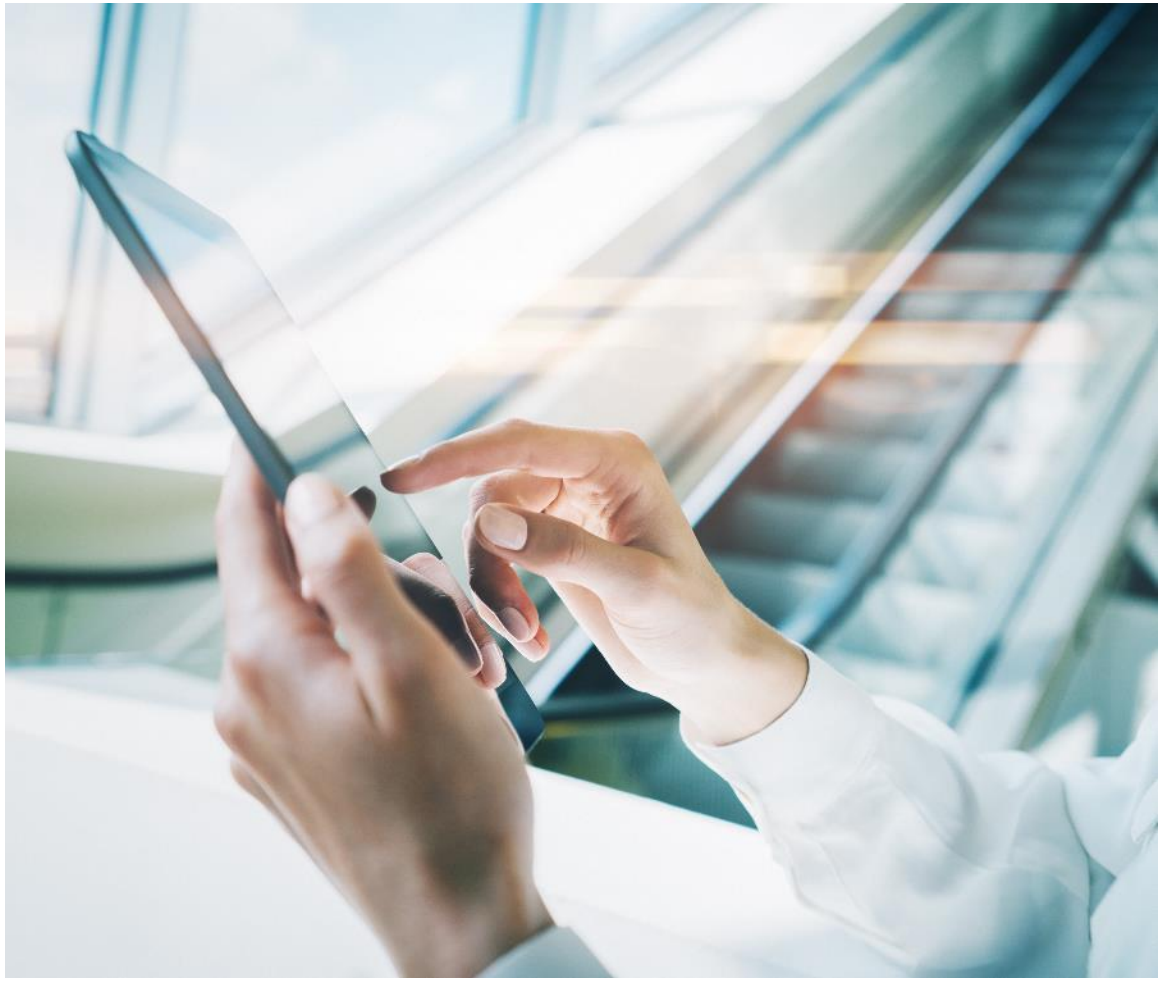

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