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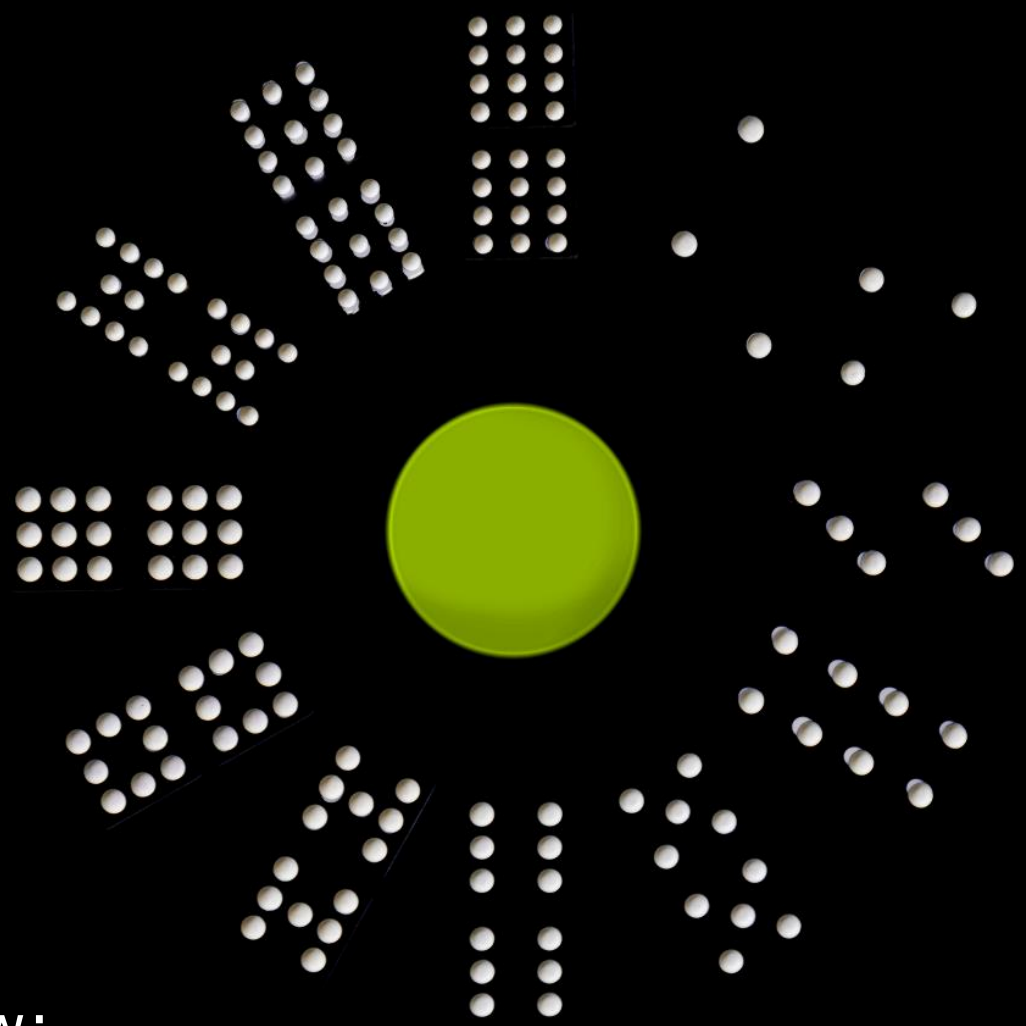


LT in Focus
Court Dispute Overview: Issue № 5

June 2018

Contents

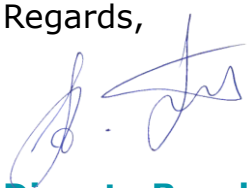
We keep an eye on your business

Dear Friends

We are happy to offer the latest in our overviews of court practices around tax, customs and environmental disputes in Kazakhstan for investment and general jurisdiction cases. We provide overviews of those disputes we consider the most significant and that have the potential to impact various aspects of your business.

We will be happy to have a more detailed discussion in relation to any of the cases in this **LT in Focus**, or the latest tax, customs and environmental court practices and other questions, including investment disputes.

Regards,



Dispute Resolution Group

Tax Disputes

Tax Audit Appeals (1/3)

Decision of the Kyzylorda Oblast Specialised Inter-District Economic Court dated 21 September 2017 in case № 4360-17-00-2/1830

KazRosMunay LLP

To recognise tax authority actions as illegal and cancel notification

Following a tax audit of KazRosMunay LLP ("Taxpayer") tax liabilities between 1 January 2011 and 30 September 2015, the Kyzylorda Oblast State Revenue Department ("Department") served Notification #129 on 28 November 2016, which accrued additional tax and other obligatory budget payments, and late payment interest of KZT 20,568. The Taxpayer disagreed with the audit findings, and filed an appeal with the Ministry of Finance State Revenue Committee, which issued Appeal Review Notification #129/1 dated 28 June 2017 ("Notification").

The Taxpayer brought the case because of a letter from the Department's Deputy Executive Officer referring to tax evasion by the Taxpayer.

The Taxpayer asked the court to recognise the writ and tax audit act, and actions of the Department illegal, to cancel the Notification, and for compensation for damage done to its business reputation.

Importantly, the taxpayer argued that the audit had been initiated according to provisions of the Criminal Procedural Code ("CPC"), but no criminal investigation had been initiated, which would be a mandatory condition for instigating a tax audit under the CPC.

The Kyzylorda Oblast Specialised Inter-District Economic Court partially upheld the Taxpayer's appeal, recognising the Department's actions as illegal and cancelling the Notification. No compensation was awarded for damage to reputation.

Case Review History

Court of First Instance Position:

The court claimed that during the audit, the Department had breached the following Business Code and Tax Code provisions:

Time Period	Instance	Decision
September 2017	Court of First Instance	Upheld, partially in favour of the Taxpayer

- **No grounds for conducting an audit:** the letter of the Department Deputy Executive Officer served as the basis for the audit. However, no criminal investigation into the Taxpayer was carried out
- **The Taxpayer provided documents in a number of volumes.** The additional tax in the tax audit act was accrued due to the Taxpayer's failure "to provide all documents", even though almost all audit-related documents were duly provided
- **Tax audit period.** The deadline for completing the audit as indicated in the writ was missed (167 business days overdue).

Thus, the court of first instance upheld the Taxpayer's arguments and ruled partially in its favour.

Learn more

Tax Audit Appeals (2/3)

Ruling of the Astana City Court Civil Dispute Board dated 6 September 2017

"Company A"

Ruling in favour of the tax authorities

After a comprehensive tax audit of "Company A", the Astana State Revenue Department ("Department") issued a Documentary Tax Audit Act dated 2 July 2015 ("Act # 1") and Notification of Tax Audit Results dated 2 July 2015 ("Notification").

The Taxpayer disagreed with the findings in the Notification and filed an appeal with the State Revenue Committee ("Committee"), which resulted in a targeted audit, the corresponding Documentary Tax Audit Act dated 2 December 2016 ("Act #2") and a subsequent ruling.

Additional CIT was accrued on non-residents in connection with Taxpayer transactions to purchase equipment and services under Agreements with Company B, a German resident

Act #1 recognised Company B revenue received on services provided to the Taxpayer as the income of a non-resident on work and services performed in Kazakhstan and accrued additional CIT at 20%. The Committee's targeted audit came to a different conclusion, and in Act #2 recognised Company B's income as royalties which are taxed at 15%. This resulted in Notification of Appeal Results dated 17 January 2017 (the "New Notification").

Disagreeing with the Committee's new argument to recognise the services received from Company B as royalties, the Taxpayer requested the court to annul the sections of the New Notification relating to CIT and late payment interest.

The court ruled in favour of the Taxpayer.

Case Review History

Time Period	Instance	Decision
June 2017	Court of First Instance	In favour of the taxpayer
September 2017	Court of Appeal	CFI decision overturned; new ruling against the taxpayer

Positions of the Court of First Instance and the Court of Appeal:

The Court of First Instance challenged the recognition of Company B revenue under agreements with the Taxpayer as royalties, by stating that:

- **the Department had applied the law incorrectly with respect to the definition of "royalties".** Under the Agreements with the Taxpayer, Company B provides the latter with a non-exclusive, permanent, limited license to use software in Kazakhstan. The Taxpayer has no proprietary or temporary right to use the software. Copyright to the software remains with Company B, with the Taxpayer holding a non-exclusive, permanent and limited license to use the software to service the equipment for which the software was developed.

In view of the above, the Software is not the subject of the Agreements, but rather an integral component of the equipment provided, without which the latter cannot be used.

Tax Audit Appeals (3/3)

Section 12(1)(30) of the Tax Code defines "royalties" as a payment for the use or the right to use copyrighted materials, software, patents, drawings, models, trademarks or other similar types of rights.

In accordance with section 12(3) of the Double Income and Property Tax Treaty between Kazakhstan and Germany (the "Treaty"), the definition of "royalties" to be used by both states in tax relations means any types of payments obtained as consideration for the use or the right to use any copyrighted works of literature, art or science, including cinematographic pictures, any patent, trademark, design or model, plan, secret formula or process. As such, royalties are defined as income deriving from the granting of a right to use copyrighted materials.

In accordance with section 2(5) of the Tax Code, if an international agreement ratified by Kazakhstan sets other rules than those envisaged in the Code, the former will apply.

Thus, royalties are defined in accordance with the Treaty and not the Tax Code.

Given the provisions of the Treaty, the Court concluded that for the dispute in question, royalties are not a payment for the use of software, but rather for the use of copyrighted material, which testifies to the illegality of the New Notification if Treaty norms are applied.

Also, according to the Law dated 10 July 1996 *On Copyright and Related Rights*, a copyright contract is an agreement covering the transfer of proprietary rights to use copyrighted materials. The Court ruled that the Taxpayer and Company B did not enter into a copyright or license agreement, and the agreements they did conclude did not discuss the acquisition of copyright to the new software functions.

In view of the above, the Court found that Company B revenue did not constitute royalties and ruled in favour of the taxpayer.

However, the court of appeal overturned the decision of the Court of First Instance, ruling that it does not correspond to the circumstances of the case.

The court of appeal, assessing the court's decision and the argument of the parties, based its decision on the fact that the Taxpayer had purchased a non-exclusive, limited and perpetual license to use updated software and a new version of the software, which constitutes intellectual property belonging to Company B, for a consideration.

Under the Treaty, the court of appeal upheld the Department's reasoning in relation to classifying Company B revenue as royalties.

Thus, the court of appeal overturned the decision of the court of first instance and issued a new decision in favour of the tax authorities.

Customs Disputes

Customs Value of Exported Goods (1/3)
Case #1

Ruling of the Supreme Court Board of Judges dated 12 May 2017 on case № 2a-17-17

Karachaganak Petroleum Operating B.V. operating through a branch

Ruling in favour of the Company

After performing an unplanned visit-based customs audit of Karachaganak Petroleum Operating B.V. (the ”Company”) in relation to its compliance with customs and other legal norms when exporting goods from 1 January 2014 until 30 November 2015, the West-Kazakhstan Oblast State Revenue Department (“Department”) issued customs audit act and notification #42 dated 9 June 2016 (“Notification”) accruing additional customs declaration fees of KZT 282,522,775 and imposing a fine of KZT 67,980,607 (KZT 350,503,382 in total).

The grounds for the additional accrual was the Company’s failure to include expenses related to the transportation of oil to the destination port in the Customs Value of the goods, and the unreasonable reduction of the customs value of the goods in connection with the application of the quality bank.

The Company went to court to have the notification recognised as illegal and cancelled.

The Astana City Court ruled partially in favour of the Company. The parts of the notification accruing additional customs declaration fees of KZT 257,648,058 and fine of KZT 62,168,776 (KZT 319,816,834 in total) were recognised illegal and cancelled.

The court rejected the Company’s arguments in relation to the application of the quality bank when determining the customs value of goods.

Case Review History

Time Period	Instance	Decision
February 2017	Court of First Instance	Partially in favour of the taxpayer
May 2017	Court of Appeal	Court of first instance ruling upheld

Position of the Appeal Board of Judges of the Supreme Court of Kazakhstan:

- The Company exports crude oil FOB (Incoterms 2000) under contracts concluded with foreign companies.
- Incoterms 2000 is an international document setting out the rules for interpreting trade terms (Incoterms), devised by the International Chamber of Commerce. FOB ("Free on Board“) means that the seller has met its obligation to deliver when the goods have passed over the ship's rail at a named port of shipment.

Customs Value of Exported Goods (2/3)
Case #1

- From this moment, all expenses and risks of loss or damage of goods transfer to the purchaser.
- The procedure for determining the price of oil and gas produced at the Karachaganak oil, gas and condensate field is established by rules approved by Government Resolution #848 dated 26 June 2012. The Company complies with these rules when determining contract prices.
- According to article 10(2) of the Transfer Pricing Law, objects of taxation and/or objects connected with taxation for commodities are quoted taking into account the range of prices and margin indicated in information sources. The exchange oil price is determined according to contractual terms and conditions and complies with the above legislative provisions.
- Government Resolution #1568 dated 21 December 2011 designated Platts Crude Oil Marketwire magazine as the source of information on crude oil, (or) gas condensate and oil product market prices.
- Case materials contain a letter dated 2 February 2017 confirming that Platts Crude Oil Marketwire forms quotes inclusive of pipeline transportation costs.
- In accordance with the Methodology for keeping International Trade Statistics, approved by Order of the Chairman of the Statistics Committee #204 dated 14 December 2015, for goods delivered FOB delivery and ship loading expenses are included in the price of the goods.
- In accordance with section 122 of the 1995 Customs Law and section 98 of the Customs Code, the customs value of goods exported from the Customs Union is based on the transaction price actually paid or payable.
- To determine the customs value of goods, the transaction price includes transportation expenses, unless they have not already been included in the price.
- In such circumstances, the court of first instance reasonably concluded that the transaction price includes Company expenses to transport oil to the delivery base, and, consequently, they should not be considered again when determining the customs value of the goods.

Position of the court of appeal:

The Supreme Court specialised board of judges ruled that the Astana City Court ruling dated 28 February 2017 be upheld and the appeal and appeal protest be rejected.

Thus, the court of appeal supported the Company's arguments, upholding the decision of the court of first instance.

Source: *Court Cabinet of the Supreme Court of Kazakhstan*

Learn more

Customs Value of Exported Goods (3/3)
Case #2

Decision of the Specialised Board of Judges of the Supreme Court dated 6 March 2018

"Company C"

On the recognition of notification as illegal and its cancellation

After an unplanned customs audit of "Company C" ("Customs Applicant"), the Aktobe Oblast State Revenue Department ("Department") issued a customs audit act and notification of audit results dated 29 August 2016 accruing additional customs declaration fees and a fine. The fine was subsequently increased by an additional notification ("Notification'). The Customs Applicant disagreed with the Notification and applied to court to have it recognised as illegal and cancelled.

The Astana City Court ruled in favour of the customs authorities.

Case Review History

Time Period	Instance	Decision
December 2017	Court of First Instance	Against the Customs Applicant
March 2017	Court of Appeal	Decision of the court of first instance upheld

Position of the court of appeal:

The court determined that:

- **the Customs Applicant had missed the deadline for appealing the Notification and provided no valid justification for doing so. The board of appeal upheld the decision of the court of first instance, referring to** section 172(6) of the Civil Procedural Code ("CPC"), whereby a judge will reject a case without consideration of it if the relevant limitation period or a deadline for applying to court has been missed with no justification**.**
- In the case in question, the Customs Applicant had submitted its appeal against the Notification in court on 10 November 2017, 9 months and 20 days after the deadline.
- The Customs Applicant also failed to provide proof of any legitimate reasons for missing the deadline.
- In accordance with the court of appeal ruling, earlier, the State Revenue Committee also declined to review the Customs Applicant's appeal because it had missed the filing deadline.
- In view of the above, the Customs Applicant's appeal was reviewed on its merits, even though it stated that oil was delivered FOB (Incoterms 2010).
- It is worth pointing out that in a similar court case, the judges ruled in favour of the plaintiff. In accordance with the ruling, oil transport expenses were included in the customs value of the oil (please see the court case analysed on slide 9).

Thus, the court of appeal agreed with the arguments of the court of first instance and ruled against the Customs Applicant.

Environmental Disputes

Environmental Audit Appeal (1/2)

Ruling of the Pavlodar Oblast Court dated 20 September 2017 in case № 5599-17-00-2a/ 1990

JSC Kazakhstan Electrolysis Plant

Ruling on recognising a writ to rectify a breach of environmental law and a writ to compensate for environmental damage as illegal and have them cancelled

After a sample environmental audit of JSC Kazakhstan Electrolysis Plant ("KEP"), the Pavlodar Oblast Environmental Department ("Department") issued Audit Act #105 dated 24 November 2016 ("Act"), based on which it issued a writ on 24 November 2016 to rectify a breach of environmental law and writ #52 dated 8 December 2016 for compensation for damage caused to the environment as a result of emitting hydrogen disulphide without an emissions permit ('Writs").

Disagreeing with the audit results, KEP applied to court to have the Writs recognised as illegal and cancelled.

In turn, the Department submitted a claim against KEP demanding compensation of KZT 280,649,647 for damage caused to the environment as a result of emitting hydrogen disulphide without an emissions permit.

The Department was successful in the court of first instance. The court of first instance ruled that damages of KZT 280,649,647, as well as state duties of KZT 8,419,489 be paid by KEP to compensate for damage caused to the environment.

KEP's appeal was rejected.

Position of the court of appeal:

Proceedings established that the Department had violated measuring procedures:

- **The court of first instance did not consider device operating margins.** A Polar-T device was used as the benchmark, resulting in a hydrogen disulphide emission range of 1-2mg/m^3. The court of first instance, while assessing case facts, did not take into account the fact that the Polar-T device manufacturer had set a permissible operating margin of 0-500 mg/m^3 +/- 5 mg/m3 for hydrogen sulphide. The Department was aware of this and did not deny its existence, but did not take it into account when measuring emission volumes.

In addition, according to a letter from the manufacturer's official representative, Polar T data within 5 mg/m^3 should not be treated as confirmation of the presence of hydrogen sulphide in an analysis.

- Since the audit recorded hydrogen sulphide in the range of 1-2 mg/m^3, i.e. below 5 mg/m^3, the Department's conclusions on the presence of hydrogen disulphide were based on unreliable data and should be recognised as unreasonable.
- **The court of first instance rejected KEP's arguments that fuel flaring does not take place during initial aluminium production. According to a letter from an official representative of the Polar-T manufacturer,**

Environmental Audit Appeal (2/2)

Case Review History

Time Period	Instance	Decision
April 2017	Court of First Instance	In favour of the Department. KEP claim is rejected
September 2017	Court of Appeal	Decision of the court of fist instance overturned and a new decision taken to reject the Department's claim. Decision to reject the KEP appeal overturned and a new ruling issued in favour of KEP.

Electrolysis as part of aluminium production is not a flaring process, which means that sampling cannot be carried out using Polar gas sensors. The court of first instance, referring to the Polar-T device being equipped with a hydrogen disulphide sensor and as such being applicable for use during emission control at other units, did not take into account that "other units" included those with hydrogen disulphide emissions.

In addition, according to a chemistry PhD expert, Professor of the Professional Study and Protection of the Environment at the Pavlodar Toraygyrov State University, Mr A K Sviderskiy, aluminium production by means of electrolysis does not hydrogen disulphide due to the absence of its component – hydrogen.

Also, hydrogen disulphide cannot be created due to the temperatures associated with the processes, which are significantly higher than those required to breakdown hydrogen disulphide. Likewise, hydrogen disulphide of 2 mg/m^3 as measured by the portable multi-component Polar T gas sensor should not be considered as it constitutes a residual indication stored in the device's memory or a measurement error.

Thus, the court of appeal decided that the Department was in breach of sampling procedures and thus ruled partially in favour of KEP.

In view of the above, the court of appeal partially overturned the part of the decision of the court of first instance rejecting KEP's appeal and issued a new ruling in favour of KEP, and also rejected the Department's claim.

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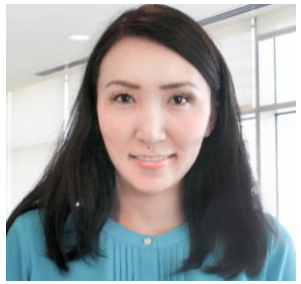

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