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CIS Tax News

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CIS Tax News is a monthly publication providing news, comment and analysis on the tax and legal issues facing businesses in Russia and the other CIS countries.

Comments and suggestions from readers on the content of CIS Tax News are welcome.

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Tax news

It is proposed to make significant changes to the **Kazakh** Tax Code Amendments regarding the levies for placing outdoor advertisements were introduced in the Kazakhstan Tax Code.

Amendments regarding income from business activities in free economic zones were introduced in the **Kazakhstan** Tax code.

Changes to the Tax Code relating to additional tax allowances for unified social tax, personal income tax, profits tax and property tax were introduced in **Russia**.

The National Bank of the **Ukraine** approved a resolution providing for a change to the way maximum interest rates on external loans to residents are set.

Analytical article

Currently, tax relations in the Republic of Belarus are regulated by legislative acts which do not provide for clear guidance. The ambiguities which arise lead to uncertainties and questions. One controversial issue is the taxation of income from the disposal of shares by foreign companies of joint-stock companies incorporated in the Republic of Belarus.

International taxation

In the Czech Republic significant changes to domestic taxation were introduced. In particular, these amendments will allow a decrease in the tax burden via a reduction in tax rates or exemption of particular transactions from taxation. On the other hand, the thin capitalization rules will be tightened.

Court practice

Russian taxpayers have received a significant boost in arguments available to support the “economic justification” of the costs, following a recent ruling by the Russian Constitutional Court.

The **Ukrainian** courts have recently been taking a consistent position on the rights of taxpayers in relation to VAT tax credits (input VAT recovery). This article considers a case covering VAT refund issues where the registration documents of the counterparty were void.



Tax News

Azerbaijan

Changes and Amendments to the Tax Code

The President of the Republic of Azerbaijan signed into law changes and amendments to the Tax Code on submission of tax returns via the internet. According to the law,

the filing of tax returns in electronic form is subject to certain procedures determined by the Cabinet of Ministers and should correspond with the standards laid down.

VAT Exemption for Wheat Import

According to the resolution issued by the Cabinet of Ministers of the Republic of Azerbaijan on 27 July 2007 the list of goods exempt from VAT on importation has been expanded to include wheat.

Belarus

On certain excise payment issues

On 1 August 2007, amendments to Presidential Decree "On certain issues of assessment and payment of excises and value added tax" came into effect. The amendments affect the due dates for payment of excise to the budget if the amount of excise taxes payable exceeds EUR 17,000. The new method helps entities avoid substantial outflows of working capital, which is especially important in the case of the seasonal nature of shipments of

excisable oil products. In particular, this method will provide for the precise calculation of the amount of excises payable based on the excise tax rates effective at the moment of payment, without their recalculation in the future.

On excise rates for excisable goods

Decree of the President of the Republic of Belarus No. 303 dated 28 June 2007, increased the rates of excise tax for certain types of excisable goods.

The changes affected mainly the rates for alcohol products. In particular, the rates of excise taxes for low alcohol beverages have been increased almost twice, whereas for other alcohol products they increased only slightly. This Decree came into effect on 1 August 2007, therefore companies must calculate the amounts of excises on the above excisable goods for July using the new rates and reflect them in their July returns.

Georgia

Amendments to Property Tax Instructions

The Ministry of Finance of Georgia signed Order No. 759 amending the instructions "On the Property Tax Calculation and Payment Rules". The amendments bring the instructions into line with the recently introduced changes in the Tax Code of Georgia regarding property tax declarations

and payment obligations of employees in the public sector and land owners in various regions of the country. The new instructions came into effect in July 2007.

Taxpayer's Unique Card Regulations

On 2 July 2007 the Ministry of Finance of Georgia promulgated Order No. 786 amending the instructions "On

Maintenance of Taxpayer Unique Registration Cards". The changes mostly refer to relations between large taxpayers and the tax authorities. From now the tax authorities have to draw up tax reconciliation acts with all large taxpayers every six months. The ruling takes effect from August 2007.

Kazakhstan

Amendments to legislation on free economic zones

According to amendments made to the Tax Code on the taxation of the legal entities established in free economic zones (FEZs), income of legal entities should be recognized as taxable income from business activities performed in FEZs based on confirmation received from the executive bodies or administration of the FEZ.

Moreover, the following amendments to the Tax Code with respect to FEZs have been proposed and will become effective from 1 January 2008, if approved:

- Extension of the list of business activities to which the FEZ regime is applied;
- Abolition of provisions regulating taxation of the "Aktau seaport" FEZ;

- Opportunity for a VAT refund relating to payments to suppliers of goods (works, services) that have been fully consumed for the purposes of creating new, as well as expanding and renovating existing, production facilities within the FEZ;
- Right to apply VAT exemption to business activities within the FEZ by legal entities.

Russia

Amendments to Part Two of the Tax Code and certain statutory acts

Federal Law No. 216-FZ of 24 July 2007 introduces changes to the Tax Code, in particular, providing additional tax allowances for unified social tax, personal income tax, profits tax and property tax. The Law comes into effect on 1 January 2008 but not earlier than one month after its official publication (except for certain provisions with different timing specified).

Creating favorable tax conditions for financing innovative activity

Federal Law No. 195-FZ of 19 July 2007 introduces amendments to several chapters of the Tax Code of the RF to create more favorable tax conditions in relation to financing innovative activity. The amendments expand the tax exemptions for research and development as well as engineering works. The above provisions become effective from 1 January 2008 but not earlier than one month after their official publication.

Amendments to the list of codes for foodstuffs subject to 10% VAT

The Resolution of the Russian Government No. 466 of 23 July 2007 expands the list of codes for foodstuffs in the RF Classifier of Goods which are subject to 10% VAT. The Resolution becomes effective one month after its official publication but not earlier than the first day of the next tax period.

Ukraine

Change in setting maximum interest rates on external loans to residents

In accordance with a Resolution of the National Bank of the Ukraine, amendments have been approved

providing for a change to the setting of maximum interest rates on external loans to residents. The new method provides for setting maximum interest rates based on the weighted average yield on Ukrainian external bonds. It should be

noted that the maximum rate established by the National Bank of the Ukraine often serves as an indicator of the "fair" rate for the purposes of transfer pricing. The amendments will become effective from 19 October 2007.

Analytical article

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Tax on income from the sale of Belarusian corporations' securities by foreign companies

Until recently, legal relations in the Republic of Belarus have been based on by-laws (different instructions, guidelines, recommendations, etc.). Currently, legal relations are regulated by legislative acts, which prevail over by-laws. Unfortunately, neither taxpayers nor tax authorities were prepared for the change in the legal basis regulating tax issues. For example, while tax issues were previously dealt with detailed by-laws, the current laws do not include any clear rules.

One of the outstanding issues is the taxation of a foreign organization's income when it does not have a permanent establishment in the Republic of Belarus. Some types of income of such organizations are subject to withholding tax. In particular, this includes income from the disposal of shares of joint-stock companies incorporated in the Republic of Belarus by foreign companies.

In this article we will consider two major issues related to the taxation of such income: uncertainty over the tax rate applicable and the procedure for the payment of income tax.

Income Tax Rate

The taxation of income from the disposal of securities is based on two legislative acts:

- Law of the Republic of Belarus "On income and profit taxes" (hereinafter – "Law");

- Decree of the President of the Republic of Belarus "On taxation of income in some activity spheres" (hereinafter – "Decree").

In accordance with the version of the Law dated 1 January 2007, income from the disposal of participation units (or part thereof), shares, or stocks, held by participants/shareholders of Belarusian companies shall be included in "other income" for tax purposes. In accordance with Article 10 of the above Law, the tax rate applicable to "other income", with regard to foreign companies not having Belarusian permanent establishments and receiving income from sources in the Republic of Belarus is 15%.

In accordance with Point 1 of the Decree, corporate income from transactions with securities shall be subject to income tax at the rate of 40%. Therefore, the tax base shall be determined as the difference between the sale price of securities and the purchase price, including costs incurred in relation to their purchase and sale.

Thus, there is a contradiction between the two legislative acts specified above: on the one hand, the Law provides for a rate of 15% to be used for income from the disposal of shares, and on the other hand, in accordance with the Decree, the rate of 40% shall be used for income from transactions with securities.

A similar problem occurred in 2004 when, as a counter to the Decree, the

Council of Ministers of the Republic of Belarus issued a Resolution providing for the taxation of such income at a rate of 15%. The Constitutional Court of the Republic of Belarus ruled then that as the Decree had priority over the Resolution of the Government, for taxation purposes, income from transactions with securities should be subject to the tax rate of 40% established by the Decree.

Currently, a similar approach seems logical as the Decree, being part of Belarusian legislation, also has priority over the Law. At the same time, it is not clear why on 1 January 2007 the

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legislator included income from the sale of shares in "other income" subject to taxation at the rate of 15%, if the

tax rate of 40% had already been implemented. Essentially, this provision cannot be used as it conflicts with the act of a higher legal force.

Moreover, it should be noted that the Decree does not cover transactions for the sale of participation units, and as a result, income of foreign organizations from the sale of participation units in companies of the Republic of Belarus are only subject to the tax rate of 15%. Therefore, it is more favorable for investors to perform transactions with participation units, not shares.

Transfer to the budget

In accordance with the expired Instruction "On the procedure of assessment and payment of tax on income of foreign organizations not having permanent establishments in the Republic of Belarus" (hereinafter – "Instruction"), the withholding and payment of tax amounts and/or filing of income tax returns on behalf of a foreign organization may be performed by its authorized representatives.

Currently, there are no such norms in the legislation of the Republic of Belarus. Therefore, the Law provides for the obligation of legal entities and individual entrepreneurs which pay income to foreign companies, to withhold taxes on income of these foreign companies from sources in the Republic of Belarus. The above legal entities and individual entrepreneurs shall be recognized as tax agents and have the rights and bear the duties established by the legislation of the Republic of Belarus. At the same time, it is not clear whether the Law is applicable to the taxation of income from the sale of securities as similar issues are covered by the Decree, which does not provide for the obligation of the agent

to withhold the relevant tax. Therefore, the question is whether the agents or taxpayers themselves should pay the tax to the budget?

The legislation of the Republic of Belarus cannot give a specific answer to this question and as a result, current legal practice is significantly complicated by this situation.

On the basis of our analysis, it may be concluded that both the Law and the Decree referred to above regulate issues of income taxation. Hence, it may be assumed that the general provisions of the Law on the procedure of income tax payment by tax agents should be applicable to the tax on income from the sale of securities. This is confirmed by current practice – before the expiration date of the Instruction, tax agents which paid income withheld and paid income tax from the sale of securities by foreign companies. The above provision of the Instruction on payment of tax by tax agents was not considered to be in conflict with the Decree or the Law.

The Decree does not regulate certain tax issues regarding income received by foreign companies carrying out their activities in the Republic of Belarus without a permanent establishment. It simply establishes how to determine the tax base and the tax rate for certain types of income. Other issues were previously covered by the Instruction prior to its expiration.

Therefore, it is possible to say that in 2007, regardless of the fact that the Instruction has expired, the procedure of income tax payment for foreign organizations from the sale of securities remains unchanged: the tax should be withheld and paid to the budget by tax agents that pay such income.

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Nevertheless, there is no direct provision in Belarus' legislation obliging the tax agent to withhold income tax, therefore the opposite conclusion can also be reached, i.e. the income tax should be paid to the budget by the taxpayer, not the tax agent.

All of the above justifies the need for clearly defined legal procedures connected with the payment of income tax of foreign legal entities received by foreign organizations from the sale of shares. Currently, due to imperfections in the legislation, purchasers and sellers of shares may face the question of who is obliged to pay the income tax, the taxpayer or the tax agent that pays the income.

Double tax treaties (DTT)

The application of a DTT may solve a number of issues facing foreign organizations regarding the above situation, as in the Republic of Belarus DTT provides for the exemption from taxation on the income received by foreign organizations from the sale of shares of Belarusian companies.

For the purposes of DTT application, it is necessary to have confirmation of a tax residency of the foreign company. Only then may taxpayers and tax agents be exempt from tax liabilities.



International taxation

Miroslav Svoboda, Yulia Gabdullina

New Amendments to Czech tax law

On 21 August 2007, the Chamber of Deputies approved (in the third reading) a public finance reform bill containing a number of important amendments to Czech tax law that will affect companies doing business in the country. If

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approved by the Senate and signed by the President, the measures will generally become effective from 1 January 2008.

Corporate/Withholding Tax Rates

The corporate income tax rate will be reduced gradually from the 24% rate as follows:

- 21% from 1 January 2008;
- 20% from 1 January 2009; and
- 19% from 1 January 2010.

The withholding tax rates on dividends, interest and royalties (currently 25%) will be standardized at a rate of 15% for 2008, and will be further reduced to 12.5% from 1 January 2009. The rate applicable to financial leases concluded abroad will increase from the current 1% to 5%.

Thin Capitalization Rules

The thin capitalization rules will be tightened by limiting the tax deductibility of interest, including security and credit-processing costs and collateral fees on credits and loans received. These rules will also apply to transactions with unrelated parties. The debt-to-equity ratio will be 2:1 (3:1 for banks) for loans from a related party (currently 4:1 and 6:1 respectively). Loans from an unrelated party will have a ratio of 6:1 (4:1 from 2009). Other new restrictions limiting the potential deductibility of the interest include:

- interest over a specific monetary amount ;
- the loan being subordinated to other payables;
- the payment of interest being dependent upon the payor's profit or loss.

The thin capitalization rules will not apply to interest of CZK 1 million (approximately USD 49,600) or less paid

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on loans from unrelated parties. Under a transitional provision, the new rules will first apply to contracts concluded after 1 January 2008 and to amendments (on contracts concluded on or before this date) modifying the amount of loans, credit and interest that are concluded after 1 January 2008. As from 1 January 2010, the rules will apply to all loans, including those under contracts concluded on or before 1 January 2008 that have not been modified.

Exemption for Dividends and Capital Gains

Dividends and capital gains derived from the disposition of shares will be exempt from tax where both the parent company and subsidiary are resident in the EU or, if one party is resident in a country outside the EU, the country has concluded a tax treaty with the Czech Republic and other conditions are satisfied. Such conditions include:

- the subsidiary being subject to tax in its country of residence according to rules similar to Czech income tax and at a tax rate of at least 12%;
- the subsidiary is in a legal form similar to the Czech limited liability company or joint stock company;
- the parent has held at least a 10% shareholding in the subsidiary for the 12 month period prior to the disposition of shares. In the case of EU countries, the conditions of the EC Parent-Subsidiary Directive must be met for the capital gain exemption. The amendment also implements provisions of the EC Merger Directive.

Tax Deductibility of Finance Leases

The proposed rule will standardize, for tax purposes, the minimum term for finance leases related to tangible assets and the minimum depreciation period of such assets. Lease payments made under a finance lease will be deductible only if the term of the lease equals at least the minimum depreciation period of the

asset as set out in the Income Tax Act. The minimum term for finance leases for property is proposed to increase from 8 to 30 years, and finance lease payments will be deductible up to a maximum of 99% of the total lease amount. These rules will apply only to contracts concluded after the reform takes effect.

Binding Rulings

A new binding ruling system will be introduced, whereby taxpayers will be able to request a ruling from the tax authorities on the tax treatment of various expenses:

- The deductibility of expenses that relate to taxable and nontaxable income;
- The deductibility of expenses that relate to property used partly for business activities and partly for private purposes;
- Whether expenses constitute technical improvements to an asset or repair or maintenance; and

- Whether expenses that are not clearly specified can be considered used in the tax period for R&D projects. (Expenses that can be treated as R&D expenses can be deducted from the tax base.)

Miscellaneous

Other proposed changes include the following:

- A debtor will be required to increase its profits tax base by the amount of outstanding payables that are overdue by more than 36 months or that are barred by statute. If the debt is paid in the following taxable period, it will be possible to reduce the tax assessment base. This rule will not apply to certain payables, such as those relating to securities, loss settlements, loans and credit, guarantees, prepayments, fines, etc.

Value Added Tax

The reduced VAT rate of 5% will be increased to 9%.

Court practice

Raisa Alexakhina, Rasul Fatkhutdinov, Yulia Lebedeva

Russia: Economical justification of expenses for profit tax purposes

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The Russian Tax Code provides some general criteria for the deductibility of costs. Such costs should be economically justified, confirmed by supporting documents and incurred in the course of income generating activity. The Code does not contain an exhaustive list of economically justified costs.

As a result, in practice, taxpayers are often forced to prove the necessity of specific costs for their businesses and hence, their economic justification. In such situations, relevant court precedents are very helpful for taxpayers¹.

The Russian Constitutional Court recently issued a Ruling № 320-O-P of 04 June 2007 which is analyzed below.

A group of State Duma deputies applied to the Constitutional Court to challenge subparagraphs 2, 3 paragraph 1 of article 252 of the Tax Code. The deputies claimed that these provisions contradict the Constitution as they lack clarity and contain broad and mutually duplicating terms which lead to their arbitrary application in practice.

¹ Resolution of the Federal Arbitrage Court of the Volgo-Vyatskiy Region of 11.12.2006 № A82-13085/2005-37; Resolution of the Federal Arbitrage Court of the Moscow Region of 03.07.2006 № KA-A41/5722-06; Resolution of the Federal Arbitrage Court of the Moscow Region of 18.02.2005 № KA-A40/453-05; Resolution of the Federal Arbitrage Court of the of North-West region of 09.03.2006 № A56-13538/2005; Resolution of the Federal Arbitrage Court of the of North-West region of 18.06.2004 № A56-20147.

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The Constitutional Court ruled that the above provisions of the Tax Code do not contradict the Constitution and drew some important conclusions clarifying



the criteria for economically justified costs.

Firstly, the Constitutional Court stated that the legislator has intentionally included only general criteria for the deductibility of costs into article 252 of the Tax Code. Should the list of such costs be exhaustive, taxpayers' rights would have been restricted, taking into account the variety of economic activities possible. The broad definitions allow taxpayers to determine independently which costs are deductible for profit tax purposes.

The Court stated that the main criteria for deducting costs is whether the specific costs are aimed at deriving income. The given criterion directly follows from one aspect of business activity which is its

orientation towards regularly deriving profit.

Secondly, the Constitutional Court held that the economic justification of costs should not be measured by the result achieved. The above conclusion is driven by the risk nature of any business activity that envisages entrepreneurial errors. Therefore, the courts should not determine the reasonableness and effectiveness of specific costs by linking them to a specific financial result.

The Constitutional Court referred to the Resolution of the Russian Supreme Arbitrage Court (SAC) №53². This Resolution states that the justification of tax benefits cannot depend on the

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efficiency of using capital and should be determined taking into account the taxpayer's intention to receive an economic benefit from a business activity, but not the result of such an activity.

Thirdly, the Constitutional Court held that the burden of proof for the lack of economic justification rests with tax authorities. This conclusion also appears in the Resolution of SAC № 53.

However, this position does not mean that taxpayers should take a passive stance in the court process. Normally, taxpayers are motivated into take an active position as they are better aware of the specifics of their businesses and of the specific costs justified for the business.

Court practice

Grigory Pavlotsky, Yevgen Shyrynos

Ukraine: The right to a tax credit (recovery of VAT): the view of the Ukrainian Supreme Court

Recently, court instances in Ukraine have taken a consistent position related to the rights of taxpayers connected with VAT tax credits (input VAT recovery).

In its ruling¹ the Ukrainian Higher Administrative Court stated that a purchaser's right for a tax credit does not depend on the payment of VAT by the seller to the budget (the issue was considered in "Tax News" for December 2006).

The Ukrainian Supreme Court in its Resolution² went even further and stated

that a taxpayer is entitled to a tax credit even where the registration documents of the counterparty were void, along with its VAT payer certificate.

In the case under consideration a purchaser provided tax invoices which had been prepared in full compliance with the legislation in force. However, courts of the first and second instances refused to grant the purchaser a right to include VAT amounts in its tax credit and substantiated their position by the fact that the registration documents of the sellers had been identified as void.

During the review of the case, the Ukrainian Supreme Court declared that the court's decision relating to the lack of confirmation of the purchaser's right for

the tax credit was an error, emphasizing that the incorporation of the two sellers' documents had been recognized as void after the performance of business

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transactions, which resulted in the issue of disputed tax invoices and non-payment of the tax to the budget by the sellers.

¹ Ruling of the Higher Arbitration Court of the Ukraine dated 04 April 2006

² Resolution of the Ukrainian Supreme Court dated 26 September 2006

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According to the Ukrainian Supreme Court the recognition of the incorporation of documents of the seller as void and the annulment of its VAT payer certificate does not mean that all agreements of such a person, concluded from the date of state registration and up to the date of its exclusion from the Unified State Register, are invalid. Therefore, all tax invoices issued in performing business transactions prior to the exclusion of the taxpayer from the Register are valid.

It should be noted that at the time of the business transactions and inclusion of VAT amounts in the tax credit by the purchaser, the information on the sellers was included in the Unified State Register and these sellers held certificates of registration as VAT payers.

In such cases the purchaser cannot be held responsible for non-payment of taxes and obligatory levies by the seller as well as the possible unreliability of data included in the Unified State Register.

During the consideration of the case, it was determined in accordance with the Law of the Ukraine "On the state registration of legal entities and individual entrepreneurs" that all data included in the Unified State Register should be held as reliable and could be used in disputes with third parties (including tax authorities) until an amendment of the register became effective. If the data included in the Unified State Register is unreliable this fact does not deprive the

counterparty of the right to refer to this data as being reliable in disputes.

It therefore follows from the aforesaid that the non-payment of tax by the seller (including tax evasion), when actually performing business operations does not itself impact the ability to receive the VAT tax credit and a refund from the budget.

Thus, the tax authorities shall not be entitled to accrue additional VAT liabilities and impose penalties on a purchaser in the case of non-payment of the tax by a seller, as the current legislation does not provide for such penalties.

Further, the Ukrainian Supreme Court has provided taxpayers with additional arguments to defend their legal interests in disputes with tax authorities, regardless of the counterparties' good faith and performance of liabilities to the budget, relating to the payment of taxes and levies.



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