

RECENT CLARIFICATIONS GIVEN BY CONSTITUTIONAL COURT OF THE RUSSIAN FEDERATION REGARDING REPEAT FIELD TAX AUDITS

April 1, 2009

To Our Clients and Friends:

On March 17, 2009 the Constitutional Court of the Russian Federation (the “Constitutional Court”) issued its Resolution No. 5-II. In the Resolution the Court examined the constitutionality of Paragraphs 4 and 5 of Article 89.10 of Tax Code of the Russian Federation (the “Tax Code”) concerning the right of tax authorities to conduct repeat tax audits as a measure of supervision over subordinate tax authorities.

SUBSTANCE OF THE CASE

The appeal to the Constitutional Court was triggered by a repeat field tax audit of Varm LLC (the “Company”). When initiating the audit, the tax authority exercised its right to supervise the subordinate tax inspectorate that had initially audited the Company (this right is established in Paragraphs 4 and 5 of Article 89.10 of the Tax Code).¹ At the time this repeat tax audit was initiated, the results of the initial tax audit and respective findings of the subordinate inspectorate (namely, a decision finding the Company liable for taxes) had been contested in part by the Company and further held unlawful by a court decision in effect (which was further upheld by higher courts). In the belief that a new tax audit would actually result in a revision of the judicial award based on the initial audit findings, the Company applied to the court with a request to hold the decision to conduct the new audit unlawful. That was rejected,

¹ Generally, as set out in Article 89.5 of the Tax Code, a field tax audit cannot be conducted more than once in a tax period (i.e. repetitively) with regard to the same taxes. As an exception from this rule, repeat tax audits can be performed either (a) by a tax authority superior to the initial auditing tax authority as a measure of supervision (Paragraphs 4 and 5 of Article 89.10 of the Tax Code), or (b) by the initial auditing tax authority itself when it receives the adjusted tax return with a decreased amount of tax (Paragraph 6 of Article 89.10 of the Tax Code). Furthermore, field tax audits in connection with the reorganization or liquidation of a taxpayer are performed irrespectively of any audits already performed (i.e., in these cases a repeat audit is possible) (Paragraph 11 of Article 89 of the Tax Code).

as the court determined that the existence of an effective court decision does not preclude a repeat audit.²

Based on the findings of a new audit relating to the same taxes and the same tax period, the Company was again found to owe taxes for underpayment of VAT and profits tax and charged with underpayment, a fine and late payment interest. As a result, the Company had to apply to the court again in order to have these new charges declared unlawful. Arbitration courts of three instances sustained the claim, though without addressing the issue of unlawfulness of the repeat audit itself. Because it believed that its rights were breached by the provisions of Article 89.10 of the Tax Code (construed as granting a right to carry out repeat tax audits upon availability of respective court decision), the Company applied to the Constitutional Court to determine whether these provisions comply with the Constitution of the Russian Federation.

POSITION OF THE CONSTITUTIONAL COURT

In its Resolution No. 5-II the Constitutional Court explained that it is impossible to conduct a supervisory repeat tax audit without performing full-scope analysis of tax and accounting reports of the taxpayer and the actual background of its activity. This means that, apart from realizing the proper purpose of such activity (which is a supervision of the subordinate tax body), in practice the tax authorities fully examine anew the activity of a taxpayer for the previously audited period.

As a result, the findings of initial tax audit can be re-assessed, and it is possible that the re-assessment results in further identification of tax underpayment or charging the taxpayer with more late payment interest. At the same time, the provisions of Article 89.10 of the Tax Code in question do not formally restrict the tax authorities' ability to make such a re-assessment, even when the dispute on the initial findings between the taxpayer and the tax authorities has already been resolved in court.

In the opinion of the Constitutional Court, in such a situation the ability of the tax authorities to adopt a decision that would alter the taxpayer's rights and obligations, as compared to those that were determined by court decision, is inconsistent with the principle of finality of court judgment and therefore violates the constitutional right to judicial defense. Thus, the

² *The Supreme Arbitration Court of the Russian Federation upheld this decision and ruled that the right for supervision of a tax audit is not affected by the fact that decision of a subordinate tax body is held unlawful in part (Ruling No. 7463/08, dated June 18, 2008).*

provisions of Paragraphs 4 and 5 of Article 89.10 of the Tax Code were ruled unconstitutional inasmuch as they actually allow revision of court decisions in force by a decision or ruling of a tax authority.

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We will be happy to answer any queries you may have on this or any other tax issues.

Evgeny V. Smirnov
+7 495 956 3858
evsmirnov@debevoise.com

Anna S. Dulova
+7 495 956 3858
asdulova@debevoise.com