Tax & Legal Alert

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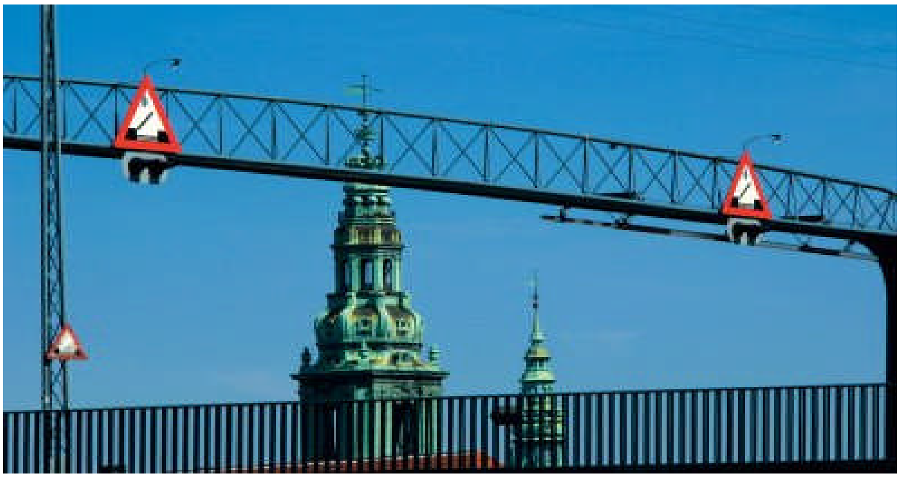
Can you explain the "why" for your transactions?

A recent letter suggests that the tax authorities may pay greater attention to commercial substance of transactions.

It may be dangerous to ignore the message.

For more information on the issue covered by this Alert, please contact your client relationship manager or one of the individuals identified below.



Scrutinising tax schemes

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On 2 April 2007, the State Tax Administration of Ukraine issued a letter entitled "How to challenge the tax minimization schemes used by loss making business entities" (hereinafter the Methodology). Although the title indicates that the Methodology should be specifically used in auditing loss-making entities, it seems likely that a similar approach will be used in auditing any business entity.

The Methodology distinguishes the following tax schemes:

1. Tax reduction and tax optimization schemes. This category is formally legal, but may have certain transactions that lack business substance. An attempt was made to differentiate the "abuse of rights" by such companies and to list the methods to identify "unacceptable activities." The Methodology encourages tax auditors to pay extra attention to transactions that generate a loss, especially if they are one-off or unusual in respect of the taxpayer's core business.

2. Tax evasion schemes. These usually involve understatement or under-declaration of taxable income, or using fictitious or bankrupt entities for expenses.

3. Fraud schemes. Such schemes are characterised by the conclusion of sham transactions and fabrication of documents, including those for illegal VAT refunds.

The Methodology lists examples of typical methods used in tax schemes, such as:

- Transfer pricing. The Methodology emphasises that according to the law transfer pricing rules apply not only to transactions with related entities, but also to transactions with all non-residents and with resident companies that pay tax at reduced or special rates. The Methodology also makes it obligatory for investigators to verify how the prices are justified and whether they correspond to "regular prices" as per Accounting Standard #23, *On disclosure of information on related parties*.

- Transactions with fictitious companies. The Methodology instructs tax inspectors to investigate the supply chain to identify if any fictitious entities exist. "Fictitious" entities are defined as those whose registration documents were cancelled by court decisions, or that report zero activity, or bankrupts, or companies that were liquidated prior

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to the date when the contracts in question were signed. When a company is confirmed as fictitious, tax inspectors are required to file a suit to invalidate the Charter (registration documents), VAT registration, and all the documents issued by the company in question.

- Purchase of services (e.g. marketing, merchandising, informational, consulting, legal services and rights to use the trademark, etc.). Tax auditors are advised to double-check not only the documents, but also to ensure that the services were actually provided.
- Loan transactions. The Methodology instructs tax inspectors to double-check the economic reasons for the loan, as well as verifying the deductibility of interest in cases when the loan was not repaid.
- Use of securities in settlements. The Methodology indicates that promissory notes are often used in tax schemes to avoid cash payments, and their use should be investigated in detail.

The Methodology emphasizes that the above operations should be considered as doubtful in every audit, and all the circumstances of such transactions and contracts should be properly documented.

The Methodology instructs tax inspectors to identify all entities that have legal and commercial relations with the audited company. Legal dependence between the shareholder, subsidiary and sister companies exists once the 10% control (direct or indirect) requirement is met. Economic dependence exists when the taxpayer has substantial (at least 10% of revenue) commercial interaction with counterparts.

The Methodology suggests that a group of companies, including the taxpayer and all entities that depend on the taxpayer either legally or economically should be audited simultaneously. The Methodology does not indicate any convincing ways to do such a sweeping group audit, so it remains to be seen if it will be feasible in practice.

The Methodology lists specific transactions that will be under special examination during the tax audit. Taxpayers are advised to contemplate the critical importance of preparing in advance and keeping all defence arguments and documents to support the business substance of all transactions.

(Letter No. 6448/7/23-5017, dated 2 April 2007)