



Taxpayers are entitled to recover losses caused by bad-faith counterparts

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Recently the Russian Supreme Court decided a case (Ruling 09.09.2021 N 302-ES21-5294), which can play an important role in future resolution of disputes between taxpayers and their counterparts that do not properly pay taxes ('bad-faith taxpayers').

The circumstances of the case were as follows. A company (the 'Company') deducted VAT charged by its contractor. However, a tax inspection refused this deduction and calculated arrears, penalties and a fine. The Company challenged unsuccessfully the decision of the tax authorities; namely, it was proved that the contractor did not have the necessary resources to perform the work contracted, the documents confirming the expenses contained various discrepancies, payments were performed to so-called 'fly-by-night' companies (i.e. impossible creditors). The interrogated persons could not explain the

circumstances related to the performance of work. On the basis of above, the courts considered that the Company failed to exercise the prescribed due diligence in the choice of the counterpart and, as a result, found in favor of the tax inspection.

The Company filed a lawsuit aimed at claiming the recovery of the losses incurred (i.e., tax, penalties and fine charged by tax authorities) as a result of the conduct of the counterpart.

The court of first instance, court of appeal and court of cassation refused the right of the Company to recover these losses. However, the Supreme Court rested on a different approach, quashed it cancelled the decision of the lower courts and remanded the case for re-hearing.

The Supreme Court pointed out that the counterpart violated the terms and conditions of the contract. In particular, it had to perform the work by itself or



through subcontractors, but only with consent of the client, i.e. the Company. Moreover, the counterparty represented false information about its resources and capability.

The Court considered that the established principle in tax disputes that the Company should identify the unreliability of information about a counterparty and prevent adverse tax consequences cannot be used as a basis for releasing the counterparty from liability for breach of contract.

The refusal to recover losses is possible when the courts establish that both parties were participants in the offense. However, in the case at stake the Company pursued a legitimate purpose, when it entered into the contract, namely, to have the work performed.

In the dispute with the tax authorities, it was found that the Company failed to exercise due diligence, and this resulted in refusal to deduct VAT charged by the counterparty. However, this does not mean that the Company was a participant to the violations of the counterparty. Such a circumstance could be a ground to reduce the amount of the contractor's liability, but not for refusing to recover losses. In addition, the Supreme Court drew attention to the fact that the statute of limitation in such cases should be calculated from the date when the tax authorities' decision on the results of tax audit enters into force.

The approach followed by the Supreme Court allows law-abiding taxpayers to shift the burden of losses (e.g. nondeductible input VAT) to their counterparties, if they are bad-faith taxpayers.



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