Yukos Part VI: Tax Claims Revisited

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I. Introduction

This comment is a further installment in series of comments I have distributed on Johnson's Russia List regarding legal aspects of the Yukos affair (JRL #s 7426, 8170, 8171, 8204, 8353 and 9020). Only one of the previous comments (JRL #8353, distributed last September) addressed the tax claims against Yukos, while the others have dealt with other aspects of the Yukos affair (the criminal indictments against Mikhail Khodorkovsky and Platon Lebedev, the arrest and sale of Yukos's assets and the bankruptcy proceeding initiated by Yukos in the United States).

Commenting on the legal aspects of the Yukos affair has been hindered by the fact that few of the relevant court decisions and key documents that contain details of the claims and the proceedings have been made public. Previous comments have been prompted by publication of one or another key document (criminal indictments, a court order, proceeding in US courts). However, virtually no official documents regarding the tax claims against Yukos have become public and press sources regarding these claims are clearly incomplete or incorrect on their face.

An exception to this general lack of official information has been the publication of the Resolution of the Tax Authorities, dated April 14, 2004, which has been available for some time on the Yukos website (www.yukos.com/taxes.asp). The Resolution sets forth the official tax claims against Yukos for the year 2000 and the main factual allegations and legal theories supporting the claims.

The premise of this series of comments has been that, regardless of the extent to which the Yukos affair is a "political" prosecution, the legal claims made against Yukos and its core shareholders cover much interesting law and may result in important precedents. The Resolution confirms that the Yukos tax cases promise to test (and apparently has already tested) a number of important legal issues in the Russian courts. While it is far from a fresh document and despite the fact that the claims set forth in the Resolution have reportedly been upheld in court and confirmed on first appeal, it remains the only source I have found that illuminates the details of the tax claims against Yukos (at least for the year 2000) and the legal theories behind them. Therefore, this comment takes another look at the tax side of the Yukos affair by analyzing the arguments put forth in the Resolution.

The short conclusion of the analysis below of the Resolution is that the tax claims brought against Yukos are based on schemes that would be considered blatant tax evasion in most countries. As is common in blatant fraud or tax cases, there may be a number of theories available to challenge the illegal behavior. The Russian Tax Authorities in fact set forth a number of parallel theories for questioning these tax schemes. The Tax Authorities clearly are using this case (along with a number of other relatively recent cases) to signal that they will use various legal tools that have not previously (or very rarely) been used, although they are explicitly and implicitly built into Russia's Civil Code, to prevent classical forms of "abuse of rights" and "bad faith" behavior. The intent appears to be to introduce a degree of "substance-over-form" thinking into the enforcement of Russian tax law and to reign in some of the more blatant forms of abuse that have been staples of "doing business" in Russia in the post-Soviet period. There is little doubt that such rules, which exist in just about every western jurisdiction in some form and are built into Russia's own law, will eventually be applied in practice in Russia. However, some of the arguments of the Tax Authorities in the Resolution may be overstating the scope of these rules (relative to their scope in other countries that apply them) or the ability of the courts to ground them in existing Russian law absent further legislation.

Although it appears that the Tax Authorities have strong grounds under one or more of the theories put forth in the Resolution to challenge the tax schemes allegedly used by Yukos, the actual amount of tax assessed for 2000 (some RUR 99 billion in back taxes, interest and penalties) appears to be overstated for a few reasons. As I discuss below, it appears that the penalties assessed for 2000 (RUR 19 billion) should be disallowed. Also, the case for assessing back value added tax against Yukos (RUR 14 billion plus RUR 11 billion in interest) may be based on a faulty understanding of the obligation of taxpayers to act "in good faith". Furthermore, Yukos may be able to offset certain taxes assessed against others, which could further reduce its ultimate bill. Therefore, even if the schemes are successfully challenged, the final tax bill for Yukos may be significantly less than the claims put forth in the Resolution.

I provide a more detailed bullet-point conclusion at the end of this comment.

II. Outline of the Resolution

The Resolution, which is over 120 pages long, begins by setting forth the general structure of the illegal schemes:

+ A Yukos production subsidiary sells crude oil at below-market prices to a shell company (i.e., a company with virtually no assets, employees or operations of its own) allegedly affiliated with Yukos and established in a region within Russia, which has granted the company tax concessions. The shell company resells the oil to domestic and foreign buyers at market prices.

+ Yukos (that is, the Yukos Oil Company, which is the ultimate parent of the group and the entity against which additional taxes have been assessed) controls entirely the operations and finances of the shell company via placement of directors, powers of attorney and also an agreement with the shell company under which Yukos organizes the purchase, sale, transport, processing and export of oil. The shell company in most cases has also delegated the authority to conduct its bookkeeping and other internal corporate matters to Yukos affiliates. Virtually all of the shell company's counterparties on its transactions are other Yukos affiliates. [1]

+ The commission that Yukos receives for these services is nominal (0.01–0.5%); whereas the shell companies earn the bulk of the profit resulting from the entire chain of production and sale of the oil.

+ Channeling revenue and profits through the shell company reduces the profits and revenue derived of the production company, which pumped the crude oil, and of the parent company Yukos, which arranged for payment, transport, processing and shipment of the oil. Since the shell company enjoys concessions on profits tax as well as a host of revenue taxes (such as road use tax, housing stock and social benefits tax and property tax), the overall group saves considerable taxes by using the scheme.

After setting forth the general description of the schemes, the Resolution analyzes the connections between 22 companies established in low-tax zones in Russia and Yukos in order to demonstrate that each company was under the control of Yukos and participated in the schemes. Five of these shell companies are discussed merely to demonstrate how they were controlled by Yukos and played intermediary roles in the scheme. For the remaining 17, the Resolution re-computes their tax bill for 2000 based upon the amount of tax that would have been due had they not benefited from "illegally obtained" tax concessions and asserts that this tax, along with interest and penalties should be paid by Yukos.

The Resolution claims that Yukos illegally reduced its own revenues for the year 2000 by some RUR 210 billion, which is almost equal to its reported revenue for the year of RUR 246 billion. The Resolution assesses RUR 48 billion in back taxes against Yukos for 2000 plus RUR 19 billion in fines and RUR 32 billion in interest resulting in the much-reported figure of RUR 99 billion.

III. Legal Theories: Choice of Five

A. Transfer Pricing (Theories 1 and 2)

As I have said in previous comments on JRL and in other articles, the facts described in the press and in the Resolution clearly constitute blatant transfer pricing schemes, which would be considered illegal tax evasion in most modern jurisdictions. Despite some early discussion in the press that such schemes were "legal at the time", a new consensus seems to have emerged that, in fact, such transfer pricing schemes were not legal in 2000. Moreover, they were regularly (albeit extremely unevenly) challenged, both before and after the new Tax Code was adopted in 1998. [2]

The allegations in the Resolution actually support two distinct transfer pricing claims:

<u>Theory 1</u>

The most straightforward theory for attacking such schemes would be for the Tax Authorities to challenge the pricing in the agreements between the Yukos production company and to adjust the price paid by the shell company upward to market rates. This would result in a re-computation of the taxes of the production subsidiary as if it had received market price for its products. Assuming that the allegations in the Resolution that such pricing was below-market and that the shell companies are affiliated with Yukos, [3] this is a very straightforward way to challenge the schemes which was well-established under the Tax Code and regulations in place in 2000 as supported by court practice. [4] However, under this theory, the tax claims would have to be brought against the various Yukos production subsidiaries that sold products at below-market prices, and not against Yukos. The Resolution does not delve into this theory much because, obviously, the Tax Authorities would rather not initiate multiple proceeding against Yukos subsidiaries (which run the risk of bankrupting those subsidiaries and causing major disruptions in oil production).

Theory 2

The alleged facts also support a transfer pricing claim against Yukos itself. Since Yukos not only allegedly controlled the shell companies, but in fact performed virtually all operations for them under commission agreements, it should be the party that earns the value added by these activities. If the value added by these activities actually produced the bulk of the value added in the entire production chain, then the nominal commission allegedly charged by Yukos for these services to the shell companies was clearly "below market price". That is, the bulk of this profit and revenue is re-attributable to Yukos from the shell companies.

Despite the clear strength of this Theory 2, the Tax Authorities do not focus on this theory. The reason for this may be that, under such a theory, only a portion of the funds that flowed through the shell company would be re-attributable to Yukos (that portion that represents their profit). This would leave significant revenue on the books of the shell companies (the portion that represents their costs). Since many of the tax concessions exploited were revenue taxes, attacking the schemes based on Theory 2 would not entirely eliminate the benefit that Yukos allegedly derived by operating the schemes since a portion of its revenue would still be shielded from various revenue taxes. I have not attempted to do the math in any detail, but venture to guess that under Theory 2 the tax claims for 2000 could be 10-15% lower than under the other theories described below.

B. Theory 3 (Two Steps): Disallowing Use of the Tax Concessions by the Shell Companies and Piercing the Corporate Veil

1. Disallowing the Tax Concessions

Despite language in the Resolution referring to transfer pricing, the thrust of the argument in the Resolution is that the shell companies were not entitled to make use of the tax concessions offered by the on-shore tax havens at all. The Tax Authorities argue, first and foremost, that this conclusion may be reached by applying the relevant laws directly to the actual circumstances regarding how the shell companies operated (let's call this "Theory 3a"). Theories 4 and 5 below also attack use of the tax concessions, but with more general "anti-abuse" arguments.

Some of the press on the Yukos affair has contained the assertion that the use of tax concessions meant to stimulate investment in specific regions of Russia by shell companies with no operations or investment in the relevant region was "legal at the time." However, it is relatively clear upon examination of the relevant laws that no such "legal loophole" existed. The relevant laws required that some level of substantive activity be conducted and/or investment be made in the relevant region in order for tax concession to be granted. These requirements were often vague, but it is difficult to argue that they permitted concessions to be granted to companies that had no real operations and made no substantive investment in the region. These laws were applied by local administrations who exercised tremendous discretion in remote regions with little direct oversight from outside regulators. It is probably more accurate to say that the big Russian companies that used these schemes had discovered an “enforcement loophole”, rather than a legal one.

Reviewing the claims that such “loopholes” really existed requires analysis of the laws governing tax concessions in each of the regions in which the 17 shell companies that are accused of illegally using tax concessions were incorporated--these regions included “closed autonomous territorial formations” within the Russian Federation (known by their Russian acronym, “ZATOs”), in which tax concessions are governed by federal law, and the autonomous regions of Mordovia, Kalmykia and Evenkia, in which the tax concessions are governed by local law.

In addition to relevant laws (which I have been able to obtain), the application of the tax concession depended on local regulations, decisions of the local administrations and the terms of tax agreements entered into between the local administrations and the companies claiming the tax concessions (which I have not been able to obtain). Although the Resolution in a few instances claims that these regulations and agreements were violated, I have assumed for purposes of the discussion below that there were no such violations since I have no means to analyze such claims.

(a) ZATO

Of the 17 shell companies alleged in the Resolution to have illegally used tax concessions, nine were located in ZATOs. These companies account for about half of the back taxes, interest and penalties claimed in the Resolution for 2000.

The rule regarding granting concessions to companies registered in ZATOs, as it existed in 1999, was quite clear: 90% of the assets of the local company must be located in the region and 70% of its activity must be carried out in the region (including having local residents comprise at least 70% of its work force, measured both in terms of salary paid and headcount). Put simply, tax concessions were granted to companies that had most of their assets and employees in the region. If the company had ancillary operations outside the region, this was permitted, but under the Tax Code, the company would have to register in each region in which it had such additional operations and pay tax there at local rates on income associated with such operations (that is, under general tax law, the concession clearly do not apply to operations outside the region, even if the company is registered in the region).

The supposed “loophole” that was exploited by companies registering affiliates in the ZATOs was the idea that one could establish a company which subcontracted all of its activity to other parties (so that it had no operations of it own outside the ZATO) and then apply the 90%/70% test to the assets and workforce that actually did exist in the region (even if these consisted of a nominal legal address and one or two employees). Following this logic, it would be easy for a shell company to pass the test: 90%/70% of zero is zero.

However, the Tax Authorities’ clarification Letter of June 24, 1999 confirms that an entirely “formalistic” reading of the 90%/70% test was not permissible. In addition to clarifying aspects of how the 90%/70% test is to be applied, the Letter also establishes additional guidelines for determining real presence in the region, including: “the management organ of the company, actually conducting management activity, is located on the territory of the ZATO." (I provide a translation of the relevant portion of the Letter in the notes below [5].) The Resolution asserts that this criteria (among others) was not met both formally, since the management function for these companies was carried out by individuals located outside the region, and de facto, since Yukos itself effectively managed the day-to-day operations of these companies. The arguments put forth in the Resolution on this point have clear precedent in court cases related to ZATOs. [6] Therefore, with respect to ZATOs, there appears to be little doubt that there was no "loophole" that allowed true shell companies to take advantage of the tax concessions and that the arguments set forth in the Resolution on this point are not new.

In addition to violations of the 90%/70% rule discussed above, the Resolution asserts that some of the shell companies registered in ZATOs violated the investment agreements that they were required to enter into with the local administration. Under these agreements, in order to get the concessions, the shell companies allegedly had to contribute a certain percentage of the tax breaks the received into a fund that financed social projects in the region--effectively, a small alternative tax. For example, one such agreement allegedly required the shell company to contribute 5% of the tax savings. In a number of instances, the Resolution alleges that the required amounts were not contributed. While it is not possible to assess such allegations without the relevant documents, if such agreements were in fact violated, it would constitute a separate ground for disallowing the tax concessions.

(b) Mordovia

Five of the shell companies participating in the alleged schemes were registered in the Republic of Mordovia.

Under the relevant local law as it existed in 2000, tax concessions could be granted to companies that "conduct activities" in specified fields including "carrying out export operations" and "carryout out wholesale trade in fuel and lubricants and other hydrocarbon raw materials". The shell companies allegedly registered by Yukos in Mordovia apparently claimed tax concessions on the basis that they conducted such activities. Obviously, the "loophole" that those using such schemes attempted to exploit is the idea that one may "carry out" these activities by subcontracting them entirely to third parties outside the region (in this case, Yukos and its other affiliates). However, this is not a very convincing reading of the law. After all, the purpose of the law (explicitly stated in its first article) is to attract investment to, and to create jobs in, the region, which would not be served if the law considered "oil traders" who had no operations and made no investment in the region to be granted tax concessions. The list of activities in the law qualifying for concessions also includes activities such as "manufacturing industrial products". Yet for such an activity it is clearly absurd for a Mordovian company that "conducts" all its manufacturing through agents and subcontractors outside Mordovia to claim that it is a "manufacturer" that is entitled to tax concessions under the law. There is no reason the interpretation should be different for trading activity.

While no legal loophole really existed here, it is clear that there was great potential for an "enforcement" loophole since it would be difficult to determine whether an oil trader (as opposed to a manufacturer) were actually conducting activities in the region simply by examining its financial statements. Or put in a different way, an official who looked the other way with respect to such an "oil trader" would have a more plausible explanation for the oversight.

(c) Kalmykia

One of the shell companies participating in the alleged schemes was registered in the Republic of Kalmykia.

According to the relevant local law as it existed during 2000, tax concessions may be granted to a Kalmyk company that is registered as an "enterprise carrying out investment in the Republic of Kalmykia" with the Ministry of Investment Policy of the republic and whose investments in Kalmykia satisfy the criteria established by the Ministry "accordance with the law". The Ministry is also responsible for confirming satisfaction of its own requirements by investors. The Resolution indicates that the Kalmyk shell company that allegedly participated in the scheme did register as an "enterprise carrying out investment" in Kalmykia. It is not clear whether any investment agreement was ever concluded or whether the Ministry ever confirmed fulfillment of any such agreement by the company. The actual amounts of investment made by the company in Kalmykia are not discussed directly, but the Resolution notes that the company had virtually no assets in the region and therefore its investments were de minimus.

The "loophole" being exploited here is the fact that the law, which happens to be called "On Tax Concessions for Companies Making Investments in the Republic of Kalmykia", delegates entirely the question of determining and approving the amount and form of qualifying investments to the Ministry of Investment Policy. This law therefore would seem to contain the perfect legal loophole and enforcement loophole rolled into one; despite lots of comforting language in the law about investment, the law contains no specific investment criteria whatsoever. Therefore, the argument goes, the Minister had absolute discretion. And as it turned out, he was a very reasonable, "pro-business" kind of guy.

Obviously, the law is terribly drafted and possibly intentionally so. Determining what bounds the law puts on the Minister's discretion is very difficult. However, the language in the law stating that its purpose is to attract investment and that the Minister must establish investment criteria in accordance with the law cannot be ignored. At a minimum, this language clearly rules out granting concessions to a company that made virtually no investment in the region whatsoever. Not only is this clear from the law, but it is supported by a series of court cases from 2002 and 2003 interpreting the Kalmyk law as it existed in 2000. [7] The Resolution alleges that the shell company neither had any assets in the region nor contributed to any regional investment program. Therefore, under the most minimal reading of the law, the shell companies did not qualify for the tax concessions.

In describing the above argument to some Russian lawyers I have been countered with the argument that the fact that a company was registered as an "investor" should be dispositive--the law grants tax concession based on registration as an investor; if the company did something wrong (lied, bribed) to get registered, then that must be shown and the registration challenged. In other words, the Tax Authorities are attempting an impermissible short-cut in their argument. I believe it is fair to say that, to most western lawyers, it is instinctively clear that the following situations both constitute the same violation of the tax law: (i) to claim the tax concessions offered under the Kalmyk law without being registered as an "investor" under the law; and (ii) to claim the tax concessions based upon being registered as an "investor" while knowing that, accordingly to the law, one should not have been registered. The equivalence of situation (ii) to (i) is based on the concept that one cannot use the rights granted by registration as an "investor" in good faith if one knows that such registration should not have been granted. As it is often said, the Russian legal culture prefers form over substance. However, this is really an issue of culture, not code. The Civil Code specifically prohibits parties seeking to assert their rights under the Code from abusing such rights ("zloupotreblenie prav"). Furthermore, the Constitutional Court has confirmed that the requirement to act in good faith also operates in the area of tax law. The court cases reviewing the Kalmyk law have also noted this point: companies that should not have been granted the tax concessions in the first place cannot claim them in good faith. Therefore, situations (i) and (ii) are equivalent in Russia as well. In my view, the courts and the Resolutions properly cite the basis for the equivalence of these situations to be the duty to act in good faith.

The cases cited by the Tax Authorities regarding the Kalmyk law, however, appear to use the concept of "good faith" to articulate a broader rule. These cases assert that companies registered as "investors" cannot claim the tax concessions in good faith if their investment is not "proportional" to the tax concessions claimed. The use of the word "proportional" by the courts is not very clear. It could mean nothing more than what is discussed above--that, if the investment is de minimus, the company has clearly not qualified for the tax concessions. However, if this "proportionality" test is meant to require something more specific, it is difficult to see where the reasoning comes from. [8] It is possible that this "proportionality" rule could be overturned or limited by other courts.

In any event, the Kalmyk law clearly does not permit companies making de minimus investments to claim the tax concession. Therefore, under the facts alleged in the Resolution, the Kalmyk company should not be entitled to the tax concessions even if the "proportionality" rule is not upheld.

(d) Evenkia

Two of the shell companies participating in the alleged schemes were registered in the Evenkia Autonomous Region. These companies represent no more than about 1% of the back taxes and penalties claimed for 2000.

The law governing tax concessions in Evenkia provides that tax concessions were granted to companies registered as "enterprises investing in Evenkia" based on their participation in the investment program of the region. The Evenkia law required the local administration to establish a list of specific investment projects that companies seeking tax concessions were required to fund directly. In other words, the "investments" required by the law were not investment in the company's own operations in the region, but rather contributions to government-sponsored projects in the region. Effectively, this law established an alternative tax regime in which both the amount of the tax and confirmation of its payment are controlled by one local ministry--the whole program is clearly a formula for corruption. However, it is difficult to determine what legal bounds the law established on the amount of the "investment" required to qualify for concessions--the only formal requirements in the law are that the absolute minimum investment is $600 per quarter.

In Evenkia, it is arguable that the goal of the investment law (improvement of economic conditions in the region) would have been served by granting tax concession to shell companies, so long as they contributed funds to the specified social programs (i.e., by getting companies to register in the region and pay this "alternative tax", the region may have been better off than without such a program). Despite the lack of guidelines, the same argument made above with respect to the Kalmyk law can be made here--de minimus contributions cannot be considered sufficient. The Resolution, however, does not discuss the amount of the contributions that were required of the shell companies allegedly affiliated with Yukos and also does not indicate whether the required contributions were made. Therefore, it is not possible to conclude based on the allegations in the Resolution that these Evenkia companies were not entitled to the local tax concessions.

2. Piercing the Corporate Veil

The argument above (Theory 3a) allows the Tax Authorities to assess billions of dollars in back taxes against shell companies that clearly have no means to pay. In order to recovered these claims from Yukos, the Tax Authorities must take a second step--they must somehow claim that the alleged control exercised by Yukos over the shell companies and their other interrelations allows them to hold Yukos liable for the tax obligations assessed to the shell companies; in short, they must "pierce the corporate veil" ("Theory 3b").

Much can and has been written about how easy or hard it is to pierce the corporate veil of various forms of Russian legal entities. On the practical side, the issue can be summarized quite succinctly: the risk of corporate veil piercing in Russia to date has been virtually zero despite the frequency of abuses that would call for the application of this concept. [9] On the theoretical side, Russian law actually contains provisions which would seem to make it easier to pierce the corporate veil in certain circumstances than, for example, US law. Under US law, piercing the corporate veil generally is possible when (i) the legal entity is entirely dominated by a shareholder or other person in the sense that the company's own internal structure does not play any real independent function; (ii) the controlling person has caused the company to engage in some sort of fraud or wrong; and (iii) the party seeking to pierce the corporate veil has been harmed by such wrong without fault of its own. It is hard to find a country in which an equivalent of veil piercing is not possible if all three of such factors are present--and veil piercing in most civil-law countries requires proving only a subset of these factors. The Tax Authorities' allegations in the Resolution indicate the presence of all three factors with respect to the relation between Yukos and the shell companies. Therefore, the allegations if proved would, in my view, provide grounds for veil piercing in most countries.

Despite the great controversy over veil piercing in Russian law, it is clear that the corporate veil may be pierced (at last theoretically) if the three factors listed above can be demonstrated. [10] Statements in the press by Yukos and others that the Tax

Authorities' attempts in these claims to pierce the corporate veil are unprecedented in Russia appear to be true (at least I have found no court decisions applying the relevant sections of law to pierce the corporate veil). However, both the law and the commentary is clear that on the facts alleged, Russian law allows the Tax Authorities to do what they are trying to do—recover from Yukos back taxes it allegedly caused these shell companies to incur.

C. Theory 4: Finding Yukos to be the "Owner" of the Assets of the Shell Companies

The Tax Authorities also put forth a parallel theory which allows them to achieve in one step what Theory 3 achieves in two steps. According to this "Theory 4", since Yukos exercised such complete and direct control over the assets of the shell companies and used such control for its own benefit, these assets, and the revenue and profits derived from them, in reality belonged to Yukos. Therefore, Yukos should be taxed on this basis. In other words, Yukos basically "parked" its assets with the shell companies to take advantage of the tax concession they enjoyed.

In order to challenge such "parking" under Russian law, the Tax Authorities put forth the following argument: Article 39 of the Tax Code provides that taxes are levied on the owners of assets or on the parties receiving income from transactions with those assets. To identify the "owner" of the assets or the benefits deriving from them, the Tax Code relies on the definition of "ownership" provided by the Civil Code (Article 209), which states that the "owner" of property has the rights to use, to possess and to dispose of property. Since Yukos in fact exercised such rights over the relevant assets and the profits derived from them, the Tax Authorities argue that Yukos cannot avoid paying tax on such profits by denying ownership since Article 209 identifies Yukos as the owner.

This argument makes much intuitive sense, but it does not, however, enjoy entirely complete logic: exercising the rights enjoyed by owners does logically lead to the conclusion that you are an owner under Article 209 ("all leopards have spots" does not mean that, if you have spots, you're a leopard). Nevertheless, legal interpretation need not rely on strict logical syllogisms and the other anti-abuse rules in the Civil Code bolster this interpretation. It may be argued that the prohibition of the abuse of rights (basically, a requirement to act in good faith) under the Civil Code militates for a more substance-over-form interpretation of "owner". Moreover, the nullity of sham transactions under Article 170 of the Civil Code also brings us to exactly the same result: if someone became the "owner" of some asset through a series of sham transactions, then these transactions are all null and void; the "real" transaction they were intended to hide is clearly the one giving ownership rights to the person actually exercising them.

Regardless of whether the Tax Authorities base this theory on Article 209 or Article 170, it is true that such "substance over form" arguments are rarely made in Russian courts and there does not appear to be any court practice on this topic. However, a legal system that condones "parking" of assets cannot support a viable tax system and so one expects that some effective rules in this area will certainly develop in time.

I note that a claim that assets have been "parked" (whether brought under Article 209 or Article 170) should, in my mind, include factual allegations that the profit from such assets were enjoyed by the "real" owner and not the "fake" owner. While the Resolution details how Yukos effectively controlled the movement and disposition of such assets, no specific facts are alleged regarding how the profit derived from them flowed to Yukos. By Yukos's own reckoning of its results for 2000, it is pretty clear that the money from these shell companies did flow back to it, but the Resolution fails to provide details in this area.

D. Theory 5: Good Faith--Full Strength

The Tax Authorities put forth one more "anti-abuse" theory to challenge the tax schemes allegedly used by Yukos. Under this theory, the entire structure of agreements and legal entities, the flows of funds and the transfers of assets may all simply be disregarded and all of the tax saved by this structure may be assessed to Yukos on the grounds that the entire scheme was allegedly created simply to avoid tax. This is an argument based on the requirement of good faith--if the law was designed to promote investment in these regions, tax breaks could not be claimed in good faith by companies that do not serve the purpose of the law in any way and were simply created to avoid taxes. This "Theory 5", like Theory 4, achieves in one step what Theory 3 does in two steps, but by using an even more sweeping anti-abuse argument.

Such an argument represents the "full strength" application of the concept of "good faith" in the tax sphere. Although the requirement to act in good faith has been applied to create such ultimate substance-over-form rules in the US, the UK, Germany and some other countries, such an approach is clearly without precedent in Russia. The attempt to apply this rule in Russia in the Yukos case has caused an outcry. Such a straightforward "substance over form" perspective cuts directly against the legal culture. While it is possible that Russia will move toward the implementation of such substance-over-form rules, it is hard to imagine how this rule can be adopted suddenly without laying substantial groundwork in the introduction of substance-over-form thinking in the legal environment. In the US, the concept that the requirement of "good faith" could be used to challenge, with one stroke, complex structures without the need to void each individual transaction within the structure separately was developed gradually over decades. Given the clear lack of experience in Russia with applying the concept of "good faith" and substance-over-form arguments generally, allowing the authorities all at once to apply extremely general substance-over-form arguments threatens to make the regulatory environment even more unpredictable. The problem is not the rule itself--which works for many countries--but rather the fact that the Tax Authorities in Russia are hardly prepared to apply such a rule at this time.

E. The Question of Value Added Tax

The theories discussed above are put forth by the Tax Authorities to challenge schemes that take advantage of tax concessions granted to companies operating in on-shore tax havens. It is not clear, however, that these theories explain the Tax Authorities' claims in the Resolution against Yukos for alleged underpayment of value added tax (except for a small portion of about 2-3% of the RUR 14 billion of the back-VAT claimed, which relates to alleged misuse of VAT exemptions granted by on-shore tax havens). The bulk of the claims for VAT are based upon disallowing the shell companies to take advantage of a basic feature of the VAT regime under the Tax Code--the rule that exported goods and services are subject to zero-rate VAT (as opposed to the standard 20% rate in effect at the time). This VAT concession is applicable to all companies conducting export operations from Russia, regardless of their location within Russia (and therefore has nothing in particular to do with on-shore tax havens). The effect of zero-rate VAT on export operations is that the company need not collect any VAT from its customers on export-related sales and is entitled to a refund of all VAT it has paid to its vendors for good and services directly used in its export activity.

The Resolution provides no separate explanation as to why the zero-rate VAT rate should not apply to the export operations of the shell companies or why the tax assessed to them should be paid by Yukos. Based on the general assertion made by the Tax Authorities, it is possible to infer two legal theories for the VAT assessments against Yukos:

> VAT Theory 1: the shell companies bought and sold oil on paper, but cannot claim to be "exporters" because they did not conduct any export (or other) activity themselves. Since they are not "exporters" they cannot in good faith claim the zero-rate VAT and they must therefore pay back-VAT with interest and penalties. By piercing the corporate veils of these companies (see Theory 3b above), Yukos may be held liable for this obligation of the shell companies.
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> VAT Theory 2: since the assets of the shell companies were really assets of Yukos (see Theory 4 above), Yukos was the "real" exporter. However, since Yukos itself never applied for zero-rate VAT within the statutorily required period (which has long passed), it is not entitled to the zero-rate and must pay up (with interest and penalties).

Under this logic, Yukos really shot itself in the foot by allegedly channeling revenues through these shell companies. As far as VAT goes, it would have been entitled to zero-rate VAT on its exported oil if it had openly conducted this activity itself. However, by allegedly using "fake" companies, Yukos has allowed the Tax Authorities to deny it this benefit. This is certainly a very draconian result, but this conclusion appears to have been upheld in a recent case related to a Yukos affiliate. [11] The reasoning in this case and in the Resolution is that a shell company that has no real operations cannot claim to be an "exporter" in good faith and therefore cannot avail itself of zero-rate VAT.

In my view, the Resolution and this recent case misapply the requirement of "good faith". [12] Under VAT Theories 1 and 2, it was bad faith for the shell company to claim zero-rate VAT because it was not a "real" exporter. However, it is not clear in what sense the structures allegedly used by Yukos represent bad faith with respect to the payment of VAT—the goal of these structures was supposedly to avoid other taxes, not VAT. The lack of good faith in one's behavior is determined with reference to each particular situation separately. One does not become a bad-faith taxpayer for the purpose of claiming all tax concessions because one has attempted to claim one specific tax concession in bad faith ("bad faith" is not the "mark of Cain" that stays with you forever, even if you are Yukos). Just because these shell companies were allegedly abused by Yukos to get local tax concessions does not mean that these shell companies or Yukos were acting in bad faith when they sought to apply zero-rate VAT to the oil that was exported by them. Even if this oil was "really" exported by Yukos, the interposition of the shell company should not be questioned because it does not appear to represent an abuse of the VAT regime.

IV. Yukos's Objections

Before the Resolution was issued, Yukos had the opportunity to raise certain initial objections to the claims. The Resolution summarizes, and responds to, some of these objections. I discuss these objections below (I note that the numbering of the objections below is my own). Since some of the objections have apparently been accepted and addressed in the final Resolution, I do not discuss those objections.

Objection 1: Yukos claims that Russian law does not allow the "interdependence" of entities to be the basis of finding one entity liable for the obligations of another—in other words, Yukos asserts that Theory 3b ("piercing the corporate veil"), Theory 4 ("no parting of assets") and Theory 5 (declaring structures that are used in bad faith to be null and void) are not recognized under Russian law. As noted above, it appears correct to say that these arguments are unprecedented. However, this does not rule out the fact that such arguments may be accepted. I note that this objection is not relevant, in any event, to Theories 1, 2 or 3a.

Objection 2: Yukos asserts that the Tax Authorities' attempts to question these schemes involve new interpretations of the law which, if they are upheld, would constitute changes to the law. Therefore, Yukos argues, these interpretations cannot be applied retroactively since the Constitution prohibits changes to the tax law from worsening the position of the taxpayer. It is probably true that in Russia (as in other countries), a change in the authorities' application of the law may amount to a change in the law (effectively, a new regulation) that is constitutionally prohibited from having retroactive effect. Such situations are particularly common in tax law. However, the "new" interpretations (or applications) introduced by Theories 3b (piercing the corporate veil) and 4 (no "parking" of assets) are not tax-specific rules being laid down by the Tax Authorities, but rather the application of general concepts which are fundamental to the structure of the civil law. I do not think that the use of such fundamental concepts can be viewed as new tax rules that cannot be applied without advance notice. Yukos may have a better argument that the sudden introduction of Theory 5 (the complete switch to "substance-over-form" reasoning in tax law) would violate the Constitution if applied retroactively. It is beyond the scope of this comment to explore this question. As noted above, there are certainly other reasons why the sudden introduction of ultimate "substance-over-form" reasoning in Russia would be inappropriate.

Objection 3: The Tax Code requires taxpayers to fulfill their obligations personally (that is, one person cannot transfer funds to the authorities to pay taxes on behalf of another). Therefore, Yukos argues, the Tax Authorities cannot demand payment from Yukos for the taxes of the shell companies. Under Theory 2 (transfer pricing), Theory 4 ("parking") and Theory 5 ("good faith"), the tax bill is actually Yukos's, so this objection is not relevant to those theories. Under Theory 3, Yukos is forced to pay the tax of the shell companies because, as a result of piercing the corporate veil, Yukos is considered jointly liable for the bill. The provision of the Tax Code to which Yukos refers (Artcile 45) is meant to stop various tax scams that were facilitated under the old tax code which failed to prohibit directly various shady offset schemes. This provision is clearly not meant to prevent the Tax Authorities from making claims against parties that the law otherwise deems owe money to the Tax Authorities. I think it is simply wishful thinking to read this provision to mean that the Tax Authorities cannot claim money from persons who otherwise owe them money.

Objection 4: Yukos objects to the fact that some of the revenue taxes assessed against it would offset some of the additional profits that are being assessed against it. Therefore, the assessment of the profit tax should actually be lower than the Tax Authorities assert. The Tax Authorities respond (citing cases) that for companies conducting their accounting for tax purposes on a cash basis (as Yukos did), in order to deduct revenue taxes from profit taxes, the company must actually pay the revenue tax and then claim the deduction from the profit tax (or a refund if the profit tax has already been paid). The Tax Authorities' position appears to be backed up by cases cited. In any event, if Yukos is right on this point, it does not appear that it would result in a very significant reduction in the ultimate bill (the Tax Authorities basically admit that a partial refund of the profit tax would be due as soon as the revenue tax is paid, but the Tax Authorities reject Yukos's argument because they insist on collecting penalties and interest (from December 31, 2000) on the full amount of unpaid profit tax, even though a portion of it will eventually be refunded).

Objection 5: Yukos claims that numerous procedural violations took place in the course of the inspections leading to the tax assessment. Only two specific violations are identified in the objections.

Firstly, Yukos claims that information subject to attorney-client and auditor-client privilege was improperly seized by the Tax Authorities. While it is not possible to determine whether procedural violations took place, there does not appear to be any information in the Resolution that looks like it would be subject to any privilege. The Resolution contains basic accounting and financial information which would not be privileged even if it were kept in the physical possession of an attorney or an accountant. While Yukos has made much noise in the press about violations of attorney-client-privilege during the Yukos affair, the simple fact that an attorney has been searched or detained does not indicate a breach of privilege. Both Enron's and Tyco's general counsels were subpoenaed, arrested and charged with crimes in connection with those corporate scandals. Arthur Andersen was found criminally liable as a company in connection with the Enron collapse. Searching and seizing basic financial data from in-house attorneys and accountants is not necessarily a violation of any privilege in Russia. Therefore, even if procedures for doing so were not followed, it appears that the authorities would have had the ability to obtain the information used in the Resolution by legal means.

Secondly, Yukos objects to the pooling of information regarding different legal entities allegedly used in the scheme. It claims such pooling constitutes an illegal disclosure of information deemed confidential under the Tax Code reasoning that, because Yukos has been charged with tax violations and not the shell companies, using the tax information provided by the shell companies is not permitted. This may very well be a violation of audit procedures under the circumstances (I have not delved into this matter deeply, although some recent cases in this area appear to support the Tax Authorities on this point). However, it appears that, even if such violations occurred, they could have been easily avoided (for example, by making formal claims against the shell companies as well).

Objection 6: Yukos objects that it is being held liable for a tax offense related to the year 2000 after the statute of limitations for such offenses has tolled. It should be clarified that "liability for a tax offense" refers only to penalties imposed for violation and not to payment of the tax itself or statutory interest. Therefore, this objection only applies to RUR 19.2 billion out of the RUR 99 billion assessment for 2000. In this respect, Yukos's objection appears to be correct. The statute of limitation for such liability related to 2000 expired on December 31, 2003. Despite the fact that an initial demand was made for these taxes, interest and penalty before the end of 2003, the Tax Authorities did not file suit in 2003--they waited until April 15, 2004. Therefore, the statute of limitation tolled and the bill for 2000 should be reduced by RUR 19.2 billion.

According to press reports, the Moscow arbitration court that heard the tax claims for 2000 disallowed Yukos's argument that the statute of limitations on the tax fines had tolled on the grounds that Yukos was not acting in "good faith" and therefore could not claim the benefit of the statute of limitations. This sounds like a very confused argument indeed. In any event, the Constitutional Court by a decision, dated January 18, 2005, has confirmed that the doctrine of "good faith" does not provide a basis for ignoring the effect of a statute of limitations. [13] Therefore, we should expect that any penalties assessed related to the claims for 2000 will eventually be excluded and the collected funds returned.

V. Conclusion

+ The schemes allegedly run by Yukos would be consider blatant forms of tax evasion in most counties.

+ The Tax Authorities in the Resolution refer to as many as five distinct theories under which such schemes could be challenged under Russian law.

+ Two of these theories (Theories 1 and 2) are based on transfer pricing and are clearly supported by Russian law (current and as it existed in 2000). The Tax Authorities, however, have not brought the tax claims based on these theories. This is most likely because the back tax computed under such theories is lower than it is if computed under the other theories put forth in the Resolution. Theory 1 is also not attractive because it provides for making multiple claims against Yukos's production subsidiaries and not against Yukos itself, which would be very disruptive and time consuming.

+ The Tax Authorities argue that the shell companies were simply not entitled to tax concessions under the relevant local legislation despite somehow having managed to have been granted these concessions by the local authorities (Theory 3a). With respect 15 of the 17 shell companies involved (all except the companies registered in Evenkia) and over 98% of the tax claimed, the Tax Authorities appear to have valid arguments based on the facts alleged and a straightforward reading of the relevant local investment laws.

+ Since the shell companies clearly do not have assets to pay the back taxes assessed to them under Theory 3a, the authorities seek to collect payment from Yukos. Russian law provides "veil piercing" mechanisms (Theory 3b) which allow the Tax Authorities to seek recovery from Yukos under the facts alleged (as the law in most other countries would as well). Although the law and expert commentary are clear on this point, Yukos is correct when it points out that use of these provisions appears to be without precedent in Russian court practice.

+ The Tax Authorities introduce an additional theory for assessing back taxes to Yukos directly: they seek to attack the alleged schemes on the basis that Yukos effectively "parked" its assets with shell companies as a way to hide revenue and profits (Theory 4). If these assets are viewed as belonging to Yukos, then none of the tax concessions claimed would apply and Yukos would be liable for the full tax bill. There seems to be grounds for preventing "parking" of assets under the Civil Code, although this theory appears to be without precedent in Russia.

+ The Tax Authorities attempt to establish with this case yet one more broad and controversial theory: the idea that the Tax Authorities may challenge any legal structure (even if it include separate legal entities and numerous contracts) if such structure was established for no purpose other than the avoidance of tax (Theory 5). Tax authorities apply such a rule in the US, UK, Germany and other countries. Russia may well be headed in this direction as well, but such a rule cuts strongly against the current "form-over-substance" prejudice in the legal culture. If this rule is adopted suddenly at this time, it is difficult to imagine the authorities applying it with any clarity or consistency.

+ The theory under which the Resolution asserts claims against Yukos for unpaid VAT does not fall directly under any of the other theories described above. The Tax Authorities appear to claim unpaid VAT on the rather technical grounds that the shell companies were not entitled to zero-rate VAT on their export operations because these operations were really performed by Yukos and not by them. The legal argument used to support this claim is based, in my view, on a misapplication of the requirement of good faith. These claims (which consist of RUR 31 billion in back VAT, interest and penalties) eventually should be rejected.

+ The Tax Authorities should not be entitled to claim penalties against Yukos for 2000 since the statute of limitations for such penalties tolled before the authorities filed suit against Yukos. Therefore, it is clear that at least RUR 19.2 billion of the RUR 99 billion claimed for 2000 should be disallowed by the courts. The Constitutional Court has confirmed this.

Notes:

[1] In my previous comment on the tax claims, I questioned how the Tax Authorities managed to bring tax claims against Yukos as opposed to against the production subsidiaries or the shell companies. However, the Resolution makes clear that Yukos is alleged to have entirely dominated the shell companies and their operations, which would provide the missing basis for bringing the claims against Yukos, as discussed further in the text.

[2] The relevant provision is Article 40 of the Tax Code which sets forth the basic statement of the Tax Authorities' power to challenge transfer pricing schemes (it has been in its current form since 1999). I note that the Civil Code provides independent grounds to challenge transfer pricing (for example, through the provision which provides that "sham transactions" are null and void).

[3] According to press accounts, Yukos's main factual objections to the tax claims have been focused on these two allegations: that the shell companies were affiliated with it and that the price of oil sold to the shell companies was below market.

The allegations in the Resolution regarding affiliation are quite specific and, unless false, would seem to be sufficient to establish affiliation if not complete domination of the shell companies by Yukos. There have been reports that various participants in these schemes have denied in court taking instructions from Yukos, but of course such testimony must be weighed in light of the documentary evidence and the court's view on the reliability of the witness.

Regarding oil price, Yukos has apparently been arguing that the price at which oil was sold to the shell companies was "market price" in the relevant regions. Yukos reportedly has argued that, for some reason, the price of oil in these various low-tax regions was lower than well-established general domestic oil prices. While transfer pricing regulations do indicate that local prices should be considered when establishing market price, the Resolution makes clear that the activity of the shell companies had little to do with the "local market" since their business was conducted from Moscow and related to the purchase and sale of oil virtually everywhere in Russia except in the low-tax regions themselves. Moreover, even if "local prices" in these regions are considered relevant, the regulations on transfer pricing specifically state that non-market transactions (transactions between affiliates, for example) cannot be used as evidence of "market price". In most countries, the issue of establishing market price under a transfer pricing claim would be addressed in court through expert testimony. It is not clear if or how the Tax Authorities have approached this issue in the proceedings.

[4] The Consultant Plus database (one of the main private legal databases for Russian legislation and court practice) contains numerous cases decided under Article 40 of the Tax Code which provide examples of transfer pricing claims in practice.

[5] "In defining the volume of activity carried out on the territory of the relevant ZATO, it is necessary to consider the following:

> ….
>
> The functions of the organization must actually be carried out on the territory of the relevant ZATO.
>
> In defining this criteria, the location on the territory of the ZATO of workspace appropriate for carrying out its own activity…. Also, it is necessary:
>
> a) actual presence of equipment and means… for carrying out its activity;
> b) the actual location of the organization in the ZATO according to its charter documents and also its postal address (including the dispatch and receipt of correspondence at such address);
> c) actual conduct by not less than 70% of the average workforce of their work duties at the location of the company and its departments on the territory of the ZATO.
>
> ….
>
> The management organ of the company, actually conducting management activity, is located on the territory of the ZATO.
>
> A settlement account of the company must be opened in a bank (or its department/branch) located on the territory of relevant ZATO.
>
> ….

The Tax Authorities have the right to demand from [such] companies the presentation of any additional documents confirming the compliance of the organization with the demands set forth in … this clarification."

[6] The Consultant Plus database contains the text of a number of such decisions.

[7] The cases cited in the Resolution are: Decisions by the Federal Court of Arbitration of the Severo-Kavkazsky Area, Case #Ф08-1013/2003-383A , dated April 8,2003, Case #Ф08-270/2003-91A, dated February 20, 2003, Case #Ф08-268/2003-98A, dated February 20, 2003, Case #Ф08-3158/2002-1140A, dated August 29, 2002, Case #Ф08-2892/2002-1051A, dated August 13, 2003, Case #Ф08-2762/2002-1009A, dated August 5, 2003, Case #Ф08-1864/2002/697A, dated June 4, 2003, Case #Ф08-1863/2002-696A, dated June 4, 2003, Case #Ф08-1368/2002-506A, dated April 29, 2003, Case #Ф08-94/2002-28A, dated January 31, 2003. I have obtained copies of these decisions through Consultant Plus, although they are not available on the general database.

[8] It is in fact possible that a court would adopt such a "proportionality" rule in relation to the Kalmyk law, although such a rule would not be relevant to the tax claims made against Yukos.

Let's say Company A had invested \$10 million in Kalmykia and was given tax concessions reducing its profits tax rate by 1% and Company B had invested \$1,000 and was given concessions reducing its profits tax rate by 30%. Furthermore, let's say that the administration of Kalmykia had established certain regulations for granting concessions (for example, not allowing them to be granted to casinos or vodka manufacturers), but the regulations don't specify the level of concessions to be granted. Finally, let's assume that both Company A and Company B qualify for concessions under these regulations and, in terms of the rules set down by the administration, there is no basis to distinguish them from each other between them. Based on the right to equal protection under the law (which is in the Russian constitution) Company A might protest being given much lower concessions than Company B based on the argument that the authorities must give a motivated reason for treating it differently from Company B. In a suit by Company A against the authorities to get tax concessions similar to those given to Company B, a court might very well refer to the right to equal protection to establish the rule that, all else being equal, the concessions should be "proportional" to the investment. The reasoning supporting such a rule would be that it is very hard, in light of the purpose of the law (promote investment), to think of any other legitimate criteria for granting different levels of concessions to different qualifying companies.

Such a "proportionality" rule would not be applicable to the Yukos case because it could only be used to protect the rights of a company seeking fair treatment in the granting of tax concessions. This rule could not be used as grounds for the Tax Authorities to revoke concessions that were already granted to a company. Furthermore, such a rule, as argued above, is not based on the requirement that the taxpayer act in good faith--as asserted in the cases cited by the Tax Authorities in the Resolution--but rather on the principle of equal protection under the law or due process. In other words, such a rule would relate not to the taxpayer's duty to act in good faith, but rather to duty of the executive authorities to act in good faith in applying the law.

[9] Cases on veil piercing tend to be relatively uncommon in most countries. Various reasons are often given for the lack of cases on veil piercing. I will not discuss these reasons here, but I think it is fair to say that the lack of cases in Russian should not be taken as unusual given that the relevant laws are all less than a decade old.

[10] The provisions I am glossing here are Articles 56 and 105 of the Civil Code, Articles 3 and 6 of the Law on Joint Stock Companies and Articles 3 and 6 of the Law on Limited Liability Companies. One main difference between Russian and US/UK veil piercing rules is that the Russian rules do not appear to require an element of wrongdoing—they appear to be most similar to the rules in Germany where veil piercing is a question of the degree of control of one company over another; although the rule itself is clearly meant to prevent fraudulent and deceptive practices, no specific showing of wrongdoing is required.

[11] Decree of the Federal Arbitration Court of the Moscow Region, dated March 14, 2005, No. KA-A40/106-05 (available in Consultant Plus).

[12] The Decree mentioned in the previous note cites an earlier case, the Decree of the Supreme Arbitration Court of the Russian Federation, dated February 8, 2005, No. 10423/04 (available in Consultant Plus). The two cases are similar in that a shell company which did not really have any operations of its own claimed zero-rate VAT on goods that it nominally exported. However, in the latter case, the company was

not part of a scheme to evade VAT, but rather other taxes. In the former case, the company was involved in a scheme to collect illegitimate VAT refunds from the government. The company's claim to be an "exporter" was part of this scheme and therefore violated the duty to act in good faith. This earlier Decree of the Supreme Arbitration Court appears to me to use the concept of "good faith" correctly. The latter case, however, appears to misapply this earlier Decree.

[13] I have received a copy of this decision.