

## LT In Focus

# Recent developments to cost allocation procedures

On 29 June 2016, the Arbitrage Court of the City of Moscow (hereinafter, "the Court") resolved [Case No. A40-51925/16](#) and challenged the allocation of costs by Russian permanent establishments (hereinafter, "PEs") based solely on calculations set out by cost allocation policies.

This court case is consistent with the general trend in administrative and court practice over the past several years. This development makes the allocation of costs not only administratively burdensome, but also risky.

Please find a more detailed summary of the court case below.

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### Primary documents become a core requirement

The Court referred to [Supreme Arbitrage Court Decision No. 1896/12 of 27 April 2012](#) (issued concerning a claim filed by an international law firm headquartered in France). The latter assessed the validity of Russian Ministry of Finance clarifications prescribing the reflection of expenses related to the Russian operations of foreign taxpayers based on the dates when the calculations are performed under cost allocation policies established in accordance with effective double tax treaties. The Supreme Arbitrage Court indicated that cost allocation calculations are of a purely informative nature and, hence, all expenses should be recognised by PEs in tax periods when the expenses were actually incurred, based on primary documents.

As a logical continuation of this ruling, the Court rejected the deduction of allocated costs by the PE for the following reasons:

- The documents provided by the company were not signed by the head office's authorised person and, hence, cannot be deemed primary documents nor can the data specified therein be confirmed (the Court examined the taxpayer's accounting policies, the calculations of costs allocated to the Russian PE verified by an independent auditor, the cost transfer certificates and a copy of the head office's expense reports);
- The cost allocation calculations and the allocation methodology used were not approved by the authorised person of the company or sealed;
- The cost allocation calculations did not contain detailed explanations for allocated general and administrative costs, and there were no documents in place supporting the figures included therein;
- The signatory's authority with regard to the cost transfer certificates has not been confirmed.

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*Thus, the Court stated that the documents cannot be regarded as primary documents and, hence, cannot be used to support deductions for tax purposes.*

Should be noted that the arbitration courts previously adhered to the opposite position and clearly differentiated direct costs from other allocated costs. The logic was as follows: direct costs should be confirmed by primary documents prepared under the Russian or foreign rules; whereas allocated costs could be allocated in accordance with the cost transfer certificates. For example, we refer to [Resolution of the Federal Arbitrage Court of Moscow Region of 19 October](#)

[2010 on Case No. A40-35277/09-35-189](#), [Resolution of the Federal Arbitrage Court of Moscow Region No. F05-2325/11 of 13 April 2011 on Case No. A40-1154/10-116-18](#) and [Resolution of the Ninth Arbitrage Court of Appeal No. 09AP-1887/2015 of 20 April 2015 on Case No. A40-3279/14](#), revising the claims of an international law firm and a consulting firm operating in the oil and gas industry, all headquartered in the UK.

### Confirmation of the business purpose of expenses

To strengthen the new approach, the Court outlined that the taxpayer failed to prove that the allocated costs were aimed at generating income at the PE level. In particular, the Court referred to the following fundamental weaknesses in the cost allocation calculations and cost transfer certificates:

- There is no evidence of a link between these expenses and the operations of the permanent establishment;
- The documents neither identified projects,

employees, and their time spent/payroll expenses, nor confirmed the relation of expenses to the business of the PE;

- The cost transfer certificates did not specify particular business operations performed for the benefit of the Russian PE.

This approach seems reasonable and is generally in line with all previous cases in which the tax authorities have tended to scrutinize the allocation of expenses to PEs.

### Translation of documents into Russian

The Court noted that the taxpayer should translate documents prepared in a foreign language into Russian and submit such documents to the tax authorities with the translation attached. The failure to submit

documents prepared in a foreign language with the attached translation means that the taxpayer deliberately waives the right to present evidence in defence.

### Lessons learned

We strongly recommend undertaking the following actions in order to mitigate potential deductibility risk:

- Revise existing cost allocation policies, templates for cost allocation calculations and cost transfer certificates to ensure (1) the completeness of the descriptions and justifications of transferred costs (2) integrity with foreign accounting registers and primary documents, and (3) due adoption/signing by the authorised representatives of the taxpayer;

- Obtain powers of attorney confirming the signatories' powers to sign the cost allocation policy and other documents;
- Obtain copies of primary documents confirming the calculations of allocated costs prepared by the head office;
- Translate all documents into Russian (this step may be postponed until a formal request from the tax authorities).

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We hope you will find the above information timely and useful. Should you have any questions in this regard, Deloitte professionals will be glad to discuss them with you.

Best regards,

**Partners of Deloitte CIS**

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