

LT in Focus

The allocation of advertising expenses between related functional entities imply significant tax risks

On August 21, 2017, the first instance Commercial Court of Lipetsk Region delivered a [judgment](#) in a rather unusual tax dispute over allocation of marketing expenses between a producer and a distributor.

The court has ruled in the tax authority's favour acknowledging that the producer's strategic marketing expenses had been actually incurred for the benefit of the related distributor that had also acted as the sole executive body.

The court held that the producer had rendered free-of-charge marketing services to the distributor, denied the deductibility of respective expenses and assessed VAT on those services.

Read on for a detailed review of the dispute and the analysis of an unconventional approach applied by the tax authorities.

[Background](#)

[Tax authority's position](#)

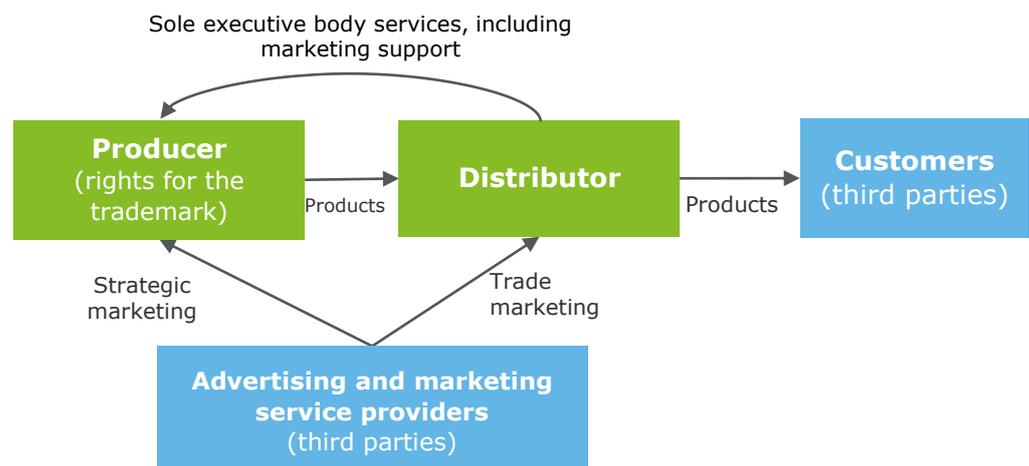
[Court opinion](#)

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Background

- The taxpayer (the "Producer") was making juices, beverages and baby foods.
- The bulk of the products were sold to the related distributor (the "Distributor") that also acted as the sole executive body.
- The advertising and marketing expenses were allocated between the Distributor and the Producer, the strategic marketing expenses being borne by the Producer, and the trade marketing costs by the Distributor.
- The Distributor also exercised a marketing support function under the sole executive body service agreement signed with the Producer.

Below is a chart showing the business arrangement between the Producer and the Distributor.



Tax authority's position

According to the tax authority, the strategic marketing expenses were actually incurred as part of the performance of the Distributor's management functions and were aimed at promoting the products purchased from the Producer.

Therefore, in the tax authority's opinion, the expenses

were attributable to the free-of-charge advertising/marketing services rendered to the Distributor.

Hence, the tax inspectorate challenged the deduction of strategic marketing expenses of over RUB 1 billion and assessed VAT on free-of-charge services.

Court opinion

The court ruled in favour of the tax inspectorate citing the following:

- The Producer had an established customer base and, proceeding from the advertising definition set forth in Item 1, Article 3 of Federal Law "On Advertising" No. 38-FZ of 13 March 2006, the Producer's advertising and marketing expenses had no impact on its business relations with the Distributor and on promoting its interest in the products
- Maintaining and boosting demand through advertising as well as preserving and improving the sales revenues was the Distributor's key business driver as the prices it had set for the Producer were stable and unaffected by demand fluctuations
- The produced extracts from the survey of marketing impact on sales failed to demonstrate how the marketing activities had actually driven the Producer's sales revenues, not the Distributor's.
- The Producer's arguments regarding advertising and marketing expense allocation did not stand because, as the sole executive body, the Distributor had actually performed the strategic marketing activities (brand advertising in media), which was testified by witnesses and service reports
- The fact of the Producer's trademark ownership is not an absolute prerequisite for attributing all marketing and advertising costs to it
- The Producer's advertising and marketing expenses had failed to generate an expected effect as the volume of ready-made products decreased and the tangible costs grew.

In accordance with the foregoing, the court upheld that the Distributor, as the sole executive body of the company

that performed marketing functions, had actually received free-of-charge advertising and marketing services, while the cost of such services had been actually attributable to the Producer.



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"The court's conclusion on the Producer having no interest in product (brand) advertising and on its incurrence of advertising/marketing expenses "for the benefit" of the Distributor is highly disputable as it is quite obvious that both the Producer and the Distributor had direct interest in boosting the end customers' demand and improving the product and brand awareness.

The volume of products that can be sold by the Producer to the Distributor and, hence, its revenues are directly dependent on the volumes that the Distributor is able to sell to its end customers. These volumes, in turn, hinge upon the advertising and marketing of respective products and brands.

Furthermore, the Producer, as a trademark owner, has direct interest in its promotion as it adds value.

We can only hope that the upper courts will have a more in-depth look at the situation and the taxpayer's arguments.

Conclusion

In the dispute under review, the tax inspectorate applied an unconventional approach to validating advertising expenses, having assessed the relevance of expenses considering the related companies' functions.

The tax authority actually concluded that the strategic marketing expenses were necessitated by the Distributor, not by the Producer with its guaranteed supply volumes and stable prices.

Interestingly, the tax authorities assessed the overall relevance of marketing expenses citing such expenses failure to drive the production volume increase and using this fact as one of their arguments.

It is also noteworthy that the tax authority did not identify the unjustified tax benefit: had the expenses been incurred by the Distributor, the latter could have deducted them for tax purposes without any loss to the budget.

In our opinion, certain arguments offered by the tax authority are quite disputable, and we hope that the upper court instances will take a closer look at the circumstances and will accept the taxpayer's position.

Nevertheless, we advise the companies to assess potential tax implications upfront, analyse the function-based intragroup expense allocation and develop a defense strategy in case of tax claims.

We hope that you will find this newsletter interesting and informative. Please feel welcome to contact us for more information on the topics covered.

Best regards,

Deloitte CIS Partners

Contacts

Tax & Legal

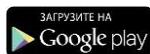


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