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Tax & Legal

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LT in Focus

New approach to tax treatment of transactions between related parties

On 15 June 2018, the Nineteenth Commercial Court of Appeals considered a dispute between PepsiCO and the Russian Federal Tax Service (FTS) over the tax treatment of intragroup transactions.

Courts of two instances supported the tax authorities in classifying the arrangement between the plant and the trading/holding company as free of charge provision of services.

According to the tax authorities, the plant's advertising and marketing expenses had contributed to an increase in the earnings of the trading/holding company and not the plant itself.

Subject matter of dispute

OOO Lebedyansky (the 'Company') is a PepsiCo Group company, a leading producer of juices and the owner of Tonus, Fruktoviy Sad, Ya, and other trademarks.

In 2011, the powers of the Company's sole executive body were assigned to PepsiCo Holdings (the 'Holding') that indirectly owns approximately 40 percent of the Company.

On the basis of a distribution agreement signed in 2008, the Holding has been purchasing goods from the Company for further distribution, including sales to retail networks. The Holding was also licensed to use the Company's trademark and logo in its sales promotion materials.

In 2012–2014, the Company paid for the advertising and marketing services aimed at promoting the Company's products (eg. the Fruktoviy Sad juices), including the placement of TV commercials, advertising development and planning, script writing, production, editing and adaptation of video advertisements, conducting marketing/sociological surveys, retail audit research, etc.

Since the Holding acted both as the Company's management company and a distributor and was entitled to use the trademarks and logos of the respective products, the tax authorities and the courts decided it was the Holding that had had actual business relations with the providers of the advertising and marketing services that contributed to the increase in the Holding's earnings (p. 10 of the Resolution of the Nineteenth Commercial Court of Appeal). In the court's opinion, naming the Company a buyer of the advertising and marketing services was inconsistent with the economic substance of the transactions (p. 12 of the Resolution of the Nineteenth Commercial Court of Appeal).

Since the Holding did not compensate the advertising and marketing costs incurred by the Company, the court resolved that the Company paid for the services on behalf of the Holding without a consideration (p. 28 of the Resolution of the Commercial Court of Lipetsk Region). Based on the above-mentioned conclusions and citing Articles 39 and 146 of the Russian Tax Code, the court ruled that the VAT base was underestimated by the cost of the advertising and marketing services allegedly provided to the Holding without a consideration.

Expert opinion

In our opinion, the court misapplied provisions of the substantive law. Not taking into consideration Sub-Items 2 and 3, Article 423 of the Russian Civil Code, it misinterpreted Article 146 of the Russian Tax Code.

Other consideration as evidence of compensation

Pursuant to Item 1, Article 39 and Sub-Item 1, Item 1, Article 146 of the Russian Tax Code, services rendered free of charge are subject to VAT.

In accordance with Item 2, Article 154 of the Russian Tax Code, the tax base for a free-of-charge provision of goods (services, works) is determined as the cost of such services based on transfer pricing rules (Article 105.3 of the Russian Tax Code), inclusive of the excise duty (for excisable goods) and exclusive of tax. Therefore, to apply Item 2, Article 154 of the Russian Tax Code along with Articles 39 and 146 of the Russian Tax Code, services must be provided free of charge.

However, since the Tax Code does not expressly define the terms 'free of charge' or 'for a consideration', they should be interpreted according to their definitions in the civil law (Item 1, Article 11 of the Russian Tax Code).

Pursuant to Item 3, Article 423 of the Russian Civil Code, a contract is presumed to be entered into for a consideration, unless otherwise envisaged by law or is implied by the nature of such contract. In other words, the Russian law presumes that contracts between business entities are reciprocal. Furthermore, there is a statutory ban on gifts between business entities (Sub-Item 4, Item 1, Article 575 of the Russian Civil Code).

In accordance with Item 2, Article 423 of the Russian Civil Code, a contract will be deemed to be free of charge only if a party undertakes to perform its contractual obligations to the other party without payment or other consideration. A contract that provides for a payment or 'any other consideration' will not be deemed free of charge (Item 1, Article 423 of the Russian Tax Code).

The law does not expressly define the term 'other consideration'; there is a unified interpretations adhered to by both the Presidium of the Russian Supreme Commercial Court and the Presidium of the Russian Supreme Court.

In accordance with Item 19 of the Digest of Rulings of the Russian Supreme Court No. 1 (2018)[1], if the contract does not provide for a payment and the donative intent of a party to such contract has not been proved, the transaction is assumed to be entered into for other consideration, defined by the nature of the intragroup relationship of the parties.

According to the Ruling of the Presidium of the Russian Supreme Commercial Court No. 8989/12 of 4 December 2012, inasmuch as one company controls the other and they have common business goals that may require a redistribution of assets (resources), it would be erroneous to classify the contracts between the two that formally do not provide for a consideration as free of charge.

The provision of services for no extra fee may incentivise the service recipient to discharge other obligations to the service provider.[2] A consideration may include other economic benefits, such as an increase in procurement volumes or achievement of other common business targets.

In accordance with the opinion expressed in Resolution of the Russian Supreme Commercial Court No. 13986/12 of 9 April 2013 (Citibank vs. Interregional Tax Inspectorate for Major Taxpayers No. 9), if a taxpayer and its counterparty have a business relationship, no goods or services the taxpayer receives from such counterparty for no extra charge should be deemed to be received free of charge.[3]

In the case under review, the Company and the Holding have a business relationship: by purchasing the goods produced by the Company, the Holding receives additional economic benefit from the advertising purchased by the Company. Therefore, given the business nature of the underlying relationship between the parties, a service rendered by one of the parties at no extra fee cannot be classified as free of charge.

Absence of donative intent as evidence of consideration

Ruling of the Presidium of the Russian Supreme Commercial Court No. 5477/09 of 8 September 2009 sets forth that in absence of proof of the parties' intent to transfer assets for no consideration, a transaction will be deemed to be made for a fee. A relationship between the parties may be classified as non-gratuitous, only if the intent of one of the parties was acknowledged to provide a donation to the other party (Item 3 of Resolution of the Russian Supreme Court Plenum No. 54 of 21 December 2017). If a contract between the parties does not expressly imply the donative intent of either of them, there will be no grounds for treating the service as rendered free of charge (Resolution of the Presidium of the Russian Supreme Commercial Court No. 13952/05 of 25 April 2006; No. 7030/01 of 26 April 2002, and No. 8303/00 of 5 June 2001).

According to Russian Supreme Court Ruling No. 305-ЭС16-12298 of 27 December 2016, a gift implies the donor's intent to transfer its assets as a gift (to endue the donee) and not based on any business relationship.

The absence of a creditor's donative intent may be evidenced, for instance, by the fact that it receives economic benefits from other arrangements with the same debtor (Item 3 of Newsletter of the Presidium of the Russian Supreme Commercial Court No. 104 of 21 December 2005).

The Company's distribution agreement has no reference to a free-of-charge placement of advertising; at the same time, such placement is associated with the supply of goods under the same agreement and cannot be classified as non-reciprocal.

In the opinion of the Russian Ministry of Finance, property transferred under a business contract cannot be considered transferred free of charge (Letters No. 03-03-06/1/4 of 14 January 2008, No. 03-07-10/20 of 12 September 2012, 03-03-06/1/589 of 16 November 2012, and No. 03-03-06/1/496 of 17 August 2011).

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[1] Approved by the Presidium of the Russian Supreme Court on 28 March 2018

[2] See Resolution of the Commercial Court of Moscow in case No. A40-120254/2015 of 5 June 2017

[3] See Resolution of the Commercial Court of Moscow in case No. A40-142537/2014 of 3 March 2015 (*Mobis vs. Interregional Tax Inspectorate No. 49 for Moscow)*

Conclusions

In the case of OOO Lebedyansky, commercial courts treated the procurement of advertising as free-of-charge services, citing the lack of express provisions for monetary compensation and failing to analyse the arrangement for the presence of other consideration.

Yet, the placement of advertising cannot be classified as a free-of-charge service, since the Company does receive an economic benefit from the product supplies it makes to the Holding. The fact that the monetary compensation was not expressly provided for by the distribution agreement does not in itself evidence the free-of-charge nature of the services.

That is why Item 3, Article 423 of the Russian Civil Code does not confine the business entity's choice of consideration to mere cash payments as the most explicit and direct form of compensation.

The way the courts distinguish between the free-of-charge services and the services provided for a consideration contradicts the 'presumption of consideration' rule formulated by the Russian Civil Code and the positions of the Russian Supreme Court, Supreme Commercial Court, and other commercial courts, according to which 'a transaction is be deemed to be made for a consideration unless expressly stated otherwise'.

The Company placed and paid for the advertising only of the goods that it supplied under the distribution agreement, which the tax authorities do not dispute. In the opinion of the Russian Ministry of Finance, commercial and civil courts, this rules out the interpretation of the transaction as free of charge.

The fact that the advertised products were not owned by the Company and the advertising campaign was run by the Holding does not evidence a free-of-charge provision of advertising and marketing services to the Holding.

The advertising does not add value to the Company and the Holding other than in connection with the distribution agreement. Therefore, the advertising procured by the Company is economically advantageous for the Holding in general and cannot be classified as a free-of-charge service.

The fact that the price of juice does not factor in the advertising costs does not mean that the Company had rendered free-of-charge services to the Holding: the cost of such service, by virtue of Item 3, Article 423 of the Russian Civil Code, is considered by the parties when determining the price of goods under the distribution agreement. This conclusion is confirmed by Resolution of the Presidium of the Russian Supreme Commercial Court No. 1488/13 of 9 July 2013.

Taking into account the fact that the Company's gross profit margin and operating margin were found to exceed the arm's length range (Clause 31 of the Resolution of the Commercial Court of Lipetsk Region), the lack of a compensation clause did not lead to an 'unjust enrichment' of the Holding and did not adversely impact the balance of rights and obligations of the parties to the distribution agreement.

The foregoing circumstances expressly indicate that the Commercial Court of Lipetsk Region and the Nineteenth Commercial Court of Appeal erroneously failed to apply Items 2 and 3, Article 423 of the Russian Civil Code. It is worth noting that the resolutions on the case do not contain references to Article 423 of the Russian Civil Code, which leaves the classification of the services as free of charge unsubstantiated. [4]

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

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[4]Articles 170 and 271 of the Arbitration Procedure Code require that in a statement of reasons the court cite the laws and regulations it based its decision on.

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