



INTRA-GROUP EXPENSES

FAO CEOs of international and Russian holding companies


Pepeliaev Group advises that in view of new case law, any expenses of a Russian company incurred to make payments to a foreign company within one international group of companies may not be treated as deductible for profit tax purposes.

Facts in the case

Decision No. A40-138879/14-75-404 of the Moscow State Commercial ('Arbitration') Court dated 4 December 2014 confirmed the legality of the tax authorities' new approach to exclude the payment of royalties from expenses.

The tax authorities raised the following claims against the taxpayer Oriflame Cosmetics LLC (the "Company"). The Company, a subsidiary with 100% foreign capital, was paying royalties abroad for the use of business solutions created by the parent company of the group. The tax authority did not challenge the solutions themselves or their value, nor did it raise the issue of whether the amount of the payments conformed to the market value. However, the tax authority excluded these payments from the Company's expenses for profit tax purposes, concluding that the Russian company, which was registered in Russia as a limited liability company, may not be treated as an independent legal entity. In the tax authority's opinion, the subsidiary is a representative office of the parent company, i.e., the subsidiary and the parent company are a single entity. Such an approach was applied based on the following facts:

- 1) The subsidiary emphasises its connection with the group, using the global publicity and reputation of its brand;
- 2) The parent company controls its subsidiary, performing its strategic management;
- 3) Some employees work for the parent company and the subsidiary at the same time, and some are transferred from the foreign company to the Russian subsidiary and vice versa.

The logo for Pepeleiev Group, featuring a stylized Greek letter pi (π) with a superscript 'g' above it, followed by a vertical line and the text 'The business of the Oriflame Group is similar to the business of many other international holding companies. Not a single parent company would leave its Russian subsidiary without control. Furthermore, the right to such control is guaranteed by Russian civil legislation. Every subsidiary promotes its goods and services by using the reputation of its better-known parent company. Staff rotation and concurrent service (i.e., in the parent and subsidiary simultaneously) are robust tools for encouraging and controlling the staff. This method ensures that the most effective and efficient staff of the group performs the work required for a specific company of the group at a specific moment. Since this is the way business is done in many international and Russian holding companies, Oriflame's dispute with the tax authority may significantly affect the tax authorities' decisions with regard to any Russian subsidiary of such holding companies.'

What to think about and what to do

The court decision has not yet come into force, but the fact that it has been adopted increases the likelihood that the tax authorities will raise similar claims against other companies.

The ruling adopted by the court gives rise to material tax risks that virtually cannot be eliminated by "therapeutic methods", i.e., without dramatically changing the business model utilised by foreign companies in Russia.

Since the case law may be applied retrospectively, the new approach creates tax risks with regard to previous periods, and it is even more difficult to eliminate or reduce such risks.

Therefore, the business community may be interested in the tax authorities and courts applying a more moderate approach to evaluating the status and nature of the business of holding structures. However, for this, joint efforts need to be applied.

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