# HOW THE COURT TREATS THE LOSSES OF MERGED COMPANIES

*FAO Heads of legal departments, finance and tax departments*

**Pepeliaev Group advises that merging a loss-making company into a profitable one and including the former's losses in the form of negative exchange rates in the expenses of a profitable company may be recognised by the courts as actions aimed at obtaining an unjustified tax benefit.**

Recently the State Commercial Court for the Moscow Circuit has considered the case of TeliaSonera International Carrier Russia in the dispute with the tax authority with regard to whether the losses of a merged company in the form of negative exchange rates may be deducted from the profit tax base of the legal successor company (resolution No. A40-128884/14 dated 18 August 2015).

The resolution is interesting owing to the conclusions that follow from it:

- a merger (as a form of reorganisation) may be treated by courts as a transaction aimed at obtaining an unjustified tax benefit;
- there should be a business purpose for negative exchange rate differences to be deducted;
- if a loan in foreign currency has a business purpose, this does not mean that there was a business purposes in the negative exchange rates that arose as a result of the overestimation of the foreign currency loan.

**Essence of the dispute**

In accordance with the provisions of the Russian Tax Code, the legal successor acquired the assets and liabilities of a reorganised legal entity including the amount of a tax loss in the form of negative exchange rates which arose owing to the overestimation of interest debt obligations in relation to monetary funds received from a foreign founder. The legal successor, when performing its tax obligations, has deducted the tax loss as part of non-sales expenses when calculating the profit tax base.

The tax authority and subsequently the courts had doubts as to whether the actions of the legal successor were lawful when it deducted such loss as a part of its expenses and whether the received loan had been used by the reorganised company to gain profit.

The courts concluded that the unlawful reduction of tax obligations was the main purpose of reorganising the company under the decision of the shareholder, though the reasons and economic consequences of company reorganisation were not reviewed. The mere fact that the merged company had losses was enough for courts to conclude that there was no business purpose behind the merger.

This conclusions is based on the following facts: (i) the companies are controlled by the one parent company; (ii) the losses with regard to the deduction of negative exchange rates as a part of expenses do not comply with the criteria of article 252 of the Russian Tax Code and with the position the Plenum of Russian Supreme Commercial Court stated in Resolution No. 53 "On commercial ('arbitration') courts assessing whether a taxpayer obtained a tax benefit on a justified basis" dated 12 October 2006.

At the same time the courts have not taken into account that when the loan was granted, the company being merged and the absorbing company had different shareholders, and an unjustified tax benefit could not been planned in advance at least owing to the fact that 10 years passed between the issue / receipt of the loan and reorganisation.

In addition, neither the tax authorities nor the courts challenged whether a business purpose was present when funds were borrowed to build a communication line which subsequently could not been operated for objective reasons.

It turns out that negative exchange rates purely owing to fluctuations of currency exchange rates cannot be deducted for profit tax purposes regardless of the fact that the transaction itself for raising loans was recognised as lawful and was aimed at gaining profit from economic activities.

**What to think about and what to do**

In the light of the issued Resolution, the likelihood increases that the tax authorities will more often raise claims against reorganised legal entities (both profitable and loss-making ones) with the intention of recognising that the main purpose of such reorganisation was for tax obligations to be unlawfully reduced and an unjustified tax benefit obtained. The courts in turn will very likely uphold the position of the tax authorities.

In this regard, we recommend exercising caution when reorganising companies, taking into account the business purpose, economic feasibility of the merger, the scope of tax consequences for the legal successor, the fact applying that the company is an affiliate. We also recommend taking a prudent approach to documenting the whole procedure and to justifying in economic terms the reasons for the reorganisation.

**Help from your adviser**

Pepeliaev Group's lawyers have extensive experience of handling issues relating to compliance with tax legislation. They are ready to provide comprehensive legal support and assistance in the reorganisation of companies and consequences arising out from this, including in cases when a dispute with a tax authority arises.

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