



Unjustified tax benefit and splitting up of business

SAC Regulation No. SAC-15570/12 in Case No. A60-40529/2011

In Case No. A60-40529/2011 the Supreme Arbitration Court has reversed the decisions of the lower courts which found justified the tax claims connected with the tax authority's opinion that Metallurgservice LLC (the "taxpayer") had received unfounded tax benefits as the result of the splitting up of business and application of the special tax treatment.

As was established by the lower courts, the taxpayer had applied the special tax treatment – the uniform tax on imputed income (the "UTII") – to its business of catering for the founder's employees. By virtue of the amended Article 346.26 of the Tax Code limiting the mean number of employees and interest in the charter capital for taxpayers applying the UTII, the taxpayer would forfeit the right to use the said special treatment in 2009. Therefore, there was set up another company interdependent (affiliated) with the taxpayer, and starting from 2009 all the taxpayer's employees and assets necessary for the business of catering were transferred to the affiliate. The new company met the criteria of the UTII payer and continued to carry out the catering under the special tax treatment, whereas the taxpayer stopped doing it.

The tax authority considered that the transfer of the business to an affiliate had been with the sole aim of receiving the unjustified tax benefit, i.e., retaining the right to apply the UTII by a group of

affiliates. The tax authority's approach was shared by the courts of the first, second and third instance which claimed the absence of a sound purpose for splitting the business and referred to Regulation of the SAC Plenum on the Assessment by Arbitration Courts of the Justification of Obtainment of a Tax Benefit by Taxpayers, dated October 12, 2006, No. 53 ("Regulation No. 53").

On the taxpayer's appeal, the SAC panel of judges referred the case to the Presidium, having indicated that since the taxpayer had stopped carrying out the business taxable by the UTII the conclusion that the business had been split up for the sole purpose of gaining tax benefits was incorrect and constituted an interference in the matters of economic expediency of decisions made by business entities, which contravened the legal approach expressed in the Regulation of the Constitutional Court, dated February 24, 2004, No. 3-P.

The SAC Presidium reversed the court judgments and satisfied the taxpayer's appeal. The SAC Regulation has not been promulgated yet, but the arguments underlying the referral of the case to the Presidium seem corresponding to Regulation No. 53 and the approach of the Constitutional Court. In effect, the parceling out of a whole branch of business into a separate business structure (a separate, although affiliated legal entity) evidently achieves the task of diversification of

business, risks and business processes of the corresponding group of companies.

We believe the precedent in question will be an important one because it shows the courts that arbitrary conclusions about the absence of business purpose in a taxpayer's economic operations are inadmissible and will promote the arbitration practice of application of Regulation No. 53 as a special, exclusive tool for suppressing obvious tax abuses rather than a method of total control over the economic expedience of taxpayer's

activity. At the same time, the case in question shows how important it is to prepare evidence that the diversification of activity had a real business purpose and entailed real organizational changes in the taxpayer's activity (in particular, the parceling out of services responsible for the management of the corresponding types of activity). It would be advisable to take care of such evidence before an official legalization of the completed diversification.

Unjustified tax benefit and distribution of expenses inside the group of companies

Regulation of the FAC of the Moscow Circuit, dated March 25, 2013, No. A40-62131/12-91-355

In its ruling of March 25, 2013, No. A40-62131/12-91-355, the Federal Arbitration Court of the Moscow Circuit recognizes as rightful the conclusion of the tax authority that inclusion of expenses on consulting services in the taxpayer's deductible expenses was unjustified. The Court agrees with the tax authority's opinion that the rendering of consultancy services to the taxpayer was a sham transaction, the consultancy services were not really provided, the business purpose in the purchase of the services was absent, and the multifold increase of the services volume as compared to the previous tax period was not proved by documents.

The taxpayer justified its expenses by the purchase of consultancy, technical and auxiliary services from the head company. It asserted that further it used the said services for rendering consultancy services to other Russian affiliated companies (the "Group companies"). At the end of the tax period, the taxpayer and its head company signed supplement agreements to the consultancy services agreement which stipulated a 25

times increase of the services volume. The tax inspectorate refused to include the increased expenses on the head company's services in the taxpayer's deductible expenses.

The Court has established that the services to be provided under the supplement agreements to the taxpayer and then to the Group companies were actually rendered by the head company directly to the Group companies. Besides, the Court has concluded that the disputed services could not be rendered in reality, because the supplement agreements for them were signed at the end of the year when the services should have been rendered already. Therefore, the Court has found the transaction for purchase of the additional volume of service invalid (sham).

The Court has also taken into consideration the absence of proofs of the real provision of services (exchange of correspondence, detailed reports of the consultant, witness testimonies, etc.). The statements of services delivery-acceptance submitted by

the taxpayer did not specify the volume of services and did not support the increase.

That example confirms the special attention tax authorities pay to expenses distributed

inside a group of companies by way of consultancy, management and other similar agreements, and the need to thoroughly work on the proofs of reality and economic justification of such expenses.

Accountable money and the individual income tax

SAC Regulation of March 5, 2013, No. 14376/12 or 05.03.2013 in Case No. A53-8405/2011

Money given to an employee on account and expended by him are not deductible for the individual income tax purposes, unless the employee submits accounting documents confirming the expenditure and the purchased goods (work, services) are accepted by the employer for accounting. That conclusion was made by the SAC in the Regulation of March 5, 2013, No. 14376/12, in Case No. A53-8405/2011.

After a field tax inspection of the company the tax authority established that the employees had regularly drawn cash from the employer's bank accounts. The initial documents supporting the expenditure of the money for the claimed purposes (purchase of agricultural machinery) were absent. The purchased products had not been accepted by the company for accounting. The employees' expenditures had been acknowledged by the company on the basis of expenses reports only.

The tax authority found those expenses non-deductible for the employee income tax purpose and held the company liable for the

failure to perform the obligations of a tax agent. The courts of the first and the appeal instance agreed with the tax authority. The Federal Arbitration Court reversed the decisions of the lower courts, but the SAC decided to affirm them. The SAC indicated that the obligation of the employee to submit a report on the expenditure of money with supporting documents was required by the procedure effective at that time. Whereas the basis for entering the purchased products in the accounting books were initial documents meeting the requirements of Clause 13 of the Ministry of Finance Order on the Approval of the Regulations on Accounting and Financial Statements in the Russian Federation, dated July 29, 1998, No. 34n. Correspondingly, in the event of a failure to comply with the requirement of submission of initial documents together with the expenditure report and acceptance of the purchased products for accounting the money given to accountable persons correspond to the criteria of income taxable by the individual income tax in accordance with Article 210 of the Tax Code.

Regulation of the SAC Plenum on Payment of the VAT in the Sale of the Bankrupt's Property, dated January 25, 2014, No. 11

According to Article 161(4.1) of the Tax Code effective as of October 1, 2011, in the event of sale of a bankrupt debtor's property (property rights), the VAT tax base is determined as income from the sale of property with account for the tax, and the VAT should accrue by the computation method. In that case the purchaser of the bankrupt's property is recognized as the tax agent. In other words, the tax agent must withhold the tax directly from the redemption value of the property.

At the same time, those provisions of the Tax Code contravene the procedure for distribution of the bankrupt's estate set forth in Article 134(2) of the Bankruptcy Law (tax obligations are placed in the fourth order among the current payments), and in the event of sale of the mortgaged property

violate the procedure for distribution of proceeds from sale of mortgage property set forth in Article 138 of the Bankruptcy Law.

The said Regulation of the SAC confirms the approach developed in the arbitration practice that priority in that collision is given to the bankruptcy law provisions and therefore money for the sold property are transferred to the purchasers and further are distributed by the receiver without the tax withholding. Resolving the legal collision in favor of private entities - taxpayers and tax agents, the Regulation makes more definite the relationship connected with settlements in the sale of bankrupt's property and makes it clear for the legislator that contradictions between tax laws and other branches of law are inadmissible.

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