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Court practice regarding advertising and marketing expenses within intra-group relations

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Pepeliaev Group advises you about the court practice regarding advertising and marketing expenses which a taxpayer that is a manufacturer of goods has incurred within intra-group relations. The position of the court regarding this case may apply to other similar disputes.

On 22 November 2018, the State Commercial ('Arbitration') Court for the Central Circuit passed a Resolution in case A36-4222/2017. In it, the court looked into whether advertising and marketing expenses incurred by a manufacturer of products (Lebedyansky LLC) were lawfully deducted. The Supreme Court, with which the taxpayer filed an appeal against the court decisions on 19 January 2019, is now determining the destiny of the dispute.

Tax authorities established that Lebedyansky LLC and its management company (PepsiCo Holdings LLC) entered into an agreement for management services. The services involved support for a marketing function. Besides, a distribution agreement between the same parties also provided for the distributor (PepsiCo Holdings LLC) to determine in its sole discretion all activities concerning trade marketing and to independently bear all expenses arising out of such activities. Other distribution agreements into which the taxpayer had entered contained similar provisions.

Courts of all instances concluded that the performance of advertising and marketing activities was vested in the management company and distributors. The courts also referred to the fact that the products advertised did not belong to the taxpayer. For this reason, the expenses of Lebedyansky LLC for the advertising and marketing of products it manufactures were not justified economically.

The courts considered that the taxpayer’s expenses had been aimed at increasing third parties’ income and had been incurred without a reasonable business purpose. In terms of the economic sense of these operations, Lebedyansky LLC in fact rendered advertising and marketing services free of charge to PepsiCo Holdings LLC. The tax authorities lawfully charged the VAT on these services.

At the same time, the courts took into account that

- it was PepsiCo Holdings LLC that entered into legal relationships with providers of advertising and marketing services while it was acting for Lebedyansky LLC as its management company and a distributor of its goods at the same time and in this capacity had a right to use trademarks and logos of the goods;
- in the audited period PepsiCo Holdings LLC provided services to Lebedyansky LLC to support its marketing function, which involved advertising services;
- the distribution agreement with PepsiCo Holdings LLC and other distributors envisaged that the distributor determined in its sole discretion all activities concerning trade marketing and independently bore all the expenses;

- 99 percent of the total amount of the products sold were sold to legal entities of PepsiCo group;
- an analysis of the taxpayer's revenues from selling products that it had manufactured evidenced that the demand had dropped and the information about income showed that, with respect to the taxpayer's activities, the advertising and marketing services did not contribute to the growth of profitability;
- the distribution agreements were concluded for an extended period and the range of buyers of the manufacturer's products was defined overall, and, based on the concept of advertising, the advertising and marketing services did not influence relationships of the supplier and the distributor and did not keep up their interest in the products.

The court also rejected the taxpayer's argument that the cumulative effect of the intra-group activities had caused no damage to the state budget and tax authorities and the income had been actually redistributed within the holding. The court stated that tax authorities did not check whether PepsiCo Holdings LLC had assessed and paid taxes correctly and were not able to conclude whether that company had booked the disputed advertising and marketing expenses lawfully.

What to think about and what to do

Companies that manufacture goods and work with distributors who are members of the same group of companies should take into account the legal positions applied by tax authorities and courts regarding intra-group advertising and marketing expenses. The position formed may also have a negative influence on those manufacturers of goods who envisaged in their agreements with non-related distributors that it is the distributor at its sole discretion that will bear advertising and marketing expenses.

We recommend that the manufacturers should check terms and conditions of distribution agreements and should compare the functions established in them with the activities the parties actually perform and expenses they incur. In the case of a controlled transaction, such comparison should be performed with details reflected in transfer pricing documents (to find out whether the manufacturer's price covers the relevant functions or not). The practice shows that any inconsistency may be used to justify taxes being assessed additionally.