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New clarifications of the federal tax service on intra-group services: the concept of shareholder activity

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In its Letter No. ShYu-4-13/1749@ dated 12 February 2021, the Russian Federal Tax Service clarified how intra-group services and shareholder activities should be distinguished within MNE groups.

The compensation of expenses on shareholder activity, unlike expenses on services, is not deducted as expenses for tax purposes. This issue, therefore, is one of the key issues in the entire topic of booking intra-group expenses.

1. Dividing two concepts

First of all, the Federal Tax Service repeats the position set out in Letter No. ShYu-4-13/12599@ dated 6 August 2020 that the concepts of 'shareholder activity' and 'intra-group services' should be clearly divided when intra-group expenses are assessed in terms whether they are grounded. The mere fact that a service has been supplied by a shareholder (member) of the taxpayer company does not mean that such activity is shareholder activity.

Although this idea seems obvious, the tax authority still repeats it, justly assuming that some tax inspectors may be unaware of these concepts and unfamiliar with international documents in which they are described. More importantly, the Federal Tax Service agrees and stresses that a company may pay its shareholder for services, with such expenses being recognised for tax purposes. We hope that the tax authorities will leave in the past their approach (which, unfortunately, used to be supported by courts) that a transaction inside the group is lacking economic justification from the outset, because 'everything belongs to the shareholder all the same'.

The Federal Tax Service proposes that the services be separated from advantages and benefits generated by members of a multinational enterprise (MNE) group thanks to the synergistic effect of the MNE group's activity. The services represent a result of 'acknowledged and coordinated actions of a MNE group's members', which is obvious, identifiable and verifiable (i.e. 'may be demonstrated by the taxpayer'). According to the Letter, the 'assessment of this effect may require a deep economic analysis'.

The Federal Tax Service justly points out that such a separation is essential. At the same time, the proposed criterion of the 'acknowledged and coordinated' nature of the actions, as well as their obvious, identifiable and verifiable result, may hardly be viewed as suitable. The first two characteristics disregard the fact that services may be ordered and provided in various forms, including under long-term agreements that do not require the parties to interact with each other on a daily basis. The remaining three essentially represent the requirement for the activity to be verifiable, but they do not define the activity (or service) itself.

It is even more worrying that, on the one hand, the Federal Tax Service requires the services (or the result of the services) to be as transparent, understandable and obvious as possible, but on the other hand, it acknowledges that it is difficult to classify these relationships correctly without a 'deep economic analysis'. However, if this means that tax authorities are required to perform this analysis, and it is regarded as an acceptable way of explaining and confirming the substance of the relationship, then one can only welcome this approach.

2. The characteristics of shareholder activity

The Federal Tax Service names the principal characteristics of shareholder activity:

- it is conducted to address the needs of the shareholders of the group, rather than of individual companies;
- the economic benefit of such activity can be seen at the level of the group or of its business segment in general, rather than at the level of individual local companies;
- companies of the group would not engage independent third parties to provide such services on a fee-paying basis and would not conduct such activities on their own.

Whereas this approach is in line with international practice, it is doubtful that lower-level tax authorities will take it in the right spirit. The general pro-state budget approach and suspicions in relation to any intra-group transactions will prompt an inspector to look for the shareholder's needs and benefits in any type of intra-group service. And he/she will certainly find them. This is especially true given that the Federal Tax Service suggests determining these benefits at the level of a 'business segment' without justifying why an activity generating economic benefit (income) for specific companies forming part of an operational (business) segment is suggested to be treated as shareholder activity by default.

3. List of specific examples

In its new letter the Federal Tax Service sets out examples of shareholder activity, dividing it into activity connected with strategic management of the group (devising a strategy for the development of a MNE group as a whole and in regions, assessing the feasibility of investment projects etc.), and activity relating to business planning and business control (strategic planning and budgeting, preparing consolidated reports, analysis of return of investments etc.). The classification of certain activities proposed by the Federal Tax Service depends on particular circumstances (specifically, their purpose), for instance:

1. developing standards, methods, policies and other internal regulations:

    - if this work is aimed at developing business and boosting the profits of certain companies, these are intra-group services;
    - if the effect of the work extends to all companies of the group (or business segment), this is shareholder activity.

2. A MNE group conducting market research to study the environment and particular features of a market:

    - if the research is performed with respect to goods that are already being manufactured on this market and are sold by a local company, this work is intra-group services;
    - if the purpose is to build a new line of business with respect to the production and sale of the goods in a new jurisdiction, as well as with respect to new products launched on the market, then the work constitutes shareholder activity.

Describing the Federal Tax Service's position not only by concise wording, but also illustrating it by examples is an approach that is in line with international practice, and this often allows for the state authority's position on a certain issue to be understood better. At the same time, it is important for lower-level tax authorities to understand that the below examples are given as an illustration of

possible (but not compulsory) scenarios to help them make a decision under specific circumstances. Given the specifics of local tax offices' work, we would suggest that the Federal Tax Service be more careful with the wording of the examples.

For instance, templates and standards may be developed for all group companies, but be intentional, 'coordinated' and directly instrumental in their generation of income on local markets. Without such standards a subsidiary would probably go to an independent advisor that would provide it with pre-developed templates and methods that it uses for its other clients. Moreover, at the request of the client, an adviser could subsequently oversee how the provided documents are used by the company and give further recommendations. It is obvious that in this situation the tax authority would not have any doubt as to whether the expenses are justly deducted for tax purposes specifically as expenses on services.

In our opinion, the example in which research relating to new products that have not been launched on the market is classified as shareholder activity is also unsuitable. It appears that if a MNE group develops a new product to be subsequently sold by all group companies, such a classification is probably justified. However, if the product, further to the results of research, is launched on the market by a specific local company, then the research is deemed to have been performed in that company's interests, and it therefore should be classified as services.

On the whole, it appears more than questionable that the common ground for separating services from shareholder activity, as may be deduced from the examples given by the Federal Tax Service, consists of such activity being performed either with respect to 'all or the majority of group (business segment) members' (shareholder activity) or with respect to 'specific companies' (intra-group services). If interpreted literally by tax authorities, such an approach may lead to discrimination between taxpayers that are part of groups of companies and acquiring individual services from members of the group for conducting their activities, as compared to taxpayers acquiring similar services from independent third persons.

4. Reclassification of expenses and the risk of their being taxed at source.

The Federal Tax Service notes that if, during an audit, payments to related foreign companies are recognised as the compensation of expenses on shareholder activity, this results not only in such expenses being excluded from the tax base, but also in such payments being possibly reclassified as other types of income based on articles 309 and 310 of the Tax Code.

The Federal Tax Service's position has been expressed rather cautiously. The tax authority does not suggest an unambiguous approach to classifying such expenses, but only points to a possibility of such classification, which should not be arbitrary, but should be based on the specified rules. We hope that this will change the approach of tax inspectorates, frequently seen in practice, that these payments must be regarded and taxed as dividends for the sole reason that they are made within the group and, consequently, there is a direct or indirect interest on the part of shareholders.

What to think about and what to do

The letter attests to the fact that the Federal Tax Service is paying attention to such a complex matter as intra-group services and that it wishes to shift law enforcement practice to another channel that is closer to the international approach. The tax service's desire to set landmarks for both tax authorities and taxpayers is undoubtedly commendable.

At the same time, the principal provisions of documents that are of such importance are better discussed before publication with the business community. This would allow for the wording of documents and examples set out in them to be formulated more precisely and for the risk to be reduced of local tax authorities misinterpreting them.

Companies need to assess the risks stemming from the new clarifications of the Federal Tax Service and to channel their efforts towards shaping a position in the business community that a number of provisions in this letter need to be set out in greater detail.