# Shareholder activity on the radar of the Russian tax authorities

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On 12 February 2021, the Federal Tax Service clarified the rules on the taxation of intragroup services in letter No. ShYu-4-13/1749@* (the "**Letter**"). The Letter defines what constitutes shareholder activity. It also gives specific criteria for distinguishing such activity from the provision of intragroup services within a multinational group of companies (the "**MGC**").

**Qualification of shareholder activity**

According to the Letter, as well as previously issued clarifications of the Russian tax authorities on the matter, when assessing the economic justification of the intragroup services rendered within an MGC for tax deductibility purposes, the tax authority should primarily distinguish these services from shareholder activity.

Shareholder activity is driven by the need of the beneficial owners of the MGC to control their investments in the subsidiaries and to ensure that the MGC meets its objectives (e.g. increasing its business income and mitigating risk), including through strategic management and planning activities.

Shareholder activity may be aimed at an MGC as a whole or at specific operational (i.e. business) segments forming an MGC.

Such shareholder activity may be performed either by an MGC's ultimate parent entity or any other company part of an MGC duly authorised to conduct such shareholder activity. However, the mere fact that the analysed services are rendered by a shareholder of a company benefiting from such services should not automatically result in their qualification as shareholder activity.

The Letter specifies the following qualifying criteria of shareholder activity:

- Shareholder activity is driven by the economic needs of the shareholders and not of the separate participants in an MGC.
- Such activity benefits an MGC as a whole (or the operational (i.e. business) segments of an MGC) and not to its separate participants.
- If the MGC participants could choose their counterparty for particular services, they would not acquire similar services from third parties, nor would they perform such an activity independently.

The Federal Tax Service also claims that the results of intragroup services provision should be distinguished from the synergetic positive economic outcome of an MGC's activity that may benefit its separate participants. A Russian taxpayer benefitting from such services and wanting to ensure their tax deductibility should conduct an in-depth economic analysis and make additional efforts to distinguish these two categories.

**Examples of shareholder activity**

The Letter contains practical examples of what functions should qualify as fulfilment of shareholder activity, including the following:

- elaborating a development strategy for the MGC (or its operational (i.e. business) segments and/or regions where it is present);
- conducting a market search or analysis for the planned business activity.

  The Letter specifies that the MGC's marketing expenses associated with the activity that is already carried out by a local entity belonging to the MGC (e.g. related to the sale of goods by this entity) may be recognised locally by the entity concerned. However, marketing expenses associated with new lines of activity and/or goods that are not yet present on the local market should instead qualify as an MGC's costs;
- strategic planning and budgeting;
- preparing consolidated financial or management accounting reports;

- analysing the investments made by an MGC;
- controlling an MGC's financial and economic activities, including performing internal audit and control functions, monitoring whether the reporting forms correspond to the requirements set by a shareholder, ensuring compliance with applicable legislation in the country where the shareholder is present and controlling whether the MGC participants meet the requirements of the Russian or foreign stock exchange (when listed at such a stock exchange);
- organising an MGC's financing in terms of interaction with financial institutions, ranking assignment, reducing the MGC's external financing cost, its efficient use of available funds and ensuring the financial security of an MGC.

  At the same time, the core commercial activity of a financial group (i.e. banking, insurance and investment banking) should be considered when assessing the shareholders' role in such activities;
- elaborating group standards, methodologies, policies or other internal documents, other than those aimed at the development of commercial activity and a revenue increase of a specific company that is part of an MGC;
- implementing and controlling such standards, methodologies, policies or other internal documents;
- approving significant decisions and transactions, including investment programmes, that do not relate to the on-going activities of an MGC's participants.

**Tax treatment of shareholders' costs**

The Letter states that Russian shareholders can deduct the costs they incurred in their shareholder activity for taxation purposes in Russia, provided that these costs are properly documented and economically justified according to Russian law requirements. In turn, Russian taxpayers belonging to an international MGC should not compensate the costs of foreign shareholders associated with the conduct of a shareholding activity. If such compensation takes place, not only will the corresponding costs not be deductible for Russian taxpayers, but tax authorities auditing the respective cross-border payments should consider the possibility of qualifying such payments as distribution of a passive income, subject to a withholding taxation in Russia.

**Comments**

On one hand, the Letter clarifies the approach of Russian tax authorities when determining shareholder activity and contains guidelines for local inspectorates to develop a unified and consistent approach to auditing intragroup services, which is compliant with international practices.

On the other hand, the Letter contains several vague and general statements. Consequently, regional tax authorities have room for a wide interpretation of shareholder activity qualification criteria. As a result, economically justified costs could be non-deductible on a formal basis.

For example, in certain cases, the MGC may offer to its participants unique knowledge and services associated with an activity of the MGC that cannot be reasonably acquired from any third parties acting on the market.

In addition, more generally taxpayers will likely face an additional administrative burden because they need to prove the economic justification behind acquiring the services of an MGC rather than third-party suppliers.

The Letter also expressly disallows deductibility of the costs associated with planned (and not on-going) business activities of an MGC. However, in practice, such planned activities may ultimately benefit particular local markets and entities operating on such markets (e.g. in case of a launch of specific localised products).

More importantly, the Russian tax authorities' formal approach in the Letter could in many cases contradict the international practice of cost reinvoicing in the MGC. This would in fact result in double taxation for the group (since the foreign service providers will be recognising the income derived from the provision of services that cannot be deducted by Russian taxpayers).

Interestingly, the Letter remains silent as to whether it is possible to use flat allocation keys in terms of intragroup services provisions, although Russian taxpayers requested such clarifications many times. So this remains a risky area in Russia.

**Take action**

The Letter demonstrates that Russian tax authorities are increasingly scrutinising the deductibility of intragroup services costs and, in particular, those acquired from foreign group companies. Thus, if Russian taxpayers incur these expenses, they run the risk of additional tax accruals resulting both from non-deductibility of such costs for tax purposes and potential withholding tax application to the cross-border settlement of the invoices issued by the MGC, together with the corresponding fines and late payment interest that will be accrued by tax authorities

revealing tax underpayments in case of a tax audit.

This being said, it is highly recommended that Russian taxpayers benefitting from such cross-border intragroup services review and reconsider the scope of the services rendered, bearing in mind that they could be requalified as shareholder activity according to the Letter.

Particular attention should be paid to the proper description of such services in the formalising documentation issued both between the parties to the service agreement and internally by the local taxpayers (e.g. describing the economic need of the taxpayer in such services and reasons behind acquiring such services from the MGC members rather than third-party providers).

We also recommend assessing the risk of requalification of such services (wholly or partly) as distribution of passive income. This may be a negotiation point between the Russian taxpayer and its MGC when defining the scope and nature of costs reinvoiced locally, as well as their formalisation and treatment at group level.

For more information on this eAlert, please contact CMS Russia experts **Dominique Tissot**, **Maria Kabanova**, **Anna Osmakova** or your regular contact at CMS Russia.

** In Russian*

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