

# Federal Tax Service of Russia explains the approaches to be applied to check the reasonableness of expenses for intra-group services

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## What happened?

On 6 August 2020, the Russian Federal Tax Service (**hereinafter, the "FTS"**) issued [Letter](#) No. SHU-4-13/12599@ "On Certain Issues of Taxation of Intra-Group Services" (**hereinafter the "Letter"**), in which it clarifies to the lower tax authorities how to check expenses on intra-group services, in terms of their economic justification and the sufficiency of supporting documentation.

The tax authorities often challenge expenses on intra-group services provided by foreign (non-Russian) Group companies, since they consider such payments to be a mechanism to repatriate profits in favour of the headquarters of multinational enterprises (**hereinafter, "MNE"**).

The tax authorities have no unified approach to checking intra-group services, in particular as regards the following:

- identifying the subject of field (desk) tax audits and transfer pricing audits, i.e. what a field audit may check as regards the services remuneration based on the costs of the provider;
- what evidence in supporting documentation is sufficient to confirm the receipt of services, their type and scope, and the economic benefits received from the consumption of the services;
- where the distinction lies between the terms "shareholder activity" and "management and consulting services";
- the substitution of the terms "indirect-charge method for determining the cost of services" and "reallocation of expenses within the MNE" is inadmissible.

Court practice on cross-border intercompany service charges is primarily negative for taxpayers.

Therefore, such clarifications were highly awaited, and the Letter **partially comments on the above issues**:

1. The FTS recognised that intra-group services may include **regular (ongoing) administrative support**, as well as financial, legal, human resources, internal control, internal audit, manufacturing and sales, IT and other services. The FTS confirms that for some types of services (depending on the essence) **requests from the service recipient for each item of advice are not required, and the need for such services may be proved by other documents**.
2. When requesting documents, the tax authorities should use the principle **of reasonable correlation between the volume of requested documents and the volume of services provided**. At the same time, **the list of possible supporting documents is not exhaustive**.
3. The FTS guides the tax authorities **to avoid taking a formal approach** when assessing the economic justification and sufficiency of supporting documentation as evidence.
4. The FTS states that **a check of the level** of prices should not be part of field and desk tax audits.

However, the FTS states that the field (desk) tax audit should examine documents related to the procedure used to determine the fees for services, and assess whether a transparent pricing methodology is being ensured.

The key question of the feasibility of the indirect-charge method as the basis for the services fee remains unanswered. The FTS states that applying the procedure of determining the price based on the total costs of the provider plus mark-up is standard practice, and may not be considered per se as the reallocation of incomes and losses between MNE companies or serve as the sole independent grounds for declaring corresponding expenses to be unjustified. However, the FTS does not comment on whether such a procedure for determining the cost “costs plus mark-up” is possible for the “indirect-charge method” that is applied extensively in practice, when the aggregate amount of the service provider’s costs incurred on the delivery of the services to all recipients is determined, and when the cost of the services for a particular recipient is determined based on this aggregate “pool” of expenses and allocation keys.

The FTS clarifies that the tax authorities should during tax audits check the following five criteria in this order:

1. **Services were actually rendered,**
2. **There was no duplication** of expenses for identical services,
3. **The services have economic or commercial value** to enhance and maintain the commercial position of the taxpayer,
4. **The expenses** declared by the taxpayer **do not constitute compensation for expenses on shareholder activity**, and
5. **There is a transparent pricing methodology** that is identical throughout the MNE, even though the actual expenses and assessment of the arm’s length price in the transaction are not the subject of the field (desk) tax audits.

## We summarise here the key clarifications of the FTS on each criterion:

### Services were actually rendered

#### 1. Services may assume various forms, *inter alia*:

- rendered on the basis of requests for a specific service;
- in the form of access to services for a pre-established fee;
- through the provision of resources not at the disposal of the Russian entity,
- the service may consist of the assignment and transfer by the Russian entity of some of the functions and/or support of some of the processes to one or more foreign participants of the MNE

It is important to note here that the FTS draws attention to the lack of any need for formalised requests for each individual service. Documents can be submitted which show that the receipt of the service was expected (for example, an internal policy of interaction containing a description of the actions of the service provider

The lack of a detailed description of the services in acts does not serve as confirmation that the services were not rendered, but does serve as grounds for requesting relevant explanations and documents from the taxpayer. However, there is no exhaustive list of the possible items of supporting evidence to confirm the actual rendering of the services. The FTS gives examples, including:

- business correspondence,
- details of phone calls, the minutes of meetings,
- business memos and certificates,
- timesheets,
- reports on the services rendered, including a breakdown of the services with a description of the counterparty’s actions,

	<ul style="list-style-type: none"> <li>— presentations,</li> <li>— printouts from internal electronic systems, printouts of the electronic calendar, computer screenshots.</li> </ul> <p>The tax authorities should take account of other evidence, for example, deliverables, <b>witness statements</b>, travel orders, timesheets, reconciliation reports.</p> <p>The taxpayer has the right to submit documents prepared, <i>inter alia</i>, in accordance <b>with the usual business practices applicable in a foreign country</b>, and also to substantiate <b>the need to conclude the transactions</b> in the selected form and <b>the need to engage foreign companies</b> in the taxpayer's processes.</p>
<p><b>No duplication</b></p>	<p>The FTS understands duplication to mean costs on identical services paid to several service providers. The tax authorities should analyse the functionality, experience and competencies derived by the taxpayer.</p>
<p><b>Existence of economic (commercial) value</b></p>	<p>Citing <b>OECD documents</b> (<a href="#">final report on actions BEPS 8-10</a>), the FTS states that economic or commercial value where the goal is to improve or support the business situation of a Russian company (i.e. whether the entity is ready to pay an independent party for similar services on comparable terms or engage in this activity using its own resources) is assessed with due account of the following principles:</p> <ul style="list-style-type: none"> <li>— it is necessary to gain assurance that <b>the service deliverables are used</b> in the taxpayer's business activity;</li> <li>— the existence of a benefit is assessed by considering circumstances that attest to the entity's intention to obtain a positive economic effect. However, the <b>negative financial result of a service may not serve as the only grounds</b> for declaring expenses to be unjustified;</li> <li>— if the service deliverables were not used for objective reasons, this also does not indicate that the expenses were unjustified;</li> <li>— in order to assess the reasonableness of the acquisition of certain services, due attention may be paid to the extent to which such services are acquired by other entities <b>of the same industry from independent parties</b>.</li> </ul>
<p><b>No signs of shareholder activity</b></p>	<p>Shareholder activity is due to the need for MNE owners to control their investments in subsidiaries and is carried out in respect of such companies <b>solely by virtue of the fact that they are part of the same MNE</b>. This shareholder activity takes place even though the companies in the MNE are not ready to pay an independent party for such activity or engage in such activity using their own resources.</p> <p>Shareholder activity includes, for example:</p> <ul style="list-style-type: none"> <li>— the receipt of information on the activity of a company that is a participant of the MNE;</li> <li>— participation in the distribution of profits;</li> <li>— participation in the general meeting of shareholders, exercise of the right to receive dividends;</li> <li>— activity aimed at ensuring compliance by other group companies with the laws of other countries (<b>including audits and the preparation of consolidated financial statements</b>);</li> <li>— the purchase of shares/participation interests (including <b>expenses related to the relations of the parent company with investors</b>);</li> <li>— compliance by other group companies (including the direct shareholder of a Russian entity) with <b>the requirements of a foreign stock exchange</b>; and also any support activity related to the corporate governance of the MNE.</li> </ul> <p>The FTS focuses in particular on interaction involving <b>the provision of global policies, strategies, and standards</b> and instructs the tax authorities to examine them in terms of whether they are <b>an attribute of affiliation with the MNE</b> or represent a targeted measurable product affecting the development of business activity and the profitability of the Russian entity.</p>

## Transparent pricing methodology

The FTS states that **the factor of price, the mechanism and principle for determining the price, constitutes an integral characteristic of the service itself.**

The tax authorities should check:

- whether there is a transparent methodology use to determine the cost of the service,
- whether this methodology is applied consistently throughout the MNE,
- whether the service provider included the costs of the Russian company on the services in income for profits tax purposes under the legislation of a foreign country.

At the same time, the amount of the expenses of the service provider should not be assessed.

Taxpayers are also entitled to submit **transfer pricing documentation** or certain components of such documentation. In addition, we believe that the information may be obtained from the **Master File of the MNE**. In connection with this fact, it is advisable to check not only the existence of a transparent methodology used to form the cost of services, **but also the consistency of its description in both the Master File and the TP documentation (Local File).**

Given that the FTS highlights the importance of functional analysis when confirming the commercial value of a service, and also the criterion as to whether the entity would be prepared to pay an independent party for similar services on comparable terms or engage in this activity using its own resources, **one option for supporting documentation might be to supplement the TP documentation with a description of the commercial and economic benefits derived from the receipt of the services ("benefit test").**

**It is important to note** that the FTS states that applying the procedure of determining the price **based on the total costs of the service provider's expenses plus mark-up** is standard business practice and **may not be considered per se as the reallocation of incomes and losses between MNE companies** or serve as the **sole independent grounds** for declaring corresponding expenses to be unjustified.

However, the FTS has not directly commented on the indirect-charge method that is applied extensively in practice when the **aggregate amount** of the service provider's costs incurred on the delivery of the services to **all recipients** is determined, and when the cost of services to a particular recipient is determined based on this aggregate "pool" of expenses and allocation keys.

In addition, unlike the OECD Guidelines, **the FTS has not specified the acceptable level of such a surcharge (mark-up).**

## What should you do?

These recommendations of the FTS give some hope that the methods to check cross-border intra-group services charges and the approaches to challenging them will become less formal and more justified.

However, it is already clear that the tax audits will be detailed, and the process for justifying the expenses will not be easy for taxpayers.

## We recommend:

1. Analysing existing service agreements to determine whether they need to be amended, taking into account the Letter (for example, outlining the process of requesting the services).
2. Collecting a convincing **defence file** to confirm the receipt of services, their use in the company's operations, their value for the recipient, and the absence of duplication of costs. We also recommend including a "benefit test" in transfer pricing documentation.
3. Justifying the services remuneration structure (the methodology for calculating the cost of the services provider and allocation keys) and the proving the absence of "allocation" of the shareholders' costs.
4. Preparing for the potential questioning of employees and former employees regarding the services received.
5. Considering application of the mutual agreement procedure in accordance with double tax treaties if expenses are challenged.

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