The Business Purpose Test in Russian Jurisprudence

This article analyses the origins of the business purpose test worldwide and how the principle has been implemented in Russia by way of the most recent court decisions.

1. Introduction

Russian tax law is relatively new and, as such, contains inconsistencies and loopholes. Court precedents, therefore, have a key role to play in determining Russian tax rules. In particular, Russian courts determine anti-avoidance rules, as the tax statutes are almost silent on this issue. However, from 2006 onwards, a business purpose test has become a major aspect of Russian anti-avoidance practice.

2. The Origins of the Business Purpose Test

The business purpose test is derived from the United States. In Gregory v. Helvering (1935),1 the US Supreme Court held that a tax-motivated transaction should have a business purpose.2 The Supreme Court has confirmed this approach in numerous later decisions.3

The business purpose test is treated as a part of the economic substance test, which argues that a court should disregard a tax benefit where a transaction giving rise to that benefit does not change the taxpayer’s economic position.4 The economic substance doctrine implies a two-stage test:5

(1) an objective economic substance test: a court should assess the financial and economic result of the transaction, i.e. its potential for a non-tax change in the taxpayer’s economic position; and

(2) a subjective business purpose test: a court should examine a taxpayer’s motives for engaging in the transaction, i.e. what non-tax objectives the taxpayer wished to achieve, for example, financing, winning new markets, branding, etc.

There was a difference of opinion as to whether both or either of the tests should be met for a transaction to be respected. In some cases, US courts held that any of the tests (a conjunctive test) could justify a transaction.6 In other cases, the courts respected the transaction only if both tests (a conjunctive test) were met.7 A unitary test was also applied.8

In March 2010, the economic substance doctrine was incorporated into US law. According to amended section 7701(o) of the US Internal Revenue Code (IRC), a transaction has economic substance if: (1) it results in any substantial change in economic position of the taxpayer; and (2) the taxpayer has a substantial purpose (apart from receiving a tax benefit). Section 7701(o) of IRC also states that both tests should be met (a conjunctive test). Accordingly, in United States, a business purpose is part of the economic substance doctrine that tests the subjective motives of a taxpayer in ascertaining the non-tax benefits of a transaction.

3. Business Purpose

3.1. Europe and the European Union

In Europe in general, the business purpose test has encountered difficulties, as, initially, European courts decided to treat a tax benefit as a valid purpose for a transaction. In Duke of Westminster (1936),9 the UK House of Lords stated that the legal form should prevail over the substance and supported the taxpayer in his strategy to reduce tax by dividing salary into two parts, one of which reduced the tax due. Although the operation in this case was wholly tax-driven, the court agreed with the taxpayer. In Brepols (1961),10 the Court of Cassation of Belgium held that there is no tax fraud where, in order to benefit from a more favourable tax treatment without violating any legal obligations, the parties entered into acts in respect of which they accept all the consequences. This was confirmed in Au Vieux Saint-Martin (1990),11 where the court held in favour of a taxpayer that had entered into...
the transaction with the sole purpose of reducing the tax due.12

Currently, most Member States of the European Union try to counter tax-driven transactions. In United Kingdom, the legal form over substance principle was revised. Specifically, in Furniss v. Dawson (1984),13 the House of Lords held that, where a transaction has pre-arranged artificial steps which serve no commercial purpose other than to save tax, the proper approach is to tax the effect of the transaction as a whole.

The business purpose was supported by the European Court of Justice (ECJ). In Halifax and Others v. Commissioners of Customs & Excise (Case C-255/02),14 the ECJ held that an abusive practice existed if an essential objective of a transaction is to obtain a tax advantage. However, business purpose cannot restrict the application of the freedom of establishment and freedom to provide cross-border services.15 In Cadbury Schweppes v. Commissioners of Inland Revenue (Case C-196/04),16 the ECJ held that the fact that a company was established in a Member State for the purpose of benefiting from more favourable legislation did not, in itself, constitute abuse of the freedom of establishment. The only criterion to disregard a low-tax company would be an objective test, i.e. where the company constituted a wholly artificial arrangement.17

3.2. Russia

The right of a taxpayer with regard to tax planning was confirmed by the Russian Constitutional Court in 2003.18 However, following this decision, there were a number of tax cases with negative outcomes for taxpayers trying to use tax-saving transactions. Accordingly, there was a need for clear criteria to distinguish acceptable from unacceptable tax planning. Russian tax statutes do not contain explicit anti-abuse rules.19 In response to this, the Russian courts started to introduce the business purpose test as the most convenient way to distinguish between acceptable and unacceptable tax planning.

The business purpose test appears for first time in 2004 in a letter of the Russian Supreme Arbitrage Court (SAC),20 where the SAC held that the good faith of a taxpayer should be ascertained by analysing the taxpayer’s transactions, in particular, in those cases where the transactions do not have a reasonable business purpose. However, the SAC’s letter neither clarified the meaning of the reasonable business purpose test nor provided any criteria in respect of this principle.

The doctrine was considered later in Resolution No. 53 of the SAC.21 According to paragraphs 3 and 9 of Resolution No. 53, a tax advantage may not be the sole or essential purpose of the transaction. Resolution No. 53 states that the requirements of a motive test should also be met and whether or not the transaction has a business purpose is based on the taxpayer’s motives in realizing non-taxable profits.

Resolution No. 53 does not clearly refer to the objective test. However, the objective test was introduced by the Russian Constitutional Court, which held that the transaction should have the potential to realize non-tax prof-

its.22 In the meantime, the Constitutional Court has also stated that losses should not be disregarded with regard to the transaction, as there is always a risk of an adverse outcome in respect of a business activity.

Russian scholars treat the business purpose test as consisting of both subjective and objective parts. In particular, Pepeliaev (2008) states that the business purpose test may have any of the following three aspects: (1) economic – the objective of the transaction to achieve business outcome; (2) financial – profits to be derived from the transaction; or (3) legal – statutory limitations affecting business structure. A transaction must be respected should any of these tests be satisfied.23

Although the business purpose has been applied in numerous cases, there are two types of cases that demonstrate the SAC’s approach in applying the business purpose test. These are outsourcing (see section 4.) and intellectual property (IP) structuring cases (see section 5.).

4. Outsourcing

4.1. In general

Outsourcing is popular in Russia, partially due to the associated tax benefits (social contribution exemptions). A typical structure is as follows. The beneficiary is a medium-sized company (with over 100 employees) paying social contributions at the highest rates. According to Russian tax law, a number of taxpayers can be exempt or may apply low rates of social contributions, for example, socially-oriented companies and companies employing no more than 100 employees. In the light of these exemptions, the beneficiary establishes several controlled companies (CCs) with a reduced tax burden (the “simplified tax regime”). The beneficiary’s employees are hired by the CCs (the labour contracts with the beneficiary are terminated and new labour contracts with the CCs are concluded, but the employees continue to fulfil similar duties).24

Therefore, the CCs incur no social contributions and pay a reduced tax rate (in the case of a reduced tax burden, the tax regime is “simplified”). To enhance the tax advantage, the CCs can be established in tax havens (tax havens are non-resident companies established in a tax haven and used for tax optimization).25

According to Resolution No. 53, the purpose of social contribution exemptions is to provide tax advantages. In the case of CCs, tax advantages cannot be achieved. However, the Constitutional Court has stated that losses should not be disregarded with regard to the transaction, as there is always a risk of an adverse outcome in respect of a business activity.

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12. For further details, see, D. Garabedian, Belgian Report, in Form and substance in tax law, Cahier de droit fiscal international Vol. LXXXVIIa pp. 153-173 (Kluwer Law International 2002), Online Bks. IBFD.
14. UK: ECJ, 21 Feb. 2006, Case C-225/02, Halifax plc, Leeds Permanent Development Services Ltd, County Wide Property Investments Ltd v. Commissioners of Customs & Excise, ECJ Case L. IBFD.
16. UK: ECJ, 12 Sept. 2006, Case C-196/04, Cadbury Schweppes plc & Cadbury Schweppes Overseas Ltd v. Commissioners of Inland Revenue, ECJ Case L. IBFD.
19. Though RU: Tax Code, Natl. Legis. IBFD provides a specific example for applying the business purpose test, i.e. where the reorganization of a taxpayer (in the form of a split-up) results in the separated company not paying tax, for example, due to a lack of funds, the tax due should be paid by other companies engaged in the reorganization (art. 30 Tax Code).
22. RU: RCC, 4 June 2007, No. 320-O-P.
functions). The CCs provide outsourcing services to the beneficiary under the outsourcing contract. As the CCs pay reduced social taxes, the overall social contribution burden is reduced.

In 2009/10, such outsourcing structures were targeted by the tax authorities. The SAC issued several rulings regarding such cases, most in favour of the tax authorities.24 Specifically, the SAC held that CCs lacked a valid business purpose, as the sole purpose of their establishment was to reduce the social contributions due.

As follows from the SAC’s position, tax assessment was based on the subjective business purpose test, i.e. the taxpayer (the beneficiary) had created the CCs with the sole purpose of avoiding social contribution payments. In this regard, the SAC referred to the following tax-motivated facts:
- the beneficiary had full control over the CCs;
- the beneficiary was the only purchaser of the outsourcing services and the CCs did not have business activity apart from the relations with the beneficiary; and
- the employees were transferred from the beneficiary to CCs only on paper, as the functions of the employees did not change after the transfer and CCs did not hire their own staff, i.e. the CCs were artificial.

The SAC did not make use of the objective economic substance test, in particular, as to whether or not the CCs and outsourcing services change the economic position of the beneficiary. The clear tax-driven nature of the CCs in themselves was sufficient to disallow the tax benefit.

There are, however, outsourcing cases with a positive outcome for taxpayers. The SAC has held in favour of the taxpayer if the CC can demonstrate that it has own business activity, for example, hires personnel, provides services to third parties, etc.25 In such circumstances, the SAC typically uses, inter alia, the objective economic substance test to support the taxpayer and to demonstrate that the CCs change the taxpayer’s economic position.

4.2. Corresponding functions

Other outsourcing-related cases concern corresponding functions. The taxpayer, in these cases, purchases outsourcing services, whilst having its own (in-house) personnel with similar functions, for example, the company has an in-house lawyer, but purchases legal services to support a dispute. Should this be the case, there it is likely that the tax authorities will disallow outsourcing fees, as there is no business purpose for the fees paid given that the taxpayer has staff who can fulfil this function.

In contrast to other outsourcing cases, in these cases, the courts generally find in favour of the taxpayer. In particular, the SAC has held that the existence of in-house personnel does not in itself demonstrate a lack of a valid purpose to acquire services from third parties. The SAC also stated that the provider may have more appropriate experience and skills to deal with a business problem and to fulfil that task.26 Notably, the argument of the tax authorities that the in-house lawyer had over 53 years experience was rejected by the court.

5. IP Structuring

IP rights that are subject to tax risk in Russia have the following structure. A foreign company (ForCo) with IP transfers the IP to a related Russian distributor (RusCo1) under a licence, for example, a royalty of RUR 1. RusCo1 engages another related Russian company (RusCo2) with necessary equipment and tools to produce the goods. In some cases, RusCo1 transfers the IP rights to RusCo2 based on the sub-licence agreement, for example, for a royalty of RUR 0.1, so that RusCo2 produces the goods under the control of the sub-licensor. Once the goods are produced, RusCo2 sells them to RusCo1, which distributes the goods in Russia.

The Russian tax authorities disallowed a royalty deduction by RusCo1 for profits tax and VAT purposes, as RusCo1 lacked a valid business purpose in acquiring the licence from ForCo. The IP rights were used by RusCo2, as it produced the goods and introduced them into the Russian market (by selling the goods to RusCo1). Once the goods had been introduced into the Russian market, RusCo1 did not require IP protection and, therefore, did not need to make royalty payments to ForCo.

This type of case has been considered by the SAC on several occasions, including SABMiller (2011).27 However, previously, the SAC’s position had been different, in particular, as demonstrated in TransMark (2007),28 in which the SAC held that RusCo1 lacked a business purpose in respect of the royalties paid to ForCo, as, after the sale of the goods from RusCo2 to RusCo1, the goods were introduced into the Russian market and, as such, no longer required IP protection.

However, in 2008, the SAC revised its position. In TransMark (2008),29 the SAC held that RusCo1 as a distributor should be treated as a beneficiary of the structure. In this respect, separating distribution and production functions is a normal business practice, whilst it is the distributor and not the producer that requires IP protection in distributing the goods and, as such, should bear the burden of the royalty payments.

The same position was adopted by the SAC in SABMiller, Grundfos (2010)30 and JTI (2010).31 Grundfos and JTI differ from TransMark as a result of the business structure adopted. In particular, in Grundfos, RusCo1 and RusCo2 did not have a sub-licence agreement, i.e. RusCo1 placed an order to produce goods with RusCo2 under a supply agreement.

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contract. RusCo1, therefore, controlled the production of the goods. In this case, the courts held that any person, and not only the licensee, could produce goods under the order and control the licensee.

In JTI, RusCo1 placed order with RusCo2 to produce goods under a processing contract. Accordingly, when RusCo2 transferred the goods to RusCo1, the tax authorities could hardly demonstrate that RusCo2 had introduced the goods into the Russian market, i.e. RusCo1 held the title to the goods during the whole process of their production. RusCo1 also controlled the production of the goods, including their image and the quality of the goods and, therefore, RusCo1 was the holder of licence at the production stage.

The SAC stated that separating distribution from production functions should have a business purpose, as the distributor has the key function in marketing and selling. In addition, in JTI, the SAC held that, irrespective of what contract was concluded with the producer (supply or processing), it is essential to clarify who requires the licence for distributing goods, control and receives the proceeds from selling the goods.

6. Conclusions

The recent tax cases considered in this article reveal that Russian courts tend to apply the US model of business purpose. This, in turn, implies that both the motive and objective of the business purpose tests should be used to justify transactions for tax purposes.