

Business “splitting” as a way for business entity to retain its leading positions on the market

Olga Averyanova

Department of Law

Saint Petersburg State University of Economics

21 Sadovaya ulitsa, 191023 Saint Petersburg

Russian Federation

e-mail: olin83@mail.ru

Evgeniya Alekseeva

Department of Law

Saint Petersburg State University of Economics

21 Sadovaya ulitsa, 191023 Saint Petersburg

Russian Federation

e-mail: jenn08@mail.ru

Iuliia Litvinova

Department of Law

Pushkin Leningrad State University

Peterburzhskoye shosse 10, 196605 Pushkin

Russian Federation

e-mail: jul-ltv@mail.ru

Abstract Our paper addresses the issue of mapping the problems and gaps in the sphere of legal regulation of large business activity with leading market position retained through the use of controversial corporate technologies. In particular, we study and analyse the structural construction of features and characteristics of the actions of the participants of the business division scheme aimed at tax evasion. The paper uses some practical examples from the Russian legislation as well as the analysis of the current situation on the Russian market.

Our results yield that special payment forms and conditions indicating the consistency of the group's actions due to reasonable economic or other purposes (commercial purposes) might be helpful for business entities to retain their leading positions on the market.

1 Introduction

When considering the issue of a hypothetical entrepreneur engaged into a sustainable market niche (see e.g. Olugbola 2017), as well as finding the ways to improve legal regulation of business activity, in particular, building a platform for creating numerous business associations, one cannot but pay their attention to such an indicative phenomenon of the modern Russian economy as business “splitting” (see e.g. Huber and Wörgötter 1998; or De Vries et al. 2005; or Andreeva 2012).

An overview of entrepreneurial, tax and court practice, as well as of scientific sources, indicates that it is not quite unusual when the founders (or members) of collective business entities (in this case, legal entities or associations interacting through a holding scheme) introduce a subject or several entities (for example, individual entrepreneur or limited liability company (called “OOO” in Russian)), thus conducting similar (and sometimes analogous) business activity at the economic space or at the same or different markets.

The circumstances described above might lead to the emergence of reasonable fears expressed by the responsible tax authorities that might suspect that the emergence of new entities might be simply the way for the tax base understatement by applying unreasonable tax benefits and maintaining powerful leading positions in the market (Sikka 2017). This might become a serious issue and a basis for disputes between business companies and the authorities. Additionally, it might undermine the leading position of a successful company that is undergoing a split for various reasons.

This paper analyses the nature and the effects of business “splitting” using some practical examples and calling up to legislative framework. We introduce the concept of “splitting” first. Then, we analyse the law enforcement practice and make some valuable conclusions and implications both for the Russian business market and for the companies in other countries with a notion of how the leading position might be retained using these techniques and approaches.

2 The concept of business “splitting”

The concept of business “splitting” in the Russian legislation is absent. However, the Federal Tax Service of the Russian Federation (hereinafter – Federal Tax Service) has issued the Letter dated August 11, 2017 No. CA-4-7/15895@ (see Ministry of Finance 2017), that contains the analysis of court practice related to the finding on unreasonable tax benefits through formal separation (splitting) of the business and artificial distribution of revenue from the activities carried out between controlled affiliated entities. This document defines general character of actions uniformity between the participants in a business splitting scheme aimed at avoiding tax duty.

For example, within the framework of tax control measures, designees and authorities establish the facts of taxpayers reducing their tax liabilities by creating an artificial situation in which the activity semblance made by several members sugar coats the real activities of one taxpayer. At the same time, unjustified tax benefit can be gained as a result of the private law instruments use that does not formally violate the law.

Figure 1 that follows specifies the management and legal processes in a typical firm from the point of view of its management as well as its employees caused by firm “splitting”.

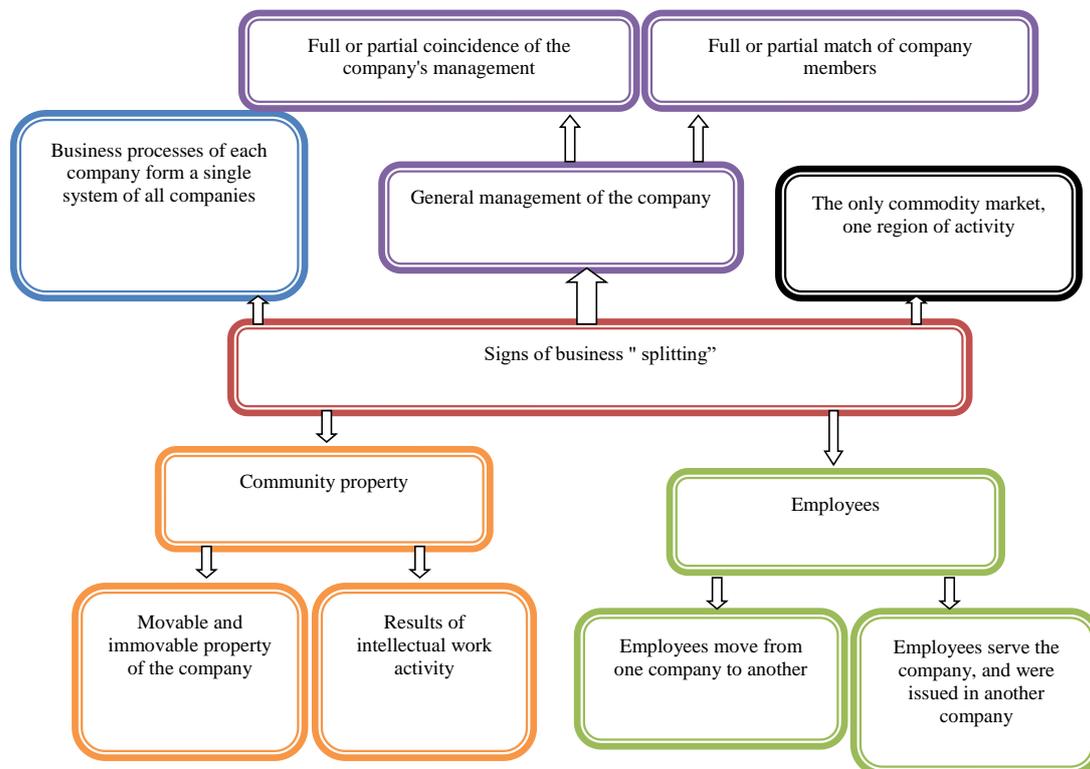


Fig.1. Management and legal processes in a firm caused by “splitting”

Source: Own results

The FTS of Russia highlights paragraphs 3 and 5 of the Resolution signed by the Plenum of the Higher Arbitration Court of the Russian Federation (hereinafter referred to as the Higher Arbitration Court of the Russian Federation) of October 12, 2006 № 53 “On Arbitration Assessment of Reasonableness of Tax Benefits Received by the Taxpayer” (Higher Arbitration Court of the Russian Federation 2006), which states that the tax benefit can be recognized as unreasonable, given the cases when, for tax purposes, transactions are not taken into account in accordance with their real business sense, or the ones that are not grounded by reasonable economic or other aims and goals of business nature.

Upon special payment forms and terms indicating the group consistency in performance, the court needs to investigate whether they are done due to reasonable economic or other purposes (business objectives).

The Constitutional Court of the Russian Federation in the Decision of July 4, 2017 No. 1440-O “On Refusal to Accept for Hearing the Claim by Buneyev on Violation of His Constitutional Rights Stated in the Provisions of Articles 146, 153, 154, 247-249 and 274 of the Tax Code of the Russian Federation” (Constitutional Court of the Russian Federation 2017) has concluded that within the tax legal relations tax legislation does not exclude disposition principle and allows the taxpayer to choose one or another accounting

policy method (use or refuse of tax benefits, implementation of special tax regimes, etc.), which, however, should not be exploited to inappropriate cuts of tax revenues to the budget caused by taxpayers' excesses.

In this Decision the Constitutional Court of the Russian Federation has noted that in cases of maintaining the tax imposition purposes, the transactions that have not been considered in line with their real economic essence or the operations not defined by any economic or other reasons (business objectives or, as in our case, leading positions in the market), but have been taken into account – this implies an additional charge of taxes and fees payable to the budget as if the taxpayer did not abuse the right, given the relevant provisions of the Tax Code of the Russian Federation (hereinafter – Tax Code), regulating the procedure of calculating and paying a specific tax and charges.

The Constitutional Court of the Russian Federation has emphasized that the provisions of the Tax Code of the Russian Federation, which determine the object of taxation and tax base for the value added tax (VAT) and corporate income tax, do not allow the taxpayer to charge additional taxes in an amount greater than the one established by the law, since they are able independently identify the amount of tax liability relying on actual indicators of the taxpayer's business activities.

3 The law enforcement practice

The law enforcement practice (Federal Arbitration Court 2009; Federal Arbitration Court 2011; Prime Arbitration Court of Appeal 2011; Arbitration Court of Volgo-Vyatskiy Okrug 2016) brings the light on the fact that one of the reasons for the courts to conclude that the taxpayer receives unreasonable tax benefit may be maintaining the formal activities by one of the participants in the business splitting scheme using simplified tax system (STS) or pays a uniform tax on imputed income (UTII), concerning the evidence of controllability and consistency of their actions with the ones performed by the members, carrying out real business activities.

The Letter of the Federal Tax Service of Russia dated on August 11, 2017 No. SA-4-7 / 15895 @, articulates common criteria highlighting that the participants in the business splitting schemes are consistent in their actions to avoid tax obligations. It is important to note the fact that the Federal Tax Service of Russia has concluded on no comprehensive or strictly imperative list of signs indicating the validity of tax authority's conclusions on the formality of business splitting (separation).

In each case, the body of evidence obtained through tax control measures will depend on specific circumstances established for the participants of the scheme and their relationship.

Thus, in order to avoid this or that type of prosecution, those business entities that legally want to take a leading position in the market and develop large business through founding some legal entities holding similar business activities, it must be born in mind that the division of business per se does not mean a violation in case if it is possible to reason economic feasibility of such splitting, as well as actual independence of all the legal entities and the fact that such organizations pursue their own economic goals. In particular, this can be traced in the fact that each of the organizations created by a founder(s) enters certain business niche, which sometimes results from the nature of the services provided.

For example, the main type of economic activity of a limited liability company ("ООО" in Russian) is a travel agency, but additional activities can be regarded as retail trade of souvenirs, folk arts and crafted goods, as well as religious and cult items; as restaurants and cafes with full restaurant service, cafeterias, fast-food restaurants and self-catering, ships restaurants and bars. Consequently, the additional activity of such LLC is largely aimed at retailing souvenirs and catering management for tourists.

Similarly, the main business activity of the second LLC is also travel services, but additional activities are aimed at organizing information and excursion services for tourists, as well as booking. At the same time, the second LLC has a different registration address.

At the same time, it will be fair to assert that the activities of the above-mentioned organizations cannot be qualified as splitting the business by their founder(s), provided that all the above-mentioned organizations:

- perform a real independent business activity and conduct financial and economic operations on its own behalf;
- independently fulfil their tax obligations to the budget (tax returns);
- keep the records of their incomes in accordance with the accounting order when applying special regimes as specified in the provisions of tax legislation, by different accountants who are not subordinate to each other;
- in each of the above-mentioned organizations, the features of HR policy are such that the implementation of touristic services is provided by various guides, volunteers who are not permanent employees, and this, in turn, indicates the absence of unified personnel team;
- independently determine the object of taxation, tax base; calculate the tax and submit the reports to the tax authority at the place of registration;
- have particular leases of used property for each organization.

4 Conclusions and discussions

All in all, a conclusion can be drawn from our research, namely, that even if the considered organizations have certain signs of interdependence and affiliation (for example, there are family ties between CEOs), there is no grounds that would prove that the relationship between these parties could affect the results of transactions; there would be no impact of one economic entity on the conditions and results of the other; it would not be founded that the taxpayer's actions lacked reasonable business goal, but are aimed at creating a scheme of unreasonable reduction of tax liabilities.

Moreover, an important evidence for that the creation of these companies has not been aimed at understatement of the tax base through the use of unreasonable tax benefits by creating a "business split" scheme is cooperation and joint business agreements that define the "areas of liabilities" for each of the parties and clearly delineate the spheres of their activities, since each of these legal entities is a separate entity of economic and tax legal relations, and these affiliated organizations aim to distribute certain market niches regarding particular goods (works, services) between them, which has had a reasonable business goal (increase in the volume of sales) and also has been carried out in full accordance with the most important business principle - the principle of demand satisfaction – the significance of which is stated in the Russian legislation and some doctrinal sources such as various federal laws.

References

Andreeva LV, Commercial (Trade) Law: course book, 3rd edn. (Moscow, KNORUS, 2012), 278 p.

Arbitration Court of Volgo-Vyatskiy Okrug (2016) The Decision of the Arbitration Court of Volgo-Vyatskiy Okrug of June 26, 2016 № Ф01-2305/2016 on the Case No. A28-13390/2014. Consultant Plus. <http://www.consultant.ru/cons/cgi/online.cgi?req=doc&base=AVV&n=74407#019549515426030495>. Accessed 27 February 2019

Constitutional Court of the Russian Federation (2017) The Decision of Constitutional Court of the Russian Federation of July 4, 2017 No. 1440-O "On Refusal to Accept for Hearing the Claim by Sergey P. Buneyev on Violation of His Constitutional Rights Stated in the Provisions of Articles 146, 153, 154, 247-249 and 274 of the Tax Code of the Russian Federation". Consultant Plus. <http://www.consultant.ru/cons/cgi/online.cgi?req=doc&base=ARB002&n=508603#011588014583430928>. Accessed 24 March 2019

De Vries MFK, Shekshnia SV, Korotov K, Florent-Treacy E, The new Russian business leaders, 1st edn. (London, Edward Elgar Publishing, 2005), 352 p.

Federal Arbitration Court (2009) The Decision of the Federal Arbitration Court of Volgo-Vyatskiy Okrug of November 9, 2009 on the Case No. A39-5016/2009. Consultant Plus. <http://www.consultant.ru/cons/cgi/online.cgi?req=doc&base=AVV&n=36035#05178229967153392>. Accessed 25 March 2019

Federal Arbitration Court (2011) The Decision of the Federal Arbitration Court of Uralskiy Okrug of December 29, 2011 No. Ф09-8395/11 on the Case No. A60-2650/2011. Consultant Plus. <http://www.consultant.ru/cons/cgi/online.cgi?req=doc&base=AUR&n=123567#07102022683142897>. Accessed 27 February 2019

Federal Law (2010) Articles 1 and 19 of the Federal Law of December 28, 2009 № 381-Ф3 "On Basic Principles of State Regulation of Trade in the Russian Federation". Consultant Plus. http://www.consultant.ru/document/cons_doc_LAW_95629. Accessed 24 March 2019

Higher Arbitration Court of the Russian Federation (2006) The Resolution of the Plenum of the Higher Arbitration Court of the Russian Federation of October 12, 2006 No. 53 "On Arbitration Assessment of Reasonableness of Tax Benefits Received by the Taxpayer". Consultant Plus. http://www.consultant.ru/document/cons_doc_LAW_63894/. Accessed 27 February 2019

Huber P, Wörgötter A (1998) Observations on Russian business networks. *Post-Soviet Affairs* 14(1):81-91. doi: 10.1080/1060586X.1998.10641447

Ministry of Finance (2017) The Letter of the Federal Tax Service of Russia of August 11, 2017 № CA-4-7/15895@ "On Submitting the Review on Court Practices Related to Appealing of Non-Regulatory Acts of Tax Authorities Following the Tax Control Measures at Which the Reception of Unreasonable Tax Revenue Through

Formal Separation (Splitting) of Business and False Revenue Distribution Proceeded from the Activities Performed by Controlled Affiliated Parties Has Been Established”. Consultant Plus. http://www.consultant.ru/document/cons_doc_LAW_256250/. Accessed 01 April 2019

Olugbola SA (2017) Exploring entrepreneurial readiness of youth and startup success components: Entrepreneurship training as a moderator. *Journal of Innovation & Knowledge* 2(3):155-171. doi: 10.1016/j.jik.2016.12.004

Prime Arbitration Court of Appeal (2011) The Decision of the Prime Arbitration Court of Appeal of June 8, 2011 on the Case No. A11-13885/2009. *Pravosudie*. <http://www.pravosudie.biz/261991>. Accessed 25 March 2019

Sikka P (2017). Accounting and taxation: Conjoined twins or separate siblings? *Accounting Forum* 41(4):390-405. doi: 10.1016/j.accfor.2016.12.003