

The impact of development of contractual relationship's complex models of TNCs on country's indirect taxation

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Abstract—The problem of contractual relationship's development firstly received a scientific basis in the process of studying the theory of social contract. Keynesian economists gave much greater importance to contractual relationship. Their main idea was to ensure that market itself is not able to create an economic equilibrium which provides full employment and increases a propensity for saving a portion of income. While examining the important question of incomplete contracts, D. Kreps found that the inevitability of such a state raises the question of the importance and the need to adapt to rapid changes in the external environment. Thus, it becomes obvious that under the terms of a concluded contract it is necessary to create an additional institution of guarantees. According to new institutional economics, the main mission of this institution is to provide protection against opportunistic behavior. So having traced the formation of contractual relationship from the simplest to the more complex forms, it is advisable to confirm in practice that the more complex the model of contractual relationship, the more difficult issues it raises (the case of Oriflame is used as an example). The subject matter of the sub-franchise agreement is granting for a fee the right to use a complex of exclusive rights of an owner to such objects of intellectual property as a trade designation ("Oriflame"), an international registration of ORIFLAME trademarks and protected commercial information on conducting business in the sales records' system.

Thus, the classic Russian-Netherlands-Luxembourg scheme based on the application of mutual agreements to avoid double taxation (henceforth DTT) is evident. This scheme is used by many TNCs that conduct their activities around the world including Russia. So, the case of Oriflame can be considered as an illustrative example of the so-called "fiscal justice" that has dominated in tax disputes. To prove this, it is enough to observe the withdrawal of money through offshore companies, so significant evidence is not needed. On the one hand, the use of this scheme for tax evasion is obvious. On the other hand, the validity and legality of the scheme used by tax authorities to analyze these legal relations is also highly controversial.

Keywords—*contractual relationship, efficiency, inter-company relations, fiscal justice, institute, royalty, VAT.*

I. INTRODUCTION

The problem of contractual relationship's development firstly received a scientific basis in the process of studying the theory of social contract. Contractual relationship began to form in times of religious wars when the traditional feudal order was replaced by informed agreement-based regulation

of social relations. The essential features and significance of these relations were studied later.

II. METHODS

Analysis and synthesis of specialized literature, publications in periodicals devoted to the international economic integration development and integration risks, system analysis, comparison, empirical and general and logical methods of research, expert assessment method, economic and mathematical modeling.

III. DISCUSSION

The policy of total protectionism was considered the most cost-effective during mercantilism. T. Mann, a representative of this school, believed that for a state's economic well-being it is highly important to understand the essence of contractual relationship. In this case a positive balance of foreign trade can be achieved with the help of economically viable contracts and public procurement. The economist claimed that the profit of a trader in the absence of due attention to the contract's conditions and its form could cause a loss for a state, while contractual relationship could bring profit [1, pp.18-20].

In the 17th century there was a decomposition of mercantilism accompanied by the rise of classical economic theory. The dominance of industrial capital replaced the dominance of commercial capital. Largely due to the diminishing role of state regulation of the economy, the role of contractual relationship has sharply decreased.

The basis of classical economic school's views was reduced to non-intervention of a state in economic processes. A. Smith, a representative of classical political economy school, considered a state as "a tolerable evil", "a night watchman", which should not interfere in the functioning of "the invisible hand". He believed that state intervention must limit the cases when private activities are impossible. A. Smith identified three functions of government: the country's protection, the organization and maintenance of public enterprises and institutions and the administration of justice. So contractual relationship allowed a state to fulfill these powers and did not affect a market in any significant way.

Keynesian economists gave much greater importance to contractual relationship. Their main idea was to ensure that market itself is not able to create an economic equilibrium which provides full employment and increases a propensity

for saving a portion of income. This tendency cannot be changed, and, therefore, a state should influence aggregate demand. The lack of sufficient demand minimizes public works and contracts with private entrepreneurs for provision of goods, services and public procurement.

J. Keynes believed that in case of consumer's inability to expand aggregate demand, its recovery turns into a state task. Contracting with TNCs for a specific product range provision can provoke additional employment by such enterprises. It will significantly affect the recovery of aggregate demand within the national economy [2, p. 37].

Along with the evolution of economic theories much attention was also paid to the study of contractual relationship. According to neoclassical economics, a contract serves as an instantaneous agreement which fixes the reallocation of resources and acts as an important element of an economic agent. A. Marshall, a representative of the neoclassical direction, paid a great attention to the stabilisation of long-term contractual obligations through the tabular standard, suggesting the use of long-term contracts in order to preserve purchasing power.

The authorized authority was obliged to publish the tables which reflect changes in gold's purchasing power so that long-term contracts could be concluded in hard currency. According to A. Marshall, such procedure could be used for loans, interest, rent and even wages [3, p.228].

D. R. Commons is considered to be the founder of the modern institutional theory of contractual relationship. The theory of transactions was his main target of research. The transaction concept included three elements such as conflict, completing transaction by concluding a contract (agreement) and interdependence of conflicting parties' interests. D.R. Commons demarcated the notions of "exchange of property rights" and "exchange of property". The exchange of property rights was called a transaction. He singled out trade, rationing and management transactions. R.T. Ely observed the interdependence between the concepts of "contract" and "property". In his opinion the main task of property and contract institutions' activity was a common weal. An important result of these studies is the conclusion that contractual relationship must regulate the private property system to take into account public interests [4, p.218].

T. Skocpol considered the contract as an institution that enshrines the inequality of classes and provides specific groups with a greater access to decision-making [5]. A serious contribution to the contractual relationship's development was made by the theorists of new institutional economics who considered an appeal as the dominant sphere of human activity. The scientists proceeded from the idea of D. R. Commons, according to which each transaction acts as an exchange of "property rights bundles" and is fixed by concluding a contract. According to the theorists of this direction, the essence of the contract is to reflect the conditions to transfer certain powers. This approach based on the fact that the analysis of contractual relationship is carried out from the standpoint of their comparative advantages to stimulate businesses to improve the efficiency of limited resources' use and the use of certain government regulatory structures to minimize the transaction costs of entrepreneurship.

The interest in contractual relationship was also caused by the publications of R. Coase, in which the notion of "transaction costs" appeared [6]. R. Coase believed that enterprise efficiency is determined by contracts' terms which an enterprise concludes in the process of its operation. If these conditions are the result of market transactions, they will ensure the best use of available resources, but taking into account transaction costs. It can be concluded that, according to the approach of new institutional economics, rationality and cost-saving are the basis for the choice of a contract to fix a particular business transaction.

While examining the important question of incomplete contracts, D. Kreps found that the inevitability of such a state raises the question of the importance and the need to adapt to rapid changes in the external environment. In order to eliminate the changes, it is necessary to convince organizational units of an enterprise (employees) that it will not abuse their freedom, thereby causing harm to its employees. To do this an enterprise should adopt a certain set of principles that will prevail in case of unforeseen circumstances [7, p.37].

Thus, it becomes obvious that under the terms of a concluded contract it is necessary to create an additional institution of guarantees. According to new institutional economics, the main mission of this institution is to provide protection against opportunistic behavior. The analysis of the mechanisms that enforce contracts' implementation is the cornerstone of new institutionalism theory. Its representatives pointed to the existence of common mechanisms and private means of regulating disputed relationships [8].

If general mechanisms are based on a legal lawsuit, the private ones involve a grant of collateral, public statements of commitments made, depositary security of commitments, etc. They provide an opportunity to interest the transactors in compliance with contract terms and reduce post-contractual opportunism [9, pp.47-51].

In addition, there are non-legal mechanisms for regulating disputed relationships with regard to a transaction made, such as an agreement on procedures that are designed to control the execution of a contract, bilateral consultations and an appeal to a third party authority (arbitrator).

The choice of the mechanism for regulating disputed relationships is determined by the contract's form and content. O. Williamson believed that the simplest contracts are regulated by market, and the complex ones are regulated by interfirm relationship. In the award of a simple contract parties' relationships are short-term and all disputes are resolved in court. In case of complex contracts the relationships are long-term and disputes are resolved through regular consultations and bilateral negotiations [10, p. 34].

The representatives of new institutional economics, who were engaged in an active and in-depth study of contractual relationship, came to the following important conclusions:

1. The contract is an indicator of parties' integrity;
2. The firm is a "network of contracts";
3. The contract serves as the basis of economic relations;

4. The contract is a protective mechanism against opportunism;
5. The contract regulates economic processes;
6. The key principle of bidding is informational openness;
7. The contracts are not always documented;
8. The specificity of contracts is determined by the structure of property rights;
9. The lack of control over the contract execution may cause economic stagnation;
10. In some cases the presence of an arbitrator is highly important. [11].

J. Buchanan's researches of the interdependence of the efficiency of resources use and contract forms led to the recognition of private agreements' importance which are often more effective in resolving various disputes and appeals to the courts. It is obvious that the possibility of effective use of non-legal mechanisms is particularly relevant in the process of forming national contractual systems in the area of public procurements as the suppression of one of the parties' opportunistic behavior in court is most often a long-term process and often unfair.

Within the theory of new institutional economics Russian scientists also studied contractual relationship. A.E. Shastitko believes that the contract is an agreement that does not always imply the voluntary relationship of both parties. On the one hand, it is quite possible to consider the contract as a voluntary transaction. On the other hand, in practice there are a huge number of agreements that are *de jure* voluntary and *de facto* forced. One can agree with A.E. Sastitko, i.e. any contract always includes an element of mutual pressure.

V.S. Lisin and K.E. Yanovsky's "Institutional restrictions of modern economic growth" includes an explanation of contractual relationship theory and the emergence of democratic institutions when citizens agree to "hire a policy" in order to provide certain services and tax payments from which they will finance the activities of this politician [12, p.447].

IV. RESULTS

So having traced the formation of contractual relationship from the simplest to the more complex forms, it is advisable to confirm in practice that the more complex the model of contractual relationship, the more difficult issues it raises (the case of Oriflame is used as an example).

LLC "Oriflame Cosmetics" appealed to the Moscow Arbitration Court with a statement to invalidate the decision of Moscow FTS on the basis of which the applicant was assessed additional income tax and VAT. The reason for the additional tax is the tax authority's assessment for the applicant's payments of license royalty to the company as "a deliberately organized and used for a long period tax optimization tool that allowed organizations belonging to the Oriflame group companies not to pay profit tax on the territory of the Russian Federation, unreasonably reimburse VAT from the budget and withdraw from the jurisdiction of the Russian Federation significant funds that were also not subjected to taxation of tax jurisdictions" [14].

Also, the claims of the tax service were caused with the expenses of Oriflame to its interdependent company located in the Netherlands for the payment of royalties under the sub-franchise contract. At the same time the Dutch company also concluded a franchise contract with one of the companies of Oriflame holding, which is located in Luxembourg, with a similar subject.

The subject matter of the sub-franchise agreement is granting for a fee the right to use a complex of exclusive rights of an owner to such objects of intellectual property as a trade designation ("Oriflame"), an international registration of ORIFLAME trademarks and protected commercial information on conducting business in the sales records' system. In this case the remuneration was determined using a mixed method, that is, in the amount of 2% of the value of goods purchased from subsidiaries and parent companies in Russia and Luxembourg and fixed payments. In two years total royalties of 2 billion rubles were paid: 1 billion rubles a year on average. Also, the inspectorate found that a subsidiary in the Netherlands transferred 98.4% of payments received from a Russian company to the owner, that is, a company located in Luxembourg.

Thus, the classic Russian-Netherlands-Luxembourg scheme based on the application of mutual agreements to avoid double taxation (henceforth DTT) is evident. This scheme is used by many TNCs that conduct their activities around the world including Russia. The peculiarity of the scheme is the existence of an agreement between companies and Luxembourg which allowed paying small fixed payments to the budget of the Principality. Thus, almost the entire amount of royalties paid by a company located in Russia was subject to minimal taxation in Luxembourg and the Netherlands while in Russia the tax base could be reduced at the rate of 20%.

The inspectorate concluded that a company located in Russia, according to the legislation of the Russian Federation, is not a legal entity, but a permanent representative office of a company located in Luxembourg, and therefore entering into licensing agreements and paying royalties on them is considered as a method of not paying the established taxes in the territory of the Russian Federation.

The situation with the accrual of VAT also looks very strange, because a company located in Russia and acting as a tax agent must first withhold and pay VAT on royalties, and then deliver this VAT to be deductible. If there is a re-qualification of Russian company's transactions under license agreements, then, in accordance with the position of the Presidium of the Supreme Court of Arbitration of the Russian Federation No. 1001/13 of March 25, 2013, it should be considered unreasonable and payment of withheld VAT to the budget. However, the judicial act does not contain this, perhaps, because the defense did not state this position. As a result, it turned out that the budget received incorrectly calculated VAT, but its return through deductions to the taxpayer was refused [15].

So, the case of Oriflame can be considered as an illustrative example of the so-called "fiscal justice" that has dominated in tax disputes. To prove this, it is enough to observe the withdrawal of money through offshore companies, so significant evidence is not needed. On the one hand, the use of this scheme for tax evasion is obvious. On

the other hand, the validity and legality of the scheme used by tax authorities to analyze these legal relations is also highly controversial.

V. CONCLUSION

Thus, on the basis of the above it can be concluded that the evolution of contractual relationship from simple to complex forms has led to the complication of their application. This statement is confirmed by the ambiguity of the Oriflame case, by the example of which it becomes obvious that the complex contractual relationship models that exist today are not perfect, and do not make it clear where to include royalties and franchising, and that they should not be included in the customs value. Moreover, the results of this case lead to serious tax risks for many international corporations whose subsidiaries are located in the territory of the Russian Federation.

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