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VAT taxation of bonuses and discounts

Will the new widely debated position of the Supreme Arbitration Court be applicable, notwithstanding contradictions with the official opinion of the Ministry of Finance?

Business practice between producers, suppliers and distributors of goods demonstrates that the granting of bonuses and discounts often constitutes a cornerstone of their relationships. In particular, the problem of VAT taxation on such incentives has often created misunderstandings between such parties and the tax authorities, which has led to additional charges of taxes and prolonged disputes¹.

Generally, suppliers tend to increase the motivation of their distributors by allowing so-called “retrospective” bonuses subject to sales results for the previous period. Today two main mechanisms of granting retrospective bonuses exist: either the retailer sells a predetermined amount of goods and gets a premium from the supplier, or the retailer purchases the goods from the supplier for reduced prices and the difference received from the retail sales becomes his profit.

In December 2009 the Russian Supreme Arbitration Court (hereinafter referred to as the “**Court**”) examined one of the cases on VAT taxation of bonuses and discounts and came to several conclusions which may substantially influence the business practice in this sphere. However, as the new position contradicts certain official opinions of the Russian Ministry of Finance (as discussed below), its practical implementation may create substantial risks.

Newly defined position of the Court

Background

In this particular case², “Dirol Cadbury”, being the producing supplier, sold its goods through a network of distributors who purchased goods for the purpose of retail sale to third parties according to contracts entered into between them. The distributorship agreements generally provided for a system of incentives (without mention of concrete discounts or bonuses), and the price was indicated in the appendixes to the relevant agreements. In practice the bonus was granted subject to the results of the distributor’s activities in percentage terms to the volume of goods sold during the **preceding period** (and depending on the sales plan realisation, timeliness of payments as well as achievement of assigned objectives).

When selling the goods to the distributors, “Dirol Cadbury” calculated the VAT base according to the price indicated in the appendixes. In the case of granting bonuses, the company decreased the said base **in the period of the bonus payment**. In fact, in the current period the company decreased the price for goods shipped in the preceding period and to justify such business operations, issued negative tax invoices («*счета-фактуры*»).

However, during an on-site tax audit, the tax inspectorate determined the operations discussed above were invalid and charged additional VAT, fines and penalties. According to the position of the tax inspectorate, both the initial price and the adjusted price (with the deduction of bonuses) must be specified in the distributorship agreement. As only the initial price was indicated in the appendixes and the bonuses were granted for the preceding period without modification of the initial documentation (tax invoices etc.) the tax authority concluded that such retrospective discount would not be VATable, would not modify the goods price and the VAT base would not be subject to correction.

Conclusions of the Court

According to the position of the Court expressed in the **Decree No. 11175/09 dated 22 December 2009** (hereinafter referred to as the “**Decree**”), proceeds from the sale of goods must be defined on the basis of all income received by the taxpayer in the context of the payment for such goods (art. 153 (2) of the Russian Tax Code (Part II dated 5 August 2000 No. 17-FZ)). Under art. 166 (4) of the Tax Code the VAT amount should be calculated looking at the particular tax period and may be adjusted according to circumstances decreasing or augmenting the tax base. Thus, **for VAT purposes profit may be defined with regard to discounts granted both in the period of the goods sale and the following period**.

The Court also stressed that the **types of incentive system** (e.g. by way of granting a discount setting at the amount of possible contract price decrease, or by way of allowing a premium (additional reward) subject to the attainment of

¹ See, for instance, the Decision of the Federal Arbitration Court of the North-West region No. A56-14177/2007 dated 26 June 2009, the Decision of the Federal Arbitration Court of the Moscow region No. KA-A40/5284-08 dated 25 June 2008, etc.

² This case No. A44-109/2008 was examined in the first instance by the Arbitration court of the Novgorod region (Decision dated 7 August 2008).

certain objectives) **and the methods of discounts and bonuses granted** (offset as a prepayment, offset as a decrease in payments in arrears, transfer to an account, etc.) **are irrelevant**: in any case the profit amount should be adjusted subject to relevant discounts and if necessary may be corrected for the tax period of goods sale.

Finally, the Court concluded that as the discounts granted by “Dirol Cadbury” to its distributors were directly related to the price of goods: the company lawfully decreased the price for corresponding goods and adjusted the VAT base.

Thus, the analysis of the Decree leads to the following legal **conclusions**:

- Discounts and bonuses granted by suppliers to distributors are VATable;
- The actual discount/bonus system/type is not important;
- The price of goods may be adjusted even for the preceding period.

Position of the Russian Ministry of Finance

The newly defined position of the Court attracted the interest of the majority of companies working in the retail sector. Certain companies even intended to modify the relationship structures between suppliers and distributors (for instance, X5 Retail Group, one of the largest retail companies in Russia, has taken steps to gross-up bonuses by the underlying amount of VAT payable³). Considering doubts in the minds of taxpayers caused by the Decree, the Committee of economic policy and entrepreneurship of the Russian State Duma requested the Russian Ministry of Finance provide practical guidance.

In response, the Russian Ministry of Finance in the **Letter No. 03-07-04/02 dated 30 March 2010** (hereinafter – the “**Letter**”) referred to its previous Letter No. 03-07-15/112 dated 26 July 2007, according to which discounts and bonuses are VATable only if the following conditions are being met:

- Discounts/bonuses are related directly to the sales operation (in particular those related to advertising services and promotion of goods);
- Calculation of discounts/bonuses is directly correlated to the payment for the goods and leads to the adjustment of the price of the goods in the current period (i.e. **if the bonus is granted in a form of additional reward/premium or a discount of the price of goods realized in the preceding period it is not VATable**);
- The relevant modifications to the price of the goods are taken into account in the relevant sales and purchase books as well as tax invoices.

The Ministry of Finance stressed that the above position does not contradict the position of the Court contained in the Decree. However, it is quite clear that if the Decree does not impose any limitations on the types of VATable bonuses, the position of the Ministry of Finance restricts their scope. Consequently, this may still lead to discrepancies in the position on the VAT taxation of discounts and bonuses not related directly (i.e. paid after the period of sale of the goods or granted in the form of a premium) to the adjustment of the price of goods.

The Ministry of Finance has also highlighted in the Letter that only the party subject to the Decree of the Court (i.e. “Dirol Cadbury”) is obliged to comply with legal requirements stated in the Decree. Other companies may do this at their own discretion or in accordance with any relevant arbitration court decision.

Possible implications for the taxpayers

It seems that the contradictions discussed above will not allow taxpayers to safely implement the position elaborated by the Court. However, we note that you may certainly continue to implement other schemes (involving, for example, granting discounts to distributors not for the preceding periods but in respect of future shipments of goods) to avoid unnecessary risks of disputes with the tax authorities.

CMS can offer you the following assistance:

- Audit of your current contractual strategy with producers, suppliers, distributors as well as advice on choosing the most suitable and efficient contractual instruments
- Draft and/or review of your agreements (for distributorship and supply services and other) and assistance in negotiations to achieve more favorable terms
- Auditing of your existing tax claims/receivables in order to determine appropriate procedures/strategies to speed up the refund of tax amounts previously paid to the budget (tax payments offset, VAT recovery, etc.)
- Auditing of existing structures with a view to tax optimization (i.e. cost reduction) of profits tax and VAT through proper structuring

³ According to information distributed in the media (see, for instance, <http://www.rbcdaily.ru/2010/03/11/market/463760>).

- Preparation and selection of documentation requested by tax inspectorates to justify expenses, calculated tax bases etc.
- Assistance in negotiation with the Russian tax authorities, to achieve early tax settlements and resolution of pending issues
- Representation of your company in disputes with tax authorities and/or contracting parties

If you have any questions on the matters referred to in this **RUSSIA TAX OUTLOOK**, please do not hesitate to contact Dominique Tissot, Partner, and Anastasia Prozor, Associate, or your regular contact at CMS, Russia.

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