

Client Update

Benefits upon Termination of Employment by Mutual Agreement Deductible as Income Tax Expense

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On March 27, 2017, the Supreme Court of the Russian Federation issued a ruling determining which benefits paid to employees upon termination of employment by agreement between the parties should be treated as income tax expense (the “Ruling”).¹ The Ruling is not binding on the lower courts and the tax authorities. Legal position of the Supreme Court of the Russian Federation may be used by the parties and by the lower courts while considering similar tax disputes.

According to the Ruling:

- In addition to the events such as personnel redundancy or company liquidation when severance payments are required by law, an employment contract may provide for other events triggering payment of the termination benefits and establish a higher amount of such benefits.
- Termination benefits paid under an employment termination agreement may operate as severance payments (earnings retained for the period until new employment) or consideration for the consent to terminate the employment contract (e.g., aimed at preventing a potential conflict upon termination).
- The Russian Tax Code does not limit the list of salary-related expenses which are deductible for taxation purposes. The list may include any payments, provided that such payments are based on employment or similar relations.

¹ Ruling No. 305-KG-18369 of the Supreme Court of the Russian Federation, dated March 27, 2017, in Case No. A40-213762/2014. Previously the Supreme Court of the Russian Federation stated a similar position in Ruling No. 305-KГ16-5939, dated September 23, 2016, in Case No. A40-94960/2015 and Ruling No. 305-KГ16-17247, dated March 17, 2017, in Case No. A40-186959/2015.

- Courts are not authorized to examine whether decisions taken by businesses, including employers, are economically feasible,² and the tax laws do not permit the tax authorities to make conclusions on whether any expenses of a company are economically feasible. Thus, subjective evaluation of the justifiability of the employer's expenses is restricted.
- An employer must prove that the amounts of termination benefits are economically justified only where such benefits are substantial and disproportionate to ordinary severance payments that an employee would be entitled to by his/her length of employment or his/her contribution or any other circumstances of his/her employment.
- If the amount of termination benefits does not exceed five average monthly wages of the terminated employee, the above-mentioned substantiation is not required, as such an amount of termination benefits may be deemed proportionate to ordinary severance payments as well as severance payments in connection with personnel redundancy or company liquidation.

In this connection, when the amount of termination benefits upon termination of employment by mutual agreement exceeds five average monthly wages of the dismissed employee, employers should have supporting documents justifying such amounts. Supporting documents may include bylaws stipulating the amount of termination benefits to be paid upon termination of employment by mutual agreement, orders providing for a specific business reason for termination, purpose of payment of the termination benefits and relation of the termination benefits to the length of employment and contribution, calculations supporting the amount of payments to the effect that the termination on other grounds would be more expensive for the employer than the termination of the employment contract upon mutual agreement of the parties, etc.

The facts of the case are provided in Annex 1.

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Please do not hesitate to contact us with any questions.

² This legal position was developed by the Constitutional Court of the Russian Federation in its Ruling No. 3-II, dated February 24, 2004.

ANNEX 1**CASE FACTS**

In 2011-2012, Mineral and Chemical Company EuroChem, Joint Stock Company (the “Company”), terminated employment contracts with eight employees by agreement between the parties and paid termination benefits of one to five average monthly wages to each employee. In August 2014, the tax authority upon a tax audit concluded that the Company had wrongfully treated such monetary benefits paid to the employees upon the termination of their employment contracts as expenses reducing the taxable income, with the total value of such benefits equal to RUB 1,329,000 (approx. USD 87,000), held the company liable for tax offense and charged underpaid income taxes, fines and penalties owed by the Company.

In the opinion of the tax authority, the payments made by the Company were not economically justified or necessary for deriving profit insofar as such payments:

- were made to employees whose employment was terminated;
- were not aimed to incite or encourage such employees’ work and are not provided for by the applicable labor legislation in the case of termination of the employment contract by agreement between the parties;
- should be comparable to severance payments of one average monthly wage or, if there is an evidence that the dismissed employees are still unemployed, two average monthly wages;
- were not related to personnel redundancy or the Company liquidation (*i.e.*, circumstances where severance payments are required by law).

In September 2014, the Company contested the decision of the tax authority by applying to a higher-level tax authority. As the Company’s appeal to a higher-level tax authority was dismissed, the Company applied to the court.

From 2015 to 2016, the case was considered by three court instances (Moscow Commercial (*Arbitrazh*) Court as a court of first instance, Ninth Commercial (*Arbitrazh*) Appellate Court as a court of appeals and Commercial (*Arbitrazh*) Court of Moscow District as a cassation court). The courts dismissed the petition of the Company.³ According to the courts, payments made to employees upon

³ Except for the Commercial (*Arbitrazh*) Court of Moscow District, which by its ruling dated November 24, 2015 set aside rulings of the lower courts and remanded the case to a court of first instance for a new trial.

termination of their employments by mutual agreement are not economically justified and cannot be treated as expenses reducing taxable income insofar as such payments:

- have social focus, are not directly related to the fulfilment of employment duties and do not qualify as incentive supplementary benefits and bonuses;
- were made pursuant to a supplement to the employment contract simultaneously with issuing an order on termination of employment, which cannot qualify as part of a remuneration for labor; and
- are not provided for by the Russian Labor Code and the bylaws of the Company.

The Company contested the court rulings by applying to the Supreme Court of the Russian Federation. In March 2017, the Judicial Panel for Economic Disputes of the Supreme Court of the Russian Federation considered the case in cassational procedure and upon the consideration took the side of the Company, invalidated the decision of the tax authority and set aside the decisions of the lower courts.

The Ruling follows the court practice favorable for taxpayers. It should be noted that the previous court practice on this matter was contradictory and courts often took a counter position according to which benefits paid to employees upon termination of employment by agreement between the parties should not be treated as income tax expense.