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Russia introduces tax manoeuvre for IT companies

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On 31 July 2020, the Russian President signed Federal Law No. 265-FZ* (the "**Law**") enacting a tax manoeuvre for the Russian IT industry. How will this manoeuvre affect domestic and foreign market players in this field?

The Law significantly reduces applicable corporate profits tax and social contribution rates for eligible Russian IT companies. This will create a viable tax environment and aims to be competitive with the tax regimes of other jurisdictions historically supporting IT businesses.

Narrowing the scope of the VAT exemption

From 1 January 2021, the disposal of exclusive and non-exclusive rights to computer software and databases will only be exempt from VAT when it relates to software or databases included in the Russian National Software Register (the"**Software Register**").

In order to be included in the Software Register, the following four criteria must be met:

- Exclusive worldwide and unlimited rights to the relevant software or database belong to at least one of the following right holders:
    - the Russian Federation; federal subjects of Russia; a Russian municipality;
    - a Russian citizen;
    - a Russian non-commercial organisation where the controlling corporate body is nominated directly or indirectly by one or more of the above right holders, provided that no foreign legal entity or individual can affect its decisions; or
    - a Russian commercial organisation where more than 50% of the share capital or participatory interest is held directly or indirectly by at least one of the right holders specified above.
- The relevant software or database has been lawfully put into circulation in Russia and, in relation to software, copies or the right to use may be freely commercialised throughout the country.
- The annual payments under any licence agreements or any other agreements for the benefit of foreign parties or any Russian entity controlled by foreign parties does not exceed 30% of the revenues generated by the right holders from its commercialisation.
- No information or data relating to or contained in software or a database is considered a state secret.

The Russian government can set additional criteria for software and databases listed in the Software Register.

Even if a piece of software is in the Software Register, the VAT exemption under the new rules will not apply to operations with IP rights for software used for advertising, counterparty searches, online trade or marketplace purposes ("**Advertising and Marketplace Software**").

At the same time, the Law specifically allows for the application of the VAT exemption to software and databases in the Software Register when they are used via remote access and removes the previously applied requirement to put in place a qualifying licence agreement. As a result, the VAT exemption should now be explicitly applicable to SaaS (Software as a Service) products which do not qualify as Advertising and Marketplace Software and are listed in the Software Register. Previously, the application of the VAT exemption to SaaS products was disputable. The Law removes this legal uncertainty.

Until the Law comes into force on 1 January 2021, the VAT exemption applies to both cross-border and domestic disposals of exclusive and non-exclusive rights to software granted under qualifying licence agreements. This exemption is frequently used both by IT businesses and companies belonging to different sectors of the economy which actively use international software products in their commercial activity, including those acquired as a result of intragroup flows. From 1 January, this VAT exemption will no longer be available to software held by foreign market players and local subsidiaries belonging to or essentially controlled by international groups.

Introduction of new tax incentives for the IT industry

Taxpayers eligible for incentives

Under the Law, new corporate profits tax and social contribution benefits will be granted to Russian IT companies meeting the following criteria:

- A company holds a state accreditation certificate as an IT company.

  A company has the right to obtain this state accreditation provided that it is incorporated in Russia and when, regardless of its legal form and form of ownership, it carries out the following activities in the field of information technology:

  - developing and implementing software and databases on physical media or in electronic form, regardless of the type of contract; and/or
  - providing services (performing works) for the adaptation, modification, installation, testing and/or maintenance of software and databases.

- Revenue from the company's core IT activity makes up at least 90% of its total income in a single tax reporting period.

  The Law expressly excludes revenues generated by Advertising and Marketplace Software from the eligible IT revenues.

  At the same time, income from SaaS products should qualify as core IT revenue for the purpose of benefits.

- The average number of employees is not less than seven people for a single tax reporting period.

Corporate profits tax implications

As of 1 January 2021, taxpayers meeting the above criteria will benefit from a reduced corporate profits tax rate of 3% instead of the general tax rate of 20%.

At the same time, the Law abolishes the currently applicable right of IT companies to immediately deduct hardware costs instead of gradually recognising such costs through depreciation payments.

Social contribution rate reduction

As of 1 January 2021, eligible IT companies will enjoy the following reduced rates:

	New rules	Old rules (applicable in 2020)
Cumulative social contribution rate (for revenues below the maximum base for social contributions)	7.6%	30%
Compulsory pension insurance rate	6%	22%
Compulsory social insurance rate	1.5%	2.9%
Compulsory medical insurance rate	0.1%	5.1%

Comments

The Law can be seen as having both positive and negative consequences. And the drawbacks could outweigh the Law's benefits.

Benefits

The main aim of the Law is to make the Russian market more attractive for software developers, which should result in the growth of the domestic IT sector. To this end, the Law proposes one of the lowest corporate tax rates in the world for this activity.

The significant reduction in social contribution rates should also allow eligible IT companies to increase salaries, which will enhance their local workforce.

In parallel, since the VAT exemption is custom-tailored to apply primarily to local IT companies, this will provide the Russian IT sector with an additional competitive advantage over international market players distributing foreign software in Russia.

Drawbacks

The long-term effect of the IT tax manoeuvre on various sectors of the Russian economy currently remains unclear.

The Law contains a rather specific definition of eligible IT activities, which excludes certain IT companies, including local IT giants, that generate most of their revenues from advertising, online trade and marketplace activities.

Also, the introduction of an attractive tax regime should normally run in parallel with the creation of a safe and stable legal environment in this sector, which has not, in our view, been provided. The arrival to Russia of more foreign companies that localise their software development would require additional legal adjustments.

Narrowing the scope of the VAT exemption will not necessarily place additional pricing pressure on operations with Russian B2B customers, who should be in a position to neutralise the VAT effect (wholly or partly) by offsetting the corresponding input VAT against local VATable flows.

However, additional costs associated with the acquisition of foreign software are difficult to avoid for customers who do not enjoy the right to offset VAT, including:

- customers in the B2C sector;
- customers belonging to VAT-exempt sectors of the Russian economy (e.g. banks and financial organisations); and
- local IT companies specialising in software exports.

Furthermore, introducing VAT on previously exempt flows (as previously reported here and here) will give rise to new obligations for foreign providers of electronic services in Russia. More specifically, such e-service providers, which previously filed simplified reporting to Russian tax authorities for VAT-exempt activities, will now need to manage full-fledged local VAT reporting and payment routine, or agree to delegate their obligations to their Russian customers. In addition, the increased VAT burden for the previously exempt flows will automatically increase the penalties for non-compliance with the specific VAT rules for e-service providers.

Finally, the Law does not provide for any transition period, and the new rules will already apply in 2021. This leaves little time to make the required adjustments.

Action required from IT companies

Affected IT market players should assess the influence of the above developments on their Russian business and pricing models, and determine whether they can benefit from the newly introduced incentives if they localise their products in Russia. Should this be impossible or impractical, they should carefully review their contractual arrangements with Russian customers, especially those formalising the provision of e-services to anticipate and cover additional tax obligations in Russia.

For more information on this eAlert, please contact CMS Russia experts **Dominique Tissot**, **Anton Bankovskiy**, **Maria Kabanova**, **Anna Osmakova**, **Irina Shurmina**, **Ksenia Danshina** or your regular contact at CMS Russia.

* *In Russian*

KEY CONTACTS

Dominique Tissot

Partner | Head of Tax, Moscow

Anton Bankovskiy

Partner | Head of Intellectual Property, Moscow

Maria Kabanova

Senior Associate | Tax, Moscow

Anna Osmakova

Associate | Tax, Moscow

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Irina Shurmina

Senior Associate | Commercial, Moscow

Ksenia Danshina

Associate | Commercial, Moscow