



Draft law: Russian VAT on software license transactions and e-commerce services

Tax Update

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By:

On 24 December 2015 a draft law was brought before the State Duma introducing important changes to the VAT taxation of software supply transactions and IT services ('Draft Law').

VAT on e-commerce services supplied to Russia

One of the aims of the Draft Law according to the explanatory note is to ensure the equal treatment of Russian and foreign companies selling content to final consumers since according to the authors e-commerce services rendered by foreign companies are currently more appealing to Russian consumers due to no VAT amount being added.

For this purpose the Draft Law suggests implementing in Russia the internationally recognised and widely used 'destination principle' for the VAT taxation of e-commerce services which implies charging VAT in the country of the services recipient's location. Therefore, certain e-commerce services rendered by foreign organisations to legal entities and individuals in the territory of Russia may become VAT-able in Russia. The authors of the Draft Law suggest adding to the Russian Tax Code a new Article 174.2 that envisages a list of VAT-able services deemed supplied in Russia if provided by foreign organisations ('E-Commerce Services'). This list covers inter alia:

- transferring software and database rights, including access to on-line games
- installing (downloading) games on PCs and cell phones, banner ad blocking programs, accounting and antivirus software, web filters
- enabling the placement of goods (work, services) offers and information related to the sale of property on websites or in programs
- furnishing information via the Internet, including making available e-books and other e-publications, graphic images, pieces of music both with and without text and audio-visual works
- making search engines and other portals available
- web-hosting services
- cloud services and cloud-based e-platforms
- providing websites visitor statistics
- broadcasting TV and radio channels using the Internet and other services.

The above list is not exhaustive and in fact the legal terminology used the Draft Law is quite diverse so that various e-commerce services may fall under the definition of the services deemed qualified for the purposes of the new Article 174.2 of the Tax Code.

If E-Commerce Services are rendered directly by a foreign organisation, then this foreign organisation must be a VAT payer. If E-Commerce Services are rendered through a foreign intermediary entity under a mandate, commission, agency or other similar agreement, such intermediary should act as a VAT withholding agent. The amount of VAT charged on E-Commerce Services is calculated at a 15.25% computed rate. This effectively assumes that the relevant invoices rendered by foreign organisations would be issued inclusive of the Russian VAT.

In the B2C supply context, the new rules assume that a foreign organisation-seller of E-Commerce Services will have to administer Russian VAT liability itself, whereas in the B2B supply mode, the Russian reverse charge mechanism may continue to apply under Article 161 of the Tax Code as expressly provided for by the Draft Law. The Draft Law also addresses agency type structures whereby Russia-tax registered entities who transact, under different forms of agreements involving monetary settlements, with foreign sellers of E-Commerce Services are required to administer the VAT liability of foreign sellers as tax agents.

'VAT driven for all taxes' or 'VAT only' registration?

According to the Draft Law a qualifying foreign organisation should register with the Russian tax authorities for 'VAT and tax control' purposes. Such foreign organisation is obliged to file a VAT return to the Russian tax authorities which will be subject to an in-house tax audit. Furthermore, the Draft Law provides for using a taxpayer's personal account (personalised e-room set for each qualifying taxpayer – which is a foreign organisation) to submit a tax registration application, VAT returns and other documents in an electronic format. Importantly, if the qualifying foreign organisation fails to perform its Russian VAT liabilities and does not respond to tax claims lodged by the tax authorities, the Russian tax authorities may collect the amount of taxes due by levying execution on the property of such foreign organisation located in Russia, if available.

It is not clear how the Draft Law, if passed, would resolve one of the key practical problems with tax registration and the INN (identification tax number) obtained by a foreign organisation registering for tax purposes which is registering for all taxes in Russia, not just for VAT only. Unless changes are introduced to the underlying sub-laws, including the Order of the Ministry of Finance regulating the procedure of tax registration for qualifying foreign legal entities, the issue of finding the right modus operandi to settle VAT liability and at the same time to prove no permanent establishment will remain one of the biggest concerns for many foreign IT services providers supplying to Russia.

Revision of VAT exemption for software supplies

Another far-reaching initiative proposed by the Draft Law is that it provides for revoking of a rule under which the supply of software rights (programs for PCs and databases) is VAT exempt (paragraph 26 of item 2 of Article 149 of the Russian Tax Code). This is going to be a very important change of Russian VAT law, as it assumes that all software supply transactions, both inbound and domestic ones, will give rise to Russian 18% VAT. It should be noted that currently many software supply transactions structured as licensing of certain qualifying IP rights benefit from VAT exemption, which has been a significant tax incentive for IT and high-tech business since 2008.

In order to compensate the Russian organisation for the loss of the such VAT concession, the Draft Law proposes granting Russian organisations supplying software a right for a VAT reclaim when they render services deemed supplied outside Russia. Certain requirements will apply in this regard.

Profits tax incentive

Another benefit qualifying Russian companies may become entitled to is the possibility to deduct (for the purposes of profits tax calculation) expenses expressly related to income generated from the supply of software and software rights in the amount exceeding the actually incurred costs (so-called 'super-deduction') under the following formula:

$$E + (I.srt - E) * 0.8$$

where:

- E means tax deductible expenses allowed for profits tax deduction in the relevant tax period
- I.srt means income from the software rights transfer during the relevant tax period.

The Draft Law requires that the expenses are justified and backed-up with documents in order to be deductible in accordance with the aforementioned rules. The qualifying Russian organisation must also be accredited in accordance with the procedure to be established by the Government of the Russian Federation.

Possible practical effect of the new VAT rules

The repeal of VAT exemption and the super deduction of costs as legislative initiatives have not been supported by the Russian Parliament as follows from its position in respect to the Draft Law. However, the Draft Law is expected to generate over 50 billion roubles of additional VAT collections just in 2017, if passed. Given that this is predominantly seen as Russia's response to OECD VAT Guidelines on digitally supplied services introduced in April 2014, some experts believe that the new law has good chances to be passed, with some technical changes.

According to the Draft Law the new rules would apply starting from 1 January 2017. It has been suggested that the first reading of the Draft Law should be scheduled for February 2016.

It is hard to predict at this stage whether the Draft Law will be brought into law in its current version. If and once the Draft Law is adopted in its first reading, both Russian and multinational IT businesses should start looking at their business set-ups and contractual instruments so as to restructure, if necessary, and by doing so to circumvent VAT leakage, ensure tax compliance and avoid tax penalties for non-compliance. This particularly regards many inbound SaaS arrangements structured as stand-alone software licence agreements, hardware and software supplies and the Russian on-shore R&D transactions.