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The Lowest Tax Rate in the World? Russia’s ‘IT Tax Maneuver’

Experts see the Kremlin’s tax cuts for software firms as its latest attempt to squeeze out foreign competition.

By Jake Cordell

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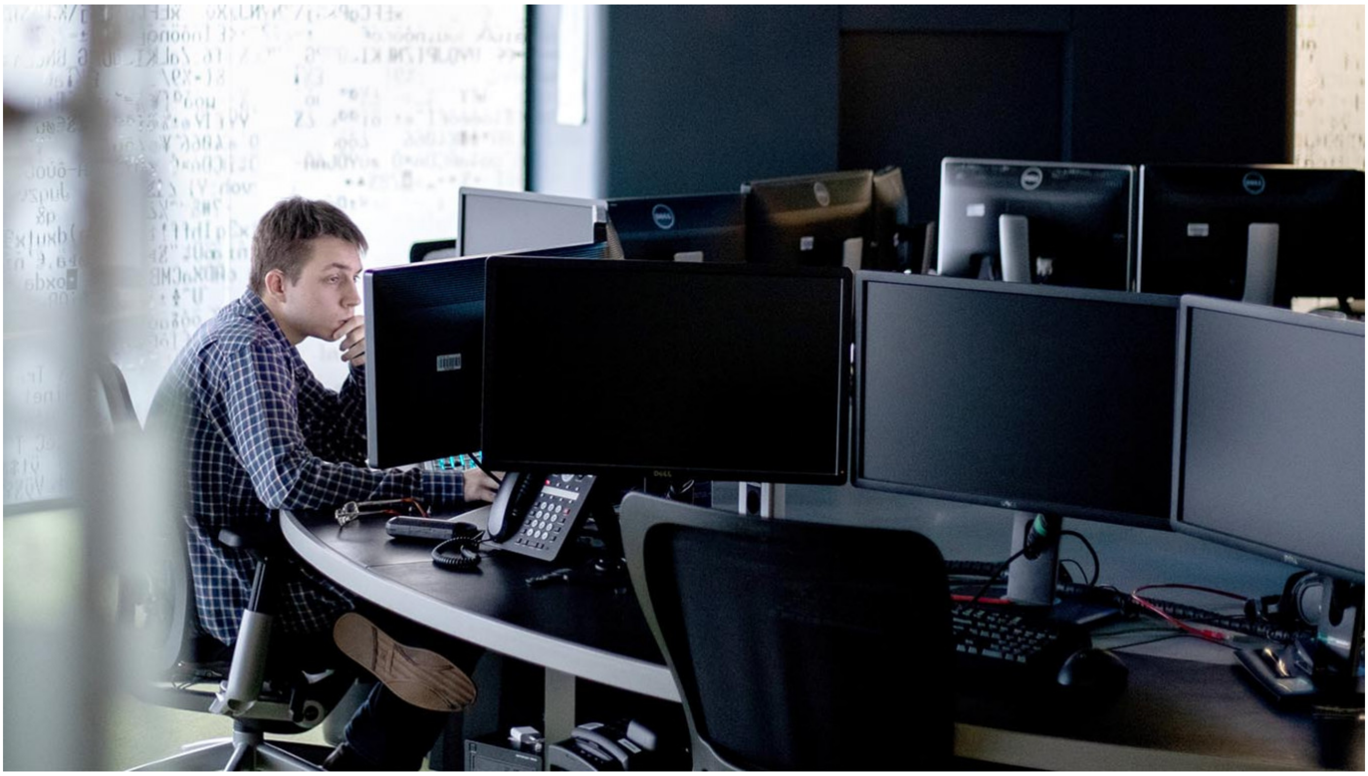

The fingerprints of Russia's tech-savvy new Prime Minister Mikhail Mishustin are all over a new tax scheme for tech companies, Russian media outlets have reported. **Sergei Bobylev / TASS**

President Vladimir Putin’s plans for digital businesses to help power Russia’s economic recovery from the coronavirus pandemic by giving Russia one of the lowest tax rates in the world for IT companies might not be what they seem, analysts told The Moscow Times.

In an address to the nation in June, Putin hailed the Russian IT sector’s “dynamism and rapid growth,” built on “powerful technological and human resources,” and commended digital firms for helping businesses, government and society get through the worst of the outbreak.

To capture this momentum and put Russia’s technology scene on an even steeper upwards trajectory, Putin announced he would be slashing taxes for IT firms from next year. Corporation tax will be cut from 20% to just 3%, and social security taxes will come down to 7.6%, compared to 30% in other sectors of the economy.

The new tax regime "is better than in the most attractive jurisdictions for IT businesses today, such as India and Ireland," Putin said. "In fact, it will be one of the lowest tax rates in the world."

However, one month after Putin's announcement, and with the government's draft law on this so-called "IT tax maneuver" now published, the tax cuts aren't that simple.

Instead of attracting foreign companies to headquarter in Russia — the goal of low-tax regimes like Ireland, Cyprus or The Netherlands — IT businesses, tax experts and lawyers suggest the flagship reforms could be a backdoor for Russia's latest bout of protectionism, resulting in higher software prices for consumers, and a less attractive market for foreign players.

VAT bombshell

Unmentioned by Putin in his speech is how Russia intends to pay for the social security and corporate tax cuts — by abolishing a popular VAT exemption on software sales and licenses.

"The abolition of the VAT exemption on software licenses is a bombshell," Maxim Vladimirov, head of tax at law firm Noerr, told The Moscow Times. "That has been the capstone of the IT industry for many years. They will find it very uncomfortable if that goes away."

Somebody will have to foot the bill if VAT — levied at 20% in Russia — is included in sales of software.

"Will IT businesses sacrifice their margins and leave prices for software at the same level as before, or will they increase them to compensate for the rise in VAT?" asked Artem Vasyutin, a tax partner at Deloitte. "It's likely that prices will be higher, maybe not by 20%, but gradually prices will rise so that the company's margins recover to the level they are now."

Previous government estimates of the revenues at stake highlight why some technology firms have been quick to claim that the real winner from the reforms is likely to be the Russian budget.

The abolition of VAT exemptions could raise 42.5 billion rubles a year for the government ($600 million), a recent paper by Russia's Communications Ministry found, while the new draft law says the tax cuts will total 32 billion rubles ($450 million). Those estimates of the extra VAT burden were left out of the official economic impact assessment which accompanied the draft law, instead a vague note stating only that extra VAT revenues would "compensate" towards losses on the other tax cuts appeared.

"It looks like this maneuver, at least in the short run, is going to generate cash for the budget, and only in later years have some benefits for the local IT industry," said Vladimirov.

Protectionism

The protectionist nature of the reform comes in the final aspect of the law — sales of software which are included in a government-composed register of "Russian computer programs and databases" will maintain the VAT exemption.

"With time, you will have a certain amount of substitution of foreign software with Russian software. There will be some localization of software development. But it's purely discriminatory — high prices for foreign software and lower costs for Russian software," said Vladimirov.

While not impossible, "it's extremely rare when foreign companies manage to get their software into this register," said Arseny Seidov, a partner at law firm Baker McKenzie. To be eligible, the software creator must be a majority-Russian entity, paying no more than 30% of its revenues to a non-Russian entity and not subject to mandatory software updates or management from abroad.

"It's another element of Russian policy that embraces protectionism and is designed to stimulate exports — which is generally in line with the direction in which the government is going," added Seidov, who heads up various tax committees at the Association of European Businesses (AEB) and American Chamber of Commerce — the largest lobbying associations for foreign firms in Russia. Both are scrambling to respond to the draft legislation as it rushes through parliament.

Related article: Foreign Firms Seek Level Playing Field in Russia's Coronavirus Response

This part of the reform — keeping VAT exemptions for domestic software — could even be an infringement of World Trade Organization (WTO) rules prohibiting tax discrimination, lawyers say.

Even for the Russian business world, it could only be "partially helpful," said Vladimirov.

"A lot of non-IT businesses will not be able to find a suitable Russian replacement, if they are used to buying foreign software. Also, Russian producers will need to apply for this 'domestic software' status. That won't be easy for them. I can't imagine a scenario where it doesn't involve a lot of cost and effort."

Rigid criteria

Reaction from tech companies to the move has been mixed.

"This is positive news for the industry: the opportunity to reinvest more funds in the development of promising products will allow companies, including startups, to increase the competitiveness of domestic IT products and potentially reduce their costs for consumers both in Russian and foreign markets," said Mikhail Pribochiy, Managing Director of Kaspersky Lab in Russia.

Mikhail Tokovinin of amoCRM told business outlet Inc. he would be happy for domestic companies to avoid VAT while foreign ones paid.

“Although, strategically it’s debatable. Are these protective measures helping local producers or not? We had protective duties on foreign cars — did this help or kill AvtoVaz?” he asked, referencing the Lada-maker which was bought out by French auto giant Renault.

But some fear the basic economics of the proposal, particularly for those not on the register — higher VAT, resulting in higher prices and weaker competition, software company Abbyy’s Olga Minaeva told Kommersant.

Meanwhile, some of Russia’s most successful technology companies won’t benefit from any of the other tax cuts, due to similarly “rigid” rules meaning that only firms that generate 90% of their revenue from pure software sales and licenses will qualify for reduced corporate tax and social security rates.

“This might imply that many business lines of Yandex and Mail.Ru might not meet this criteria, as both companies derive most of their revenues from advertising and other services,” said Vladimir Bespalov, an analyst at VTB Capital.

Tax advisers and lawyers are already discussing the possibility that larger companies might be better off carving off their software development arms into separate legal subsidiaries to qualify for the tax breaks. But that could run foul of so-called general anti-avoidance rules (GAAR) allowing tax authorities to block transactions or take away preferential tax treatment if they suspect the main reason for the change is to secure a lower tax rate.

More taxing problems

Beyond the IT sector, the impact on prices from the complicated VAT shake-up will ripple throughout the business world.

Analysts the Moscow Times spoke to all mentioned Russia’s financial services industry, which invests substantially in technology products and isn’t able to write off VAT costs like businesses in some other sectors, as a likely loser from the proposals.

Others say the tax changes barely scratch the surface of what Putin and his tech-savvy Prime Minister Mikhail Mishustin — who personally designed the new scheme according to The Bell — say they want to achieve: bringing scores of technology companies back to Russia and making the country one of the world’s most attractive for digital firms.

“Tax measures won’t help bring sophisticated development and intellectual property ownership back into Russia — because that’s really got nothing to do with standalone taxes,” said Vasyutin.