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Russia Expands Extraterritorial VAT Regime on ESS to B2B Transactions: Measuring the Impact on E-Commerce World and Intragroup Arrangements

By Arseny Seidov*

Russia has expanded its current Value Added Tax (VAT) regime on business-to-consumer (B2C) electronically supplied services (ESS or e-services) as of January 1, 2019.¹ As a result of these changes, foreign companies collecting ESS revenues under business-to-business (B2B) transactions, i.e., those concluded with Russia-based legal entities (including related companies) and/or individual entrepreneurs (collectively B2B customers), will be required to tax register, collect, report, and pay VAT into the Russian federal budget.

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¹ See Federal Law No. 335-FZ (Nov. 27, 2017).

DRIVERS BEHIND THE NEW RULES

Under the current VAT rules on B2C ESS,² non-resident suppliers and intermediaries (excluding payment processors) that collect ESS are required to register with Russian Interregional Tax Inspectorate No. 7 and report VAT through a special e-office on a quarterly basis. For cross-border supplies of electronic services in B2B transactions, B2B customers were required — until the end of 2018 — to collect VAT by way of withholding (an equivalent of a reverse-charge mechanism) and remit it to the Russian budget on the next day following the outbound payment of the ESS fee.

Some businesses, especially those that provide platform services to both B2C and B2B customers, could consider it more beneficial if they have to pay VAT on their entire Russian-source ESS turnover without the need to verify the legal status of their customers. Collecting such evidence (e.g., verifying whether the customer has registered as an individual entrepreneur and should act as a VAT withholding agent) does not contribute to simplification of related business processes, including underlying IT solutions, or to the efficiency of the business.

For the Russian tax authorities, shifting the VAT collection and payment obligation to the foreign taxpayer has more apparent benefits. The tax administration would be relieved from the need to audit hundreds or thousands of individual entrepreneurs and small and medium entrepreneurship (SMEs). The Federal Tax Service declared this to be the core rationale for the expansion of the current VAT regime on B2C ESS. There might be other drivers as well.

² See Seidov, *Russia Reshapes the VAT Landscape for Electronically Supplied Services: Impact of New Rules on Foreign Businesses in B2B and B2C Markets*, 45 Tax Mgmt. Int'l J. 463 (Aug. 12, 2016).

SCOPE OF NEW VAT REGIME

While there is sound logic behind the intention of the regulator that developed this concept and drafted the new rules, and the initiative can even be considered a win-win solution for some players in the e-commerce world, the new rules have serious drawbacks. Technically, they extend to all B2B transactions — including intragroup transactions — that capture ESS, even in a minor part, provided to Russia-based customers. Therefore, a very large percentage of multinational enterprises (MNEs) doing business in Russia through local branches, non-commercial representative offices and/or Russian legal entities will be covered by the new regulations.

Paradoxically, a mere recharge of a portion of headquarters (HQ) costs on the use of corporate software and/or the provision of associated maintenance services that include software updates and/or their remote administration would be normally treated as VATable ESS and trigger the requirement to tax register, report and pay VAT. Even though software use licenses are generally VAT exempt, software vendors would normally grant licenses to the entire customer group under a global licensing arrangement that would prohibit sublicensing. Hence, the VAT exemption would not apply to the recharge, since the latter may not be typically structured as a sublicense. In practice, such ESS fee is often not separately determined either. Rather, it may form a part of a bundled fee for a set of services that have nothing to do with ESS. The new rules also extend to these transactions.

DISTINGUISHING BETWEEN B2C AND B2B SUPPLIES

Non-resident suppliers can determine whether a B2B supply triggers the collection obligation by asking the customer to provide a Russian state registration number (SRN). A supplier that receives an SRN must charge, collect, and remit VAT on the supply to the customer because the SRN establishes that the customer is a resident of Russia. In addition, a non-resident supplier that does not receive an SRN from a customer must treat a supply as having been made to a resident of Russia, and must charge, collect, and remit VAT, if the supplier receives evidence of any one of the following: (i) the customer is a Russian branch / representative office; (ii) the customer's organizational documents reference Russia as the customer's location; (iii) Russia is the customer's effective place of management; or (iv) the customer's "permanent executive body" is located in Russia.³

If a supplier does not receive an SRN or evidence in one of these four categories, but the supplier has at

least one piece of evidence from the following list, the supply will be treated as a supply to an individual consumer who is a Russian resident, and the collection obligation will also apply: (i) the individual's place of residence is in Russia; (ii) payment is made through a bank or electronic payment operator located in Russia; (iii) the customer's network (IP) address is registered in Russia; or (iv) a telephone number with Russia's country code is used to order or pay for the supply.⁴

CATEGORIES OF ESS

Under the Russian Tax Code,⁵ electronically supplied services are defined as services performed "through an information and telecommunications network, including the Internet, automatically with the use of information technologies." If the service falls into this general definition — which would often be the case in today's era of digitalization — it has to fall into one of the following specific categories of ESS in order to be covered by the VAT regime on ESS:

- 1) granting the right to use software (including computer games) and databases through the Internet as well as provision of remote access to them, including updates and additional functional options;
- 2) provision of advertising services through the Internet, including services provided with the use of software and databases that function on the Internet, as well as provision of advertising space on the Internet;
- 3) services for displaying offers for acquisition (disposal) of goods (work and services) or proprietary rights on the Internet;
- 4) provision of technical, organizational, informational and other possibilities, with the use of information technologies and systems through the Internet, for setting up contacts between sellers and buyers, and conclusion of contracts (including real-time trading platforms on the Internet where potential buyers may offer prices using an automated procedure and the parties to the contract are informed of a sale by messages that are created and sent automatically);
- 5) provision and support of a commercial or personal presence on the Internet, support of users' electronic resources (websites and/or pages on the Internet), provision of access to them by other Internet users, provision of options to modify them;

³ See Russian Tax Code, art. 148(1)(4).

⁴ See *id.*, art. 148(1)(4).

⁵ See *id.*, art. 174.2(1).

- 6) storage and processing of information if the person that submitted the information has Internet access to it;
- 7) provision of computing capacity in real time for adding information to information systems;
- 8) provision of domain names and hosting services;
- 9) information system and website administration services on the Internet;
- 10) services provided automatically over the Internet upon the entry of information by the user, automated services for on-demand data search, selection and sorting, provision of data to the user through information and telecommunications networks (including real-time stock exchange data and real-time automated translation services);
- 11) provision of rights to use e-books and other electronic publications, informational and educational materials, images, musical works with or without lyrics, and audiovisual works through the Internet, including when providing for watching or listening using remote Internet access;
- 12) services involving searching for and/or provision of information on potential buyers for a client;
- 13) provision of access to search systems on the Internet;
- 14) provision of statistical services on Internet websites.

Exceptions From ESS Definition

The following are not considered ESS:⁶

- 1) sale of goods (works and services) if, upon ordering through the Internet, the shipment of goods (performance of works and provision of services) is performed without the use of the Internet;
- 2) sale of (licensing of usage rights to) software applications (including computer games), databases on tangible medium;
- 3) provision of consulting services by e-mail;
- 4) provision of services of granting access to the Internet.

Obviously, the definition of ESS, which is very broad, needs further clarifications — as do exceptions thereto. Interpretations by taxpayers, regulators, and the Russian courts will likely differ.

Eligibility for VAT Recovery

Non-resident suppliers and/or their foreign intermediaries will not be required to issue special VAT in-

⁶ See *id.*, art. 174.2(1).

voices. To allow Russian customers to recover input VAT that they pay on cross-border supplies, non-resident suppliers should indicate their Russian tax identification number and code of reason for tax registration in the underlying agreement and/or payment/settlement documentation.⁷ Russian regulations define “payment documentation” quite broadly. The definition includes bank transfer orders, money orders, payment orders, etc.⁸

Furthermore, the customer must have evidence of remittance of VAT (within the payment for ESS) to the non-resident supplier of e-services, and applicable VAT should be indicated as a separate line item in the payment documentation.⁹ It remains to be seen whether this requirement would cause practical problems for Russian customers — sellers using various foreign online marketplaces. As a general rule, fees for the use of a marketplace and applicable VAT are withheld from the sellers’ revenue and are not separately indicated in payment reports.

The Russian Tax Code does not provide for a tax withholding mechanism for B2B ESS. If a Russian customer voluntarily withholds and remits VAT to the Russian budget (e.g., if non-resident supplier is not tax registered in Russia), it will not be able to recover such VAT. The Russian Ministry of Finance has also confirmed this position in its guidance letters.¹⁰

VAT Reporting and Payment

The foreign supplier of e-services (or its foreign intermediary collecting proceeds from ESS) are required to (i) tax register in Russia with Interregional Tax Inspectorate No. 7, (ii) file VAT returns through an e-office, and (iii) pay VAT on a quarterly basis. Those foreign entities that have duly registered are also required to maintain a so-called transaction register (according to the form adopted by the Federal Tax Service)¹¹ and provide it (in electronic form) to the tax inspectorate upon request. Payments made by Russian customers are deemed to include incremental VAT calculated at a reverse-charge rate of 16.67% (20/120).

If ESS fees are collected in hard currency, the Russian VAT liability should be calculated at the official

⁷ See *id.*, art. 171(2.1), introduced by Federal Law No. 335-FZ dated November 27, 2017.

⁸ See Section 1.12 of Chapter 1 of the Regulations on Conducting Money Transfers, adopted by the Bank of Russia on June 19, 2012, No. 383-P.

⁹ See Russian Tax Code, art. 168(4).

¹⁰ See Letter of the Russian Ministry of Finance No. 03-07-08/76139 (Oct. 24, 2018).

¹¹ See Order of the Federal Tax Services No. ÌV-7-15/693@ (Aug. 29, 2017).

exchange rate of the Russian Central Bank on the last day of the respective calendar quarter.¹² The VAT return must be filed and applicable VAT must be paid by the 25th day of the month following the respective calendar quarter.¹³

Russian taxes may be paid only in Russian rubles. Hence, foreign suppliers/intermediaries commonly open a bank account in Russia in their own name. While there is no formal concept of a fiscal representative in Russia, foreign companies can outsource their tax payment obligations to a third-party Russia-based entity.¹⁴ The latter option is possible only if the foreign supplier/intermediary is tax registered in Russia.

FORCE OF ATTRACTION OF THE 'ERIELL' CASE

In 2016, the Russian Constitutional Court ruled that if a foreign taxpayer is tax registered in Russia, the "reverse-charge mechanism" does not apply.¹⁵ The foreign supplier should report and pay VAT itself on all its sales subject to Russian VAT. The Russian Ministry of Finance also had to adjust its approach following this case. Specifically, further to the Ministry's position,¹⁶ if a foreign company is tax registered in Russia, including on the ground of merely having opened a bank account with a Russian bank, then the foreign company must report and pay VAT itself even when its Russian customer has means to withhold applicable VAT.

As a result, if a non-resident entity is required to tax register in Russia, e.g., just by virtue of providing ESS to Russian customers, it will likely have to include non-ESS revenues subject to Russian VAT in its joint VAT return to be submitted electronically to Interregional Tax Inspectorate No. 7. Such revenues may include those generated under other agreements that provide for no ESS. The Federal Tax Service declared that it would adopt a new form of VAT return accordingly to cover non-ESS Russian-source income.

TAX LIABILITY

Foreign companies that are required to tax register, file and pay applicable VAT, but fail to do so, may be subject to the following tax liability:

- *Failure to register with the Russian tax authorities.* For failure to duly file a registration application, the Russian tax authorities will impose a fine of 10,000 rubles (approx. US\$145). Conducting business activity without required tax registration can lead to a fine in the amount of 10% of income received in the respective period.¹⁷
- *Failure to pay (or late payment of) Russian VAT.* The Russian tax authorities may impose a fine in the amount of 20% of unpaid VAT and late payment interest along with VAT to be paid into the Russian budget.¹⁸
- *Failure to duly file VAT returns.* The Russian tax authorities might impose a 5% fine of the VAT amount owed for each month of delay in provision of the tax return, but no more than 30% of VAT amount due.¹⁹

Currently, Russia does not have an effective legal means to collect tax from foreign entities with no presence or assets in Russia. Most double tax treaties with Russia do not cover indirect taxes. Under a reservation made to the 1988 Strasbourg Convention on Mutual Administrative Assistance in Tax Matters, Russia reserves the right not to provide any form of assistance to other parties to the Convention with enforcement of any foreign tax decisions or in the collection of fines for all types of taxes listed in the Convention. Accordingly, Russia may not demand the same assistance from other countries.²⁰ Therefore, unless Russia changes its rules, collecting Russian tax liability from non-registered foreign taxpayers may be problematic.

In certain limited circumstances, there might be a risk of a criminal investigation. However, there is no concept of corporate criminal liability in Russia. Furthermore, the intention of specific individuals to evade taxes must be proven in order for a criminal case to stand. Even though most would agree that the likelihood of criminal exposure in the circumstances in question will probably be low, non-compliance with the Russian tax rules may easily trigger the risk of negative publicity and reputational damage. Information on entities registered for the purposes of the VAT regime on ESS is publicly available on the official website of the Federal Tax Service.²¹

¹² See Russian Tax Code, art. 174.2(4).

¹³ See *id.*, art. 174.2(7).

¹⁴ See *id.*, art. 45(1).

¹⁵ See Resolution of the Constitutional Court No 2518-Î (Nov. 24, 2016).

¹⁶ See Letters of the Russian Ministry of Finance No. 03-07-08/82535 (Nov. 15, 2018), No. 03-07-08/66314 (Sept. 17, 2018), No. 03-07-08/65697 (Sept. 13, 2018).

¹⁷ See Russian Tax Code, art. 116.

¹⁸ See *id.*, art. 122.

¹⁹ See *id.*, art. 119.

²⁰ See reservations contained in the instrument of ratification deposited with the Secretary General of the Council of Europe on March 4, 2015.

²¹ See <https://lkireg.nalog.ru/en/registry>.

ALTERNATIVE STRUCTURING OPPORTUNITIES

The most conservative way to comply with the Russian tax rules is to tax register the respective supplier of e-services that monetizes its revenues. Suppliers would not normally welcome the need to tax register in a foreign jurisdiction, since this exposes them to a disproportionately greater compliance burden and extra tax audit risks. This is especially relevant if there are multiple non-resident suppliers of electronic services. There are various structuring opportunities available that need to be explored, with due consideration for unique facts of each particular transaction with a specific Russian customer.

It is worth exploring whether the facts can be easily changed to benefit from one of the four exceptions from the definition of ESS (e.g., transfer of software/content on tangible medium with no parallel e-transfer). If that is not possible, which is typically the case with respect to most cloud solutions, an alternative may be to consolidate and reroute all ESS from multiple non-resident suppliers through one foreign “hub” that would be integrated in the supply chain. Other possibilities, such as integrating a foreign or Russian cash collection intermediary in the cash flow route with Russian customers, are also worth exploring, though may be associated with a number of risks.

FOREIGN TREASURY COMPANY STRUCTURE

The Russian VAT rules link the tax registration and reporting obligations with the entity that collects ESS revenues from Russian customers.²² It can be a group treasury company or a cash collection hub. In such a scenario, it is the respective non-Russian intermediary collecting the proceeds from Russian customers (including related entities) that will be required to register, report and pay VAT into the Russian budget. The suppliers, in turn, would be relieved from the tax registration requirements in Russia if they do not collect their revenues directly from Russian customers.

The treasury company would be deemed a tax agent, rather than a taxpayer, for Russian VAT purposes. It would essentially perform similar tax compliance functions on behalf of the suppliers, but on a consolidated basis. The supplier does not need to change the payment terms with the customers (or contractually re-route the services through the intermediary). However, the supplier needs to indicate the foreign intermediary as the entity that would need to receive payments for the ESS, both for Russian currency control and tax purposes. It is up to the sup-

²² See Russian Tax Code, arts. 83(4.6), 174.2(3), 174.2(10).

plier to decide whether to continue issuing commercial invoices (with instructions to pay to the third party and disclosure of the latter’s Russian tax registration data) or to have the cash collection agent undertake this function.

At the same time, technically, the Russian tax rules grant the right to recover VAT, among other things, when ESS are “acquired from foreign organizations registered for tax purposes.” Therefore, based on the literal interpretation of the rules, there is a risk that the VAT credit may not be granted to Russian customers in such setups. Probably, this was not the intention of the regulator and the Parliament and can be considered a legislative gap and deficiency in the legal drafting. Otherwise, a large portion of B2B e-commerce world where suppliers use third-party treasury companies/aggregators would not work in Russia due to inability to recover VAT. The Federal Tax Service representatives promised to address this technical deficiency in a guidance letter.

THE ‘LOOK THROUGH’

Active type of income, including services income, is generally exempt from Russian withholding (corporate profits) tax under the Russian domestic tax rules.²³ With respect to those categories of ESS that represent passive types of income (e.g., royalties), the Russian customers will need to verify that suppliers (not intermediaries) are beneficial owners of Russian-sourced royalties and apply the double tax treaty provisions in the jurisdiction of the beneficial owner of the income.²⁴ Under the so-called “look through approach,” if the supplier is not the beneficial owner of Russian-sourced royalties, it can issue a negative beneficial ownership confirmation and the actual beneficial owner would issue regular beneficial ownership confirmation.²⁵

RUSSIAN CASH COLLECTION AGENT STRUCTURE

In some circumstances, a Russian cash collection agent structure may be worth exploring. In the event that a foreign supplier of ESS integrates a Russia-based entity (that could be a related company) into the cash collection process pursuant to an agency, commission or a similar contract, then such intermediary will be deemed a tax agent under the Russian VAT

²³ See *id.*, art. 309(2).

²⁴ See *id.*, arts. 7(2) and 312(1).

²⁵ See *id.*, arts. 7(4) and 312(1.1).

rules.²⁶ It would be required to calculate, withhold and remit the VAT to the Russian budget. The foreign supplier of ESS would be relieved from the tax registration, reporting and payment obligations in Russia.

This intermediary would not normally meet the statutory criteria of a dependent agent under the domestic rules (let alone the permanent establishment (PE) concept under an applicable double tax treaty that would typically follow the OECD Model Tax Convention). Under the Russian Tax Code, a dependent agent “represents the interests of the foreign principal, acts on its behalf, has and regularly exercises authority to conclude contracts or negotiate their material terms and conditions, thus creating legal obligations for such principal.”²⁷ Exceptions include cases when the contract has been fully negotiated by the principal without the involvement of the agent and was subsequently sent to the agent with detailed execution instructions, and/or when the agent acts as a professional securities broker or dealer in its ordinary course of business. Still, much depends on the functional profile of the agent and underlying circumstances.²⁸ The cash collection agent would charge an arm’s-length fee for its functions that would be subject to Russian VAT and corporate profits tax, unless the agent is eligible to tax benefits (including under the simplified tax system).

In order to be considered a dependent agent leading to a PE, the agent should perform a much greater role in generating Russian-source revenues for the foreign principal by negotiating terms and conditions of and/or executing sales contracts on behalf of the principal. The mere fact that the Russian cash collection intermediary is named an agent in the agreement with the foreign supplier of ESS (or treated as such from a commercial contracts law perspective) does not make this entity a dependent agent PE for domestic tax purposes. The agent would not normally participate in provision of ESS or negotiating commercial terms and conditions of sales contracts for such services. There would be no contractual link between the customer and the agent. Rather, the supplier would integrate the cash collection intermediary into its existing set of contracts for a limited function (and for arm’s-length consideration). The supplier would indicate (e.g., in the amendment to the underlying ESS agreements with Russian customers) that payments for ESS must be made to the Russian intermediary. The latter may be required to issue VAT invoices. It may also issue commercial invoices if the supplier authorizes to do so.

²⁶ See *id.*, art. 174.2(10).

²⁷ See *id.*, art. 306(9).

²⁸ See *id.*, art. 306(9).

The supplier may continue executing regular transfer and acceptance statements for ESS and commercial invoices (with requests to pay to the designated agent) and provide the agent with necessary data for the generation of VAT invoices. The mere fact that the Russian cash collection intermediary is named an “agent” in the agreement with the foreign supplier might increase the practical risk of higher scrutiny by, or an ill-considered decision of, the tax authorities and even the Russian courts (court practice in Russia on tax matters is very limited, with a few odd cases with arguable decisions in recent years).²⁹ Purely from a legal perspective, the dependent agent PE risk is likely inflated and should not be viewed as a reason not to consider the Russian cash collection entity structure. However, it may be sensible to approach the Russian Ministry of Finance for clarifications on VAT recovery, specifics of raising VAT invoices and the potential PE risk before implementing the structure.

Also noteworthy is that settlements between Russian customers and a Russian cash collection agent (if it is a Russian legal entity) may be performed only in Russian rubles. ESS fees can be determined in hard currency, but must be payable in rubles at an agreed rate (e.g., with a link to the Russian Central Bank refinancing rate), unless the agent is a branch (taxable PE) of another foreign legal entity. The agent would be able to purchase hard currency for Russian rubles and remit payment to the principal (supplier).

Finally, the Russian cash collection agent would be also considered a tax agent for income withholding tax purposes (with respect to passive types of income, such as royalties, and subject to applicable double tax treaty relief).³⁰

DIRECT TAX IMPLICATIONS

The supply of electronic services by a non-resident enterprise to a Russian customer does not by itself give rise to a Russian direct tax PE of the non-resident company.³¹ It remains to be seen whether Russia will change its approach based on analysis of a set of facts. For example, if a non-resident supplier processes personal data of Russian citizens (e.g., customers) through a Russia-based server (which is a mandatory localization requirement of the Russian personal data laws),³² the Russian tax authorities might treat such server as sufficient nexus in the e-commerce world be-

²⁹ See, e.g., Resolution of the Supreme Court No. 305-KG15-11546 (Jan. 14, 2016), and Resolution of the 9th Arbitrazh Appellate Court on case No. Å40-94391/10-142-134 (Dec. 14, 2010).

³⁰ See Letter of the Russian Ministry of Finance No. 03-03-06/1/555 (Oct. 17, 2012).

³¹ See Russian Tax Code, art. 306(14).

³² See Federal Law No. 152-FZ, art. 18 (5) (July 27, 2006).

tween the foreign supplier and the Russian taxing jurisdiction, especially if such server is in actual disposal of the supplier.³³ There are also ways to adapt to and comply with the Russian personal data laws and at the same time mitigate potential server-based/digital PE exposure.

GETTING PREPARED

Businesses and the expert community have been participating in ongoing discussions with and giving regular feedback to the Ministry of Finance and the Federal Tax Service on the new rules and their disadvantages for both foreign and Russian businesses, especially in the context of intercompany transactions. It is possible that the rules will be relaxed before the registration deadline of February 15, 2019, but relying on such expectations is not recommended. Instead, it is highly advisable to (i) revisit all cross-border transactions with Russian customers, including affiliates, (ii) determine whether they provide for ESS (and whether the place of supply of such ESS could follow that of the principal services that might not be subject to Russian VAT under the domestic place of supply rules),³⁴ (iii) gather data on their arm's-length price, and (iv) consider segregating and re-routing such ESS through another entity, which can be a foreign or a Russian intermediary, including ones with mere treasury functions.

Russian customers may have made down payments in 2018 for ESS to be provided in 2019, and may de-

lay payments in 2019. In some circumstances, this strategy may help win some time for foreign suppliers to finalize the target structure and implement it subject to expected guidance from the regulator and potential changes to the Russian Tax Code in the spring session of the Russian Duma, the lower chamber of the Parliament. It is also possible to enter into alternative contractual arrangements with a retroactive effect (e.g., from January 1, 2019) to procure compliance with the tax rules and eliminate the risk of imputed taxable income from gratuitous receipt of ESS.³⁵

The entire regime is untested and is associated with multiple practical difficulties and risks for businesses. The Russian tax rules do not address how to raise and record VAT invoices by Russian cash collection intermediaries. Further complications may arise when transactions provide for both e-services and non-electronic services for a bundled fee, when e-services are supplied under mixed agreements and/or are VAT exempt.

It is important to understand possible outcomes and measure their impact early, develop the most optimal target structure, subject to unique facts and circumstances of each particular business, and implement it by the registration deadline. Due attention should be given to special transition rules in light of the VAT rate increase from 18% to 20% as of January 1, 2019, and guidance issued by the Federal Tax Service.³⁶ It remains to be seen how the market will adapt to the new VAT regime on B2B ESS and whether the rules will be changed with a retroactive effect.

³³ See Commentary (p. 123) to ¶ 8 of Article 5 of OECD Model Tax Convention on Income and on Capital (Condensed Version 2017), OECD Publishing, p. 152.

³⁴ See Russian Tax Code, art. 148(3).

³⁵ See *id.*, art. 250(8).

³⁶ See Letter of the Federal Tax Service No. ÑD-4-3/20667@ (Oct. 23, 2018).