

BIRCH LEGAL

Legal overview

356 days until tax audits for IT companies begin: main risks to consider and key preparations to make

1 Current status of and prospects for the prolongation of tax incentives

Against the backdrop of the economic downturn in 2020 due to the coronavirus pandemic, the Government of the RF adopted a resolution on conducting an IT-maneuver in the Russian IT industry^[1]. Consequently, the corporate tax and insurance premium rates for IT companies was lowered in 2021 to 3% and 7.6%, respectively, in order to reduce their effective tax burden.

Later, the corporate income tax rate for IT companies was reduced to 0% for the period from 2022 to 2024 as a part of the Government of the RF's "anti-crisis" measures aimed at keeping IT specialists in Russia^[2].

The current legislative regulations on corporate income tax do not explicitly address which tax rate will be applied from the beginning of 2025. Judging solely from the text of paragraph 1.15 of Article 284 of the Tax Code of the RF (hereinafter – the "TC RF"), it follows that the 0% tax rate won't be applied from the beginning of 2025 which necessarily entails that the general tax rate of 20% will be applied.

Nevertheless, there are several initiatives currently underway in the Ministries of Finance and Digital Development of Russia aiming to preserve or otherwise alter the 0% corporate tax rate for IT companies. According to the Ministry of Finance of Russia, it will depend on the financial indicators present in the budget for the fiscal year of 2023. If the rate of 0% is not preserved, the probability of another reduced tax rate being applied again (for example, the previously applied rate of 3%) is rather high. Moreover, any rate other than 0% will immediately have an effect on the tax risks of IT companies, since it will lead to tax consequences, however minor they may be..

Although, the two main regulators are in agreement that all other incentives, namely the reduced rate on insurance premiums and VAT incentives for Russian software (hereinafter – the "SW") and databases (hereinafter – the "DBs"), must be preserved indefinitely.

It should be concluded that the IT companies who applied the preferential tax regime, which has given them a competitive edge against companies who failed to apply said regime, made the correct strategic choice since some form of tax incentives will remain in 2025 and carry on into the future.

2 On-site tax audits for IT companies

The key date is **03 March 2025**. After this date, the FTS's Moratorium on on-site audits for IT companies expires, and the tax authorities can resume carrying out such audits^[3].

Despite the Moratorium, the inspectorate's actions in the JSC "PPO Electropibor" case^[4] demonstrate that the tax authorities are scrutinizing the activities of IT companies, and if they lose their accreditation, even temporarily, such on-site audits will be carried out rigorously.

The abovementioned case leaves no room for doubt that the tax authorities will actively begin investigating **IT companies' application of their tax incentives from 2022 to 2024** after 03 March 2025. It is precisely in this period that the corporate tax rates were minimal, which means that any unfounded application of the tax incentives will be met with the maximum charges: 20% for corporate tax and 7.5% –30% for insurance premiums. Furthermore, the number of accredited companies (see Pic. 1) indicates that there is a significant number of taxpayers who have yet to undergo an on-site audit and that not all of them will be able to avoid financial losses.

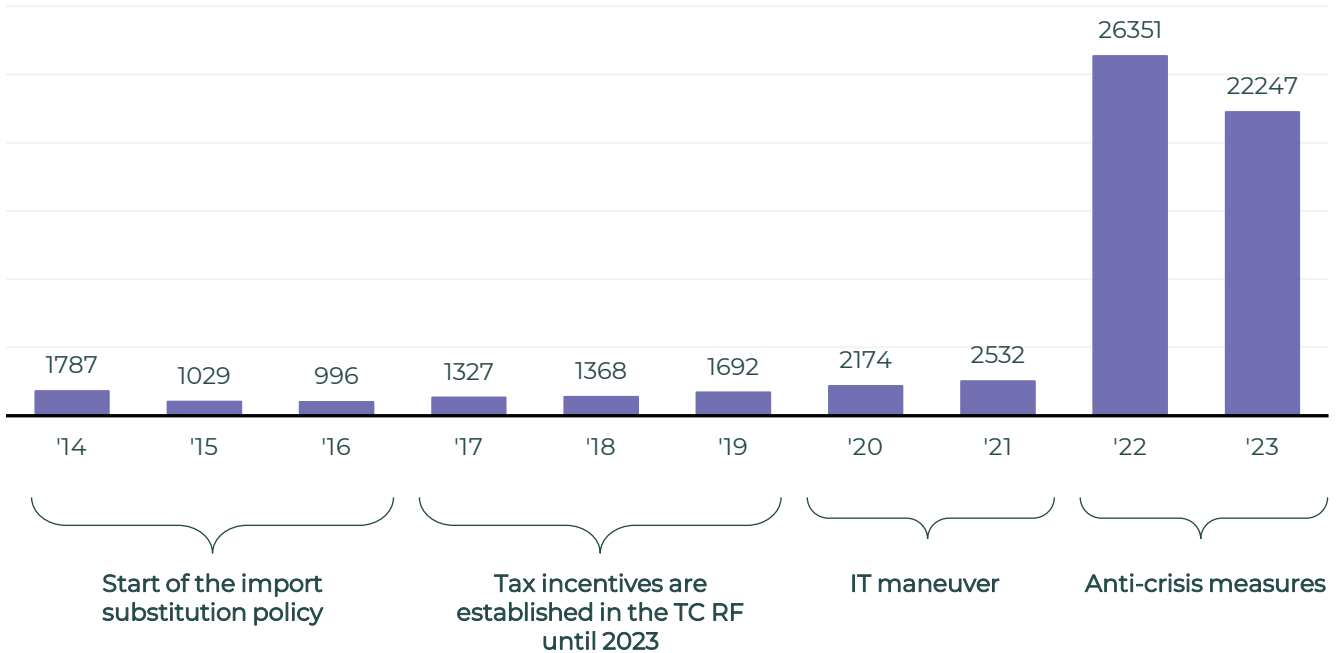
[1] Federal Law of 31 July 2020 No. 265-FZ "On Amendments to Part Two of the Tax Code of the Russian Federation"

[2] Federal Law No. 321-FZ of 14 July 2022 "On Amendments to Part Two of the Tax Code of the Russian Federation"

[3] Letter of the Federal Tax Service of Russia dated 24 March 2022 No. SD-4-2/3586@ "On the appointment of GNP in relation to accredited IT organizations"

[4] Resolution of the Arbitration Court of the Volga District dated 19 February 2024 No. F06-12596/2023 in case No. A49-6308/2023

Fig.1 Trends of IT companies obtaining accreditation (data from the Ministry of Digital Development of Russia)



In our opinion, IT companies have just under one year to assiduously vet their operations for tax risks which could deprive them of their right to IT tax incentives, voluntarily adjust their tax obligations (should risks be found) or to simply strengthen their factual and legal positions on their business risk areas.

3 What will be audited and what business risk areas do IT companies have?

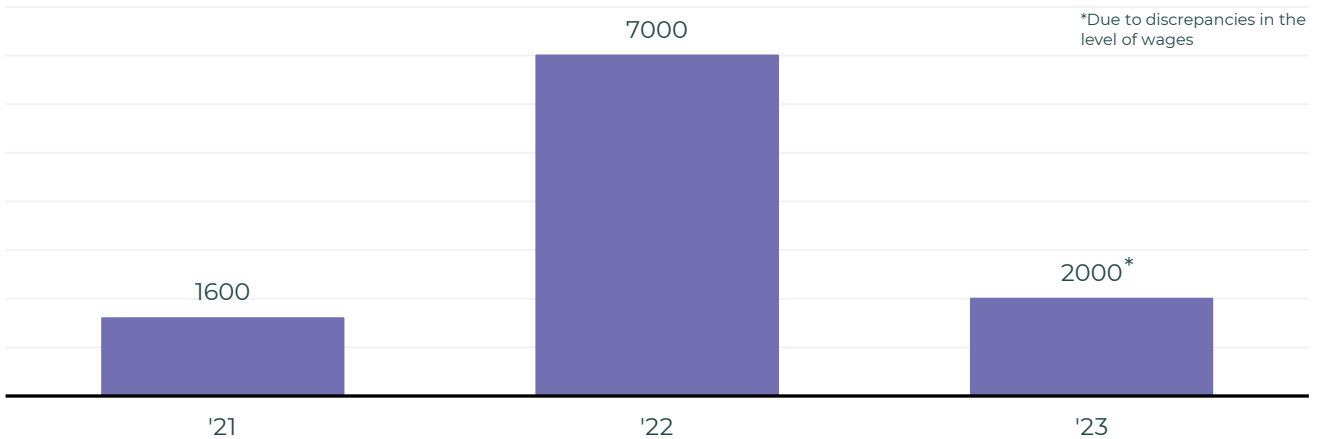
The lawyers in BIRCH LEGAL's tax practice have registered as well as supported the launch of numerous IT companies and are currently reviewing the activities of several IT companies with the goal of identifying and minimizing tax risks. Below are the most significant and widespread business risks for IT companies:

Risk: Losing IT-accreditation

State IT-accreditation from the Ministry of Digital Development of Russia is a prerequisite for obtaining both tax and social incentives to aid in successfully conducting business. Regardless of the fact that accreditation is issued for an indefinite term, the law explicitly describes the circumstances under which IT-accreditation can be revoked.

Having one's accreditation revoked entails the automatic abrogation of the right to apply the tax incentives for corporate income tax and insurance premiums. Such companies become subject to on-site audits, and its employees lose not only the right to apply for draft deferments for military service but also their preferential mortgage rates.

Fig.2 Trends in the revocation of IT-accreditation



Based on our experience, we highlight the following most frequently encountered reasons for losing IT-accreditation below:

Failing to submit or incorrectly submitting consent to disclosing confidential tax information

From the beginning of October 2022, IT companies receiving IT-accreditation for the first time are obliged to provide consent to disclose records consisting of confidential tax information.

The main risk factor when submitting such consent is forgetting to extend its validity before its expiration date is reached. If the company has provided its consent with a certain expiration date, we recommend providing consent for a longer period well in advance of the expiration of the previous consent.

However, in practice, companies are most often faced with problems of a formal nature, for example: failing to indicate code “20009” in the “Other” field in the consent form. This additional code “20009” allows you to disclose information to the Ministry of Digital Development of Russia; without it, such disclosure is impossible.

Inconsistency of wages with the average wage level in the country or region

The average monthly salary requirement affects only those companies which haven't registered their products in the register of Russian SW. This condition applies to organizations that were created no earlier than one quarter before submission of the application for IT-accreditation.

Around 2 000 companies lost their IT-accreditation in 2023 for non-compliance with this requirement alone.

Lack of information on conducting IT-related activities

For a company to successfully obtain accreditation, certain information must be available on its website. The law, however, does not strictly define requirements for this information or how it should be displayed. As a result, there is a risk of the Ministry of Digital Development of Russia misinterpreting the information on the site^[5], which could entail the revocation of the IT-accreditation. In this regard, it is imperative to ensure the presence of the following information on the company website

[5] See, for example, the Decision of the Moscow Arbitration Court dated 30 November 2023 in case No. A40-186321/22-145-1417, the Decision of the Moscow Arbitration Court dated 29 February 2024 in case No. A40-301931/22-147-2395

name of the company, its details and contact information

description of IT services that in one way or another correspond to the main economic activity of the company

description of the IT product, its functionality and its registration in the SW registry (if available)

Although the Ministry of Digital Development of Russia's reasons for revoking IT-accreditation appear to merely consist of "formalities" at first glance, disputing them in court rarely returns a result in favor of the IT company in the vast majority of cases^[6]. Accordingly, it is wise to perform qualified legal due diligence on compliance with accreditation requirements prior to an audit by the Ministry of Digital Development of Russia.

Risk: Business purpose for creating the IT company

In accordance with the Letter of the FTS of Russia dated 21 January 2021 No. SD-4-2/561@ (Letter of the FTS), support measures should equally apply to newly created IT companies. However, the creation of an IT company as a result of the reorganization of existing legal persons (division, spin-off) should be examined by the tax authorities in each individual case for signs of "business fragmentation" where the only purpose of these actions is to obtain the right to apply reduced corporate tax and insurance premium rates.

Spinning-off an IT-department into its own IT company is a widely recognized practice. However, it is important to assess how well-reasoned and -documented the business purpose for the completed restructuring is:

- Have new business processes for ordering and executing IT services been developed?
- Is the new office of the IT company the place where the specialists' actual work is done as well as the location of the equipment?
- Are all actual actions of the IT specialists included in the subject of the IT services agreement?
- Is the pricing appropriate for the services provided?
- Is the IT company's decision-making carried out independently of the parent company-customer?

Otherwise, significant risks could be incurred which would call into question the business purpose of the restructuring and lead to the retroactive revocation of tax incentives applied in previous periods.

Risk Proper qualification of IT revenue

Compliance with the condition that 70% of revenue in the total income of an IT company must come from IT-related activities is closely related to the correct qualification of earned revenue. Moreover, the correct qualification of revenue is determined by a number of complex methodological issues, including:

- formation of the cost of IT services, including the impact of wage costs for different groups of IT company specialists on different types of IT services under the contract
- grounds for the chosen prices for IT services, especially if the IT company provides services primarily within a group of companies
- calculation of rates and prices per unit of services
- ratio of IT services specified in contracts with real business processes in an IT company
- profitability/unprofitability of an IT company
- use of SW and DBs that are not proprietary developments
- as well as other issues

It is important to note that reclassification of even a few services with their consequent exclusion from the revenue base may lead to a shift in the share of IT-related income below the minimum 70% threshold followed by the need to recalculate tax liabilities.

[6] See, for example, the Decision of the Moscow Arbitration Court dated 28 July 2023 in case No. A40-60058/23-17-474, the Decision of the Moscow Arbitration Court dated 22 August 2023 in case No. A40-98773/23-92-788, Resolution of the Ninth Arbitration Court of Appeal dated 05 October 2023 No. 09AP-58185/2023 in case No. A40-40712/2023, Decision of the Moscow Arbitration Court dated 21 August 2023 in case No. A40-75337/23-146-601, Decision of the Arbitration Court Moscow court dated 26 October 2023 in case No. A40-96175/23-92-775, Decision of the Moscow Arbitration Court dated 21 August 2023 in case No. A40-75337/23-146-601

Risk: Isolation of the business of an IT company

According to the letter of the FTS of Russia dated 10 March 2021 No. BV-4-7/3060@, during a tax audit of a taxpayer who is part of a group of persons over whom control is exercised by the same persons, it is necessary to assess whether the taxpayer and other persons carry out the relevant activities independently and at their own risk using their own sufficient labor, production and other resources with the adoption of management decisions by the taxpayer's management bodies or, conversely, whether various organizationally unified activities are carried out on behalf of several formally independent entities that are coordinated by the same persons with the use of common material, technical and (or) labor resources and (or) means of individualization.

As our experience can attest, the spin-off of IT subdivisions into separate IT companies often does not lead to the total isolation of said company's activities, which could be expressed in the following criteria:

- intersection (including part-time work) in the management of an IT company and other companies of the group
- unification of business processes, for example, employees of other companies of the group can be involved in the process of agreeing on individual issues and making decisions
- use of management resources of the parent company free of charge without proper documentation, for example, the use of general accounting, financial and legal support
- the IT company lacks independent material resources: computer equipment, servers, domain name, etc.
- documentary as well as actual adoption of management decisions by employees of the company-customer in terms of the IT business

The presence of the criteria above can be taken into account as a whole by the tax authorities and considered grounds for requalification of the IT company's activities and the revocation of right to apply tax incentives.

4

Negative consequences for IT companies

The realization of the risks above can lead to the following negative consequences:

refusal to apply tax incentives for 2022-2024 and additional corporate tax charges and insurance premiums at a rate of 20% and 30%, respectively, in addition to the applicable amount of penalties

being brought to tax liability under Article 122 of the TC RF in the form of a fine for non-payment of taxes and insurance premiums in the amount of 20% of the unpaid amount. Moreover, if the IT company primarily received income from an affiliated company, then said act will be qualified as intentional, and the fine will be 40% of the unpaid amount

being brought to criminal liability for evasion of taxes (insurance premiums) under Article 199 of the Criminal Code of the Russian Federation or for fraud under Article 159 of the Criminal Code of the Russian Federation associated with the provision of false documents to obtain accreditation

Furthermore, the current situation for IT companies is one in which their activities are carried out in a "law enforcement and methodological vacuum" which could lead to an avalanche of tax disputes once on-site audits begin in the near future.

Key contacts for further information

At present, the lawyers of BIRCH LEGAL's tax practice are conducting comprehensive reviews of IT companies to assess their activities from 2022 to 2024, determine the tax and legal risks they could incur after 3 March 2025, as well as make practical recommendations for minimizing their risks in order to start 2025 on the right foot.



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