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Russia Introduces Physical Presence Requirements for Foreign Tech Companies - How to Comply with Minimum Tax Exposure?

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On July 1, 2021, Russia adopted — within just a few weeks and without any public discussion or consultation with the expert community — a paradigm-shifting law[1] *that establishes, among other things, new physical presence requirements for major foreign technology companies doing business in the Russian Internet space.*

Under this law — typically referred to as the "landing" law in the Russian mass media (herein, the "Law" or the "Landing Law") — the affected technology companies are required to "land" in Russia by opening either a representative office, a branch, or a subsidiary. This article provides a brief overview of this radical regulatory development and its Russian tax implications, reviews the compliance alternatives, and suggests means to mitigate the associated tax risks.

THE CONTEXT: RUSSIA FORCES FOREIGN IT COMPANIES TO ESTABLISH LOCAL PRESENCE TO ENSURE COMPLIANCE WITH DOMESTIC REGULATIONS

The Russian Government has expressed concerns about its lack of leverage over foreign IT giants with no local offices or other representation in Russia. Russia indeed has lacked efficient tools to enforce its laws against major technology companies that are located outside Russia but do business with customers in Russia. The mandatory opening of local offices has been considered as a potential solution to the problem.

According to the bill's explanatory note, a physical presence of the relevant foreign tech companies in Russia should help ensure a "constructive dialogue" between such companies and the Russian authorities, as well as proper communication with Russian users. The enhanced list of applicable sanctions is aimed at contributing to the intended compliance.

THE LANDING LAW

In-Scope Technology Companies

According to Russian state-owned news agencies and members of parliament, the Landing Law targets various industries: social networks, video platforms, instant messengers, e-mail services, search engines, hosting providers, online stores, and Wikipedia.org. The scope of the Law is not limited to any particular market players. Technically, the Law applies to any

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[1] Federal Law No. 236-FZ "*On the Activities of Foreign Entities on the Internet in the Territory of the Russian Federation*." Most provisions of the Law entered into force on July 1, 2021, except for several provisions that come into effect in 2022.

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foreign multinational enterprise (MNE) that meets the relevant statutory criteria.

The Law applies to two groups of targeted entities (both companies and individuals). The *first group* includes MNEs that simultaneously meet the following criteria:

- they own a website (or a webpage) or an ''information system'' or a ''computer program'' (jointly called an ''information resource'' in the Law);
- such information resource is accessed by more than 500,000 users located in Russia per day; and
- at the same time, *any* of the following conditions is met:
  - o the information resource is in the Russian language or in any local language of the Russian Federation; or
  - o the information resource contains advertising targeting Russian users; or
  - o the MNE processes Russian users' data; or

A completely separate matter deserving in-depth analysis is how such 500,000 daily users should be counted and how Roskomnadzor, the Russian Internet watchdog (the ''Regulator''), will interpret the relevant statutory rules. Specifically, whether, at some point, the Regulator or the Russian courts would consider it appropriate — in terms of the gist of the Landing Law — to merge different ''information resources'' relating to the same content / services to calculate the daily user audience.

The *second group* of targeted MNEs includes:

- foreign hosting providers or other entities involved in maintaining information resources on the Internet that are accessed by Russian users;
- businesses involved in Internet advertising if the ads target Russian users; and
- operators of online communications platforms accessed by Russian users.

The Regulator determines which MNEs from the second group will be subject to this Law (but in accordance with methodology to be approved by the Russian Government). The Regulator will also maintain a public register of MNE that will be subject to the Law. If the number of their Russian users falls below 500,000 per day for three months, they may be removed from this register.

Residency Requirements

An MNE falling under the Law must establish a physical presence in Russia in the form of a local subsidiary (i.e., a separate legal entity), a branch, or a representative office. This obligation will come into force on January 1, 2022. Such local office will be responsible for:

- processing enquiries from Russian citizens and companies;
- implementing Russian court decisions and orders from Russian authorities that relate to such MNE; representing the MNE in the Russian courts, and
- blocking or deleting ''restricted content'' on the relevant information resource.

MNEs that fall under the Law will also have to:

- register an account with the Regulator and use it to formally communicate with the Russian authorities; and
- set up a special electronic feedback form on their information resource for Russian users; and
- install certain software provided by the Regulator to count Russian users accessing their Internet resources.

To establish a local presence, MNE will have to take a number of steps, including (i) registering a branch, a representative office or a legal entity, (ii) renting premises, (iii) opening Russian bank accounts, and (iv) hiring employees. Also, the local office will then have to regularly file tax and other reports in Russia. The whole process of office establishment from start to finish may take one to two months. In-scope MNEs must complete this process by January 1, 2022.

Sanctions and Related Risks

The Landing Law establishes different sanctions that may be used separately or jointly against MNE that fail to comply with the Law. They include informing Russian users of an MNE's violation of Russian laws, various bans (e.g., on distribution of ads, money transfers, inclusion of data on legislative violations of the MNE and their businesses into search results, collection and cross-border transfer of personal data) and partial or full restriction of in-Russia customers' access to the MNE's information resource.

With a few exceptions, the Regulator may choose these sanctions at its discretion depending on the type of violation. Within three business days upon its decision to apply sanctions, it is required to publish information on the enforcement measures taken against the MNE both in the public register and in the sanctioned company's account with the Regulator.

In addition to the administrative sanctions introduced by the Landing Law, the CEO of the local office may be held both administratively and criminally

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liable for failure to enforce governmental and state court decisions intended to enforce compliance with Russian laws, including, but not limited to, personal data laws. Therefore, compliance with the Landing Law carries an incremental need to ensure overall compliance with Russian laws in the long term and minimize related bad publicity risks.

MNE COMPLIANCE WITH THE LAW

Selecting the Right Form of Presence

While in-scope foreign MNEs can select among three forms of presence for their local office (a representative office, a branch, or a subsidiary), the Russian tax implications of operating under each of these forms would vary substantially.

Under Russian law, a branch is established primarily for commercial purposes and, thus, normally leads to a taxable permanent establishment of the MNE by default. Unlike a branch, a representative office is not supposed to conduct commercial activity at all. If the representative office is in fact engaged in commercial activities, however, the permanent establishment risk also exists under the representative office structure.

Additionally, both a branch and a representative office form part of the same legal entity, the foreign in-scope MNE. Therefore, from the standpoint of limiting most categories of liability of the latter, including administrative and tax liability, the subsidiary structure may be considered preferable. Except in very limited circumstances, a subsidiary is not responsible for discharging the Russian tax liability of its parent and vice versa. The Russian court practice on tax matters, including on cases involving the statutory anti-avoidance rules and related judicial doctrines, does not suggest that the Russian tax authorities can pierce the corporate veil and collect the tax liabilities of a foreign taxpayer from its Russian affiliate. Over time, this tax enforcement practice may certainly change, but it would likely require respective legislative amendments.

In choosing among the three possible forms of presence, an MNE could apply the above rationale to matters involving data requests of Russian state authorities, including tax authorities. If, as a matter of Russian law, a subsidiary subject to the Landing Law does not have particular data and is not required to store it (e.g. data on operations of its non-Russian parent MNE subject to the Landing Law), it can rely on this argument when responding to such data requests. A branch or a representative office that is part of the same legal entity naturally has less leverage taking this position without exposing itself to respective liability and/or bad publicity risks.

For the same reason, when dealing with tax audits, a representative office or a branch structure, as opposed to a separate legal entity structure, puts the in-scope MNE into a more vulnerable position before the Russian tax and other controlling authorities. Normally, a subsidiary would not be supposed to possess or have access to documentation on its HQ activities. This fact alone might represent an additional layer of defense for the MNE before the Russian tax authorities.

Determining the Functional Profile of the Local Office

Any form of presence an in-scope foreign MNE establishes in Russia for purposes of the Landing Law implies performance of at least one function: ensuring compliance with Russian laws. This function naturally carries associated reputational, regulatory and financial risks for the MNE (e.g., due to statutory limitations on extracting profits out of Russia or complete inability to continue business in the country).

The Law does not require the MNE to re-route its revenues through such local office. The MNE is not required to use its already existing legal presence in Russia or expand its profile with additional functions.

Adding the function of required regulatory compliance to the existing structure — typically, a subsidiary — could, in turn, result in additional risks for the MNE and compromise its historical business in the country. The entire activity of such local form of presence may be hampered (e.g., due to failure of the local office to implement binding decisions of the controlling authorities and/or Russian courts and imposition of various types of liability on the CEO and/or the entity itself). Therefore, subject to specific background facts and circumstances that are often unique, enhancing the functional profile of the existing entity — whether it is involved in sales, marketing, software development, consulting or else — could arguably be viewed as a riskier structuring decision.

Whether to establish a standalone structure merely for the purposes of the Landing Law or to expand the functional profile of the existing structure is, thus, a highly complex issue. This decision may depend on multiple factors. They may include (a) the type of functions of the existing structure and their relevance for maintaining uninterrupted business operations of the MNE in Russia, (b) MNE's internal policies that could foster operations under simpler corporate structures (as opposed to creating new ones for greater risk diversification), (c) overall vision of the MNE for its future visibility and interest to the Russian controlling authorities, (d) long-term probability of adversarial communication with the latter, and (e) likely scope of future regulatory changes and additional obligations that may be further imposed upon the local office.

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In this context, it is worth mentioning that at the initial stages of development of the target physical residency requirements some members of parliament expressed an intention to merge the existing virtual offices of registered vendors of electronically supplied services (ESS) with the regulatory registrations of local offices. It is unclear whether and how such an initiative will be implemented, especially if the Russian tax-registered ESS cash collection entity and the in-scope MNE (e.g., operator of the ''information resource'') are different legal entities within the same group of companies. However, the Regulator has already used (earlier this summer) the list of ESS vendors registered with the Russian tax authorities (currently, over 3,000 companies, with over 90% of them being B2B ESS vendors) for mass mailing of standardized personal-data-related inquiries. It remains to be seen how the Regulator will further exploit such parallel channel of communication with the business for the purposes of the Landing Law.

Financing the Local Presence

The local office will need to be regularly funded to perform its functions. Funding a branch or a representative office by its HQ is fairly easy and straightforward and does not require a separate agreement within the same legal entity. Neither does it fall under the Russian currency control restrictions. In the case of a subsidiary structure, an intercompany cost plus service agreement would normally suffice to perform the required function.

If total revenues between the parties to such agreement exceed RUR 60 million (approx. USD 820,000 at the current exchange rate) per calendar year, such transaction will be deemed controlled for Russian transfer pricing purposes. The local office will be required to submit a notification to the Russian tax authorities on such controlled transaction and have transfer pricing documentation handy to provide it within 30 days upon request.

If the regulatory compliance function is added to the functional profile of the existing structure, this may complicate the benchmarking study and potentially contribute to greater transfer pricing risks in Russia. This could particularly be the case if there is room for the application of the profit split method and the Russian tax authorities decide to attribute disproportionally greater value to such regulatory function than is critical for maintaining MNE's commercial operations in and extracting profits from Russia.

Depending on the scope of the intercompany agreement and its service description, the service fee may be subject to an additional 20% Russian VAT that would be generally non-recoverable by the foreign MNE (unless it has a PE in Russia). In the event that a foreign affiliate of the local entity undertakes most third-party costs incurred for the benefit of the local office (whether for regular day-to-day operations or for a major litigation against the Russian controlling authority), technically, such local office may be subject to a 20% Russian corporate profits tax on imputed income.

Nexus and Long-Term Tax Considerations

Russia has been gradually following the path of increasing the regulatory burden for foreign technology companies doing business in Russia. The need to comply with more onerous regulatory requirements will likely contribute to greater nexus with the Russian taxing jurisdiction. This comment is particularly relevant given the long-standing obligation of foreign entities to localize personal data of Russian citizens on Russia-based servers. Coupled with the local presence under the Landing Law and tax registration under the VAT regime on ESS, these ''entry points'' into the Russian market could potentially be considered representing sufficient nexus with Russia and lead to a server-based / digital PE.

Russia is a member of the Inclusive Framework on Base Erosion and Profit-Shifting (BEPS) and is interested in implementing the resulting decision of OECD member countries within Pillar I discussions. The Russian Ministry of Finance has stated a few times that in the absence of global consensus on taxation of highly digitalized businesses deriving revenues from market jurisdictions, Russia could unilaterally introduce a digital services tax. It remains to be seen how this will be ''technically'' achieved and what the target legal framework will be.

In this context, a foreign MNE's local office under the Landing Law and/or Russian ESS vendor tax registration could be used for collecting this additional ''digital'' tax on such MNE. It may be argued that opening the required local office under the Landing Law is just the first step in a longer and fairly unpredictable ''journey'' for the MNE in the dynamic Russian regulatory and tax environment. Determining the right compliance strategy from the outset may be key for reducing the MNE's long-term tax risks in this difficult market.

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