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R95 **Russian Economy in 2020. Trends and outlooks**. **(Issue 42)** / [V. Mau et al; scientific editing by Kudrin A.L., Doctor of sciences (economics), Radygin A.D., Doctor of sciences (economics), Sinelnikov-Murylev S.G., Doctor of sciences (economics)]; Gaidar Institute. – Moscow: Gaidar Institute Publishers, 2021. – 668 pp.: illust.

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The review "Russian Economy. Trends and Outlooks" has been published by the Gaidar Institute since 1991. This is the 42th issue. This publication provides a detailed analysis of main trends in Russian economy, global trends in social and economic development. The paper contains 6 big sections that highlight different aspects of Russia's economic development, which allow to monitor all angles of ongoing events over a prolonged period: global economic and political challenges and national responses, economic growth and economic crisis; the monetary and budget spheres; financial markets and institutions; the real sector; social sphere; institutional changes. The paper employs a huge mass of statistical data that forms the basis of original computation and numerous charts confirming the conclusions.

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2.3. Challenges of international business taxation in the context of digitalization[1]

The current system of international taxation does not result in a fair distribution of the tax base between countries in a digital environment violating the principle of taxation in accordance with the added value created in the particular country. In the absence of international consensus, countries reform their tax systems aimed to collect taxes in the digital economy unilaterally by imposing Digital Services Tax (DST). By their nature, being indirect, these taxes (DST) are collected on the turnover of foreign digital companies in the market country (the country of the source of income).

Unlike VAT, credited along the entire value chain to ensure its neutrality, these taxes are more like import duties levied on a one-off basis when accessing the local digital market. Due to their specific nature, these taxes do not fall into the system applied by international tax agreements, however, according to some countries, for example, the United States, they violate existing trade agreements and WTO principles.

The introduction of such a tax will result in additional budget revenues, increase the cost of digital services for local users and create a trade barrier for foreign digital businesses. Its goal to ensure neutrality in the overall tax burden between digital and traditional business is an overly complex task that is unlikely to be implemented, given a rather simple and unclear mechanism of this approach, which assumes taxing the attributable profit of foreign digital companies through taxation of turnover at a low rate.

Principles of methodology being the platform for the VAT calculating and levying system in cross-border electronic trade in both goods and services do not generate significant disagreements between countries. The analysis of international experience proves that countries are trying to implement the destination principle to the maximum in relation to international trade as far as the tax administration allows, and, accordingly, ensure equal competition conditions and a neutral shift of the VAT economic burden to the jurisdiction of the product final consumption, including those sold in the electronic form.

These principles were developed and structured by the international consensus back in 1998[2] and further detailed in the context of their introduction owing to certain challenges associated with practical aspects, administration and control over the VAT payment by a foreign company without its physical presence in the

1 This section was written by *Milogolov N.*, Candidate of Economic Sciences, Head of IAES RANEPA Tax Policy Research Department; *Berberov A.*, Researcher of the Gaidar Institute.

2 A Report by the Committee on Fiscal Affairs, as presented to Ministers at the OECD Ministerial Conference, “A Borderless World: Realizing the Potential of Electronic Commerce” on 8 October 1998” Ministers welcomed the report and endorsed the proposals on how to take forward the work as outlined within it. URL: https://www.oecd.org/ctp/consumption/1923256.pdf

country[1]. Thus, the new rules for levying VAT on foreign services in electronic form provided to Russian individuals and enterprises have been in effect in Russia since 2017[2].

However, it should be noted that taking into consideration methodological approaches to direct taxation in the context of digitalization, the relevant international consensus is lacking today, although certain methodological approaches are being developed both by international organizations, primarily the OECD and the EU, as well as by individual countries.[3] The meaning of the mentioned discussion in relation to direct taxation comes down to rethinking of the existing rules for distribution of the tax base of international groups of companies between the country of residence and the country being the source of income, applied amid the current tax architecture, most commonly based on a chain of international bilateral tax agreements built upon the OECD Model Convention concluded by countries.

The reason for the rethinking is that within the current tax architecture, countries being sources of income (market countries) do not have appropriate rights to tax the profits from activities even when foreign companies conduct there a real business without a physical presence, for example, when a fair amount of goods is sold to local population through Internet. Governments and people in these countries consider this situation unfair and thus, stimulate political and expert discussion[4] about particular countries that are creating value and to what extent in the context of new digital business models, and about the tax consequences that should arise hereat. The discussion escalated after the onset of the pandemic when humanity was forced to go digital, and the profits of the largest digital companies significantly increased.

Aiming to maintain competitiveness and fiscal adaptation of the Russian tax system to digital realities, the authors identify *5 key areas* requiring reform in the short and medium term and also put forward appropriate recommendations.

1. Current rules requiring physical presence when creating a "tax liaison" between a market jurisdiction and a foreign company do not meet the demands of digital economy and should be updated in the interests of Russia as a significant market country.

1 Addressing the Tax Challenges of the Digital Economy. Action 1 – 2015. Final Report // OECD/G20 Base Erosion and Profit Shifting Project. Paris: OECD Publishing, 2015. URL: https://doi.org/10.1787/9789264241046-en

2 Federal Law «On Amendments to Parts One and Two of the Tax Code Russian Federation «dated 03.07.2016 No. 244-FZ (last edition).

3 Program of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalization of the Economy / OECD/G20 Inclusive Framework on BEPS. Paris: OECD, 2019. URL: http://www.oecd.org/tax/beps/programme-of-work-to-develop-aconsensus-solution-to-the-tax-challenges-arising-from-the-digitalisation-of-the-economy.htm.

4 Addressing the Tax Challenges of the Digital Economy, Action 1 – 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, Paris: OECD Publishing, 2015. URL: https://www.oecd-ilibrary.org/taxation/addressing-the-tax-challenges-of-the-digital-economy-action-1-2015-final-report_9789264241046-en

OECD (UN) standpoint: global reform is critical because users of digital products, including free ones, being residents of large market countries, apparently represent the input resources (providers of user data) for foreign companies without an appropriate physical presence in these market countries.

The unilateral introduction of taxes on digital services (digital services tax - DST) is detrimental, while it is optimal to achieve an international consensus, that is the OECD Pillar One initiative. As a result of its implementation, the market countries will be entitled to tax a share of profits of foreign digital companies whose global revenues exceed Euro 750 mn based on the extent of their digital presence in the country (for example, the level of digital sales or user database in the country).[1]

Situation in Russia: Russian tax legislation lacks effective instruments for taxing local income (profits) of those foreign companies that have only a virtual economic presence in Russia, with a profit tax. However, ignoring the issue leads to unjustified tax losses for the Russian budget and distortion of the competition between foreign and Russian digital businesses.

According to own calculations based on the determination of the Russian users' role in the activities of foreign digital companies through the geographical analysis of their Internet traffic, the introduction of an indirect gross tax on the proceeds from provision of digital services purchased by Russian users from foreign companies (DST) can contribute to the budget about Rb +37.8 bn additional tax revenues.

Russia's accession to the OECD Pillar One initiative has less fiscal potential: according to own calculations, one can talk about Rb 10 bn tax revenues. It is important to emphasize that this amount may be lower, since the list of the largest Russian digital companies includes Mail.Ru and Yandex, operating in the post-Soviet markets, and, therefore, the relevant share of their foreign tax base will not be taxed in Russia and the foreign tax will be credited against the Russian one.

Notwithstanding that the introduction of a unilateral measure is more preferable from a fiscal point of view, the application of this strategy can lead to challenges when increasing the international economic cooperation in the digital sphere with developed countries (OECD countries and, especially, the United States, due to the leadership of this country in the global digital economy).

Amid the actual contradictions and the lack of international consensus, the optimal approach is to introduce a temporary digital indirect tax on digital services purchased from foreign companies (DST). This tax may be canceled after the introduction of the Pillar One mechanism and Russia's accession, taking into consideration a pre-announcement of its national position.

This trend seems preferable, given that ease of administration and fiscal efficiency (typical for DST) currently seem to be more important than fairness in international taxation. Moreover, the introduction of a temporary digital tax is in line with Russia's position as a "market country" and the current needs for

1 Secretariat Proposal for a "Unified Approach" under Pillar One // OECD. URL: https://www.oecd.org/tax/beps/public-consultation-document-secretariat-proposal-unified-approach-pillar-one.pdf

fiscal consolidation amid the pandemic economic consequences. Finally, a similar position is now becoming an "international consensus" in developed countries (except for the United States and the "hub countries").

2. Due to the novelty of digital business, revenues from digital operations may fall under several articles of tax treaties and provisions of internal legislation at once (they can be classified as income from business activities, royalties, income from asset disposal). This uncertainty creates opportunities for tax optimization and fiscal risks for the state, as well as increasing risks for entrepreneurs and investors.

OECD (UN) standpoint: the key principle is the analysis of the economic and legal meaning of the transaction based on the scope of rights transferred to the buyer (compared to provisional minimum required standard ("de minimis"). If this threshold is not exceeded, the income received will be interpreted as "income from entrepreneurial activity." Otherwise, the income will be considered a royalty. In a recent initiative, the UN proposes to expand the definition of "royalty" aimed to apply withholding tax to any B2B payments for software.[1]

Situation in Russia: the analysis of the Russian tax legislation shows its current uncertainty regarding the category of income received by a foreign organization from provision of digital operations within the license agreements that fix the "limits" for using the results of the intellectual activity or the means of individualization by the licensee.

The reference to "limits" is shaping the complexity of the reliable definition of the income category. First, in most cases, any transfer of rights can be a transfer of (1) partial or full rights in relation to the underlying copyrights, (2) partial or full rights to using a copy of the program, (3) know-how or a secret formula.

Second, as for mixed contracts, it remains debatable whether the main purpose of the contract should be highlighted to the tax payer when calculating income tax liabilities according to recommendations expressed in the comments to the OECD MC (2017).[2] It should be emphasized that lacking the relevant judicial practice on direct taxes does not allow us to determine the business end of this issue.

In short term, it is relevant to develop a national approach aimed at unambiguous identification of income from provision of digital services (Clause 2, Article 174.2 of the Tax Code of the Russian Federation) for income tax purposes, which should be expressively reflected as Letters of the Ministry of Finance and detailing the provisions of Chapter 25 of the Tax Code of the Russian Federation. In its drafting, one should build upon the principle "de minimis" used in the OECD MC (2017)[3] and tax legislation of various countries (for example, Singapore).[4] In this regard,

1 Discussion draft: Possible Changes to the United Nations Model Double Taxation Convention between Developed and Developing Countries Concerning. Inclusion of software payments in the definition of royalties / UN. URL: https://www.un.org/development/desa/financing/sites/www.un.org.development.desa.financing/files/2020-09/Revised%20discussion%20draft%20final.pdf.

2 Articles of the Model Convention with respect to taxes on income and on capital (2017) // OECD. URL: https://www.oecd.org/ctp/treaties/articles-model-tax-convention-2017.pdf

3 Ibid.

4 Rights-Based Approach for Characterising Software Payments and Payments for the Use of or the Right to Use Information and Digitised Goods // IRAS. URL: https://www.iras.gov.sg/irashome/

we do not share the latest UN initiative[1], since economically different types of transactions should be classified differently for the purposes of tax treaties based on the scope of rights transferred to the recipient.

3. Despite the progress made in the BEPS plan, companies still have the opportunity to avoid paying corporate taxes by redirecting their profits to low-tax jurisdictions, which is especially important for digital businesses.

OECD (UN) standpoint: elimination of unfair tax competition through the introduction of an internationally agreed minimum tax rate (method of calculating is under discussion) and the implementation of the following global rules (OECD Pillar Two)[2]:

- the country of residence of the parent company is entitled to additionally tax the foreign profit of the subsidiary if it has been taxed at a rate lower than the agreed minimum (*income inclusion rule);*
- the country of residence is entitled to switch from the exemption of foreign income from taxation (for example, the income of a permanent establishment) to its taxation at the minimum rate, if it was taxed at a rate lower than the agreed minimum (*a transition rule that will be introduced into tax agreements) ;*
- the country of source is entitled to refuse deducting a payment in favor of a related party or in case of its preferential taxation, if the payment is taxed in the recipient's country of income below the minimum rate (*the rule of compulsory payments* (*including the supplementing tax rule*).

Situation in Russia: the insights of the recommendations related to the second component of the OECD proposals (OECD Pillar Two) indicate that the Russian legislation already has analogues of these rules introduced at the national level. In particular, the *"income inclusion rule"* proposed by the OECD is similar to the CFC rules, which are better adapted to the requirements of Russia's economic policy**.**

The "*transition rule*" is irrelevant for Russian tax practice for the purpose of eliminating double taxation, since Russia already applies the method of offsetting foreign tax in all cases. Finally, the "*rule of compulsory payments*" can also be recognized as not meeting Russia's interests due to the following:

- its implementation may "devalue" provisioning of low tax rates in Russia for foreign investors as a tool to attract foreign investment;
- if increasing the withholding tax rates to 15% is completed in tax agreements with "transit countries", the rule implementation will be irrelevant from a practical point of view, including due to "thin capitalization" rules in Russian legislation;

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uploadedFiles/IRASHome/e-Tax_Guides/etaxguides_CIT_rights-based%20approach_2013-02-08.pdf

1 Rights-Based Approach for Characterising Software Payments and Payments for the Use of or the Right to Use Information and Digitised Goods // IRAS. URL: https://www.iras.gov.sg/irashome/uploadedFiles/IRASHome/e-Tax_Guides/etaxguides_CIT_rights-based%20approach_2013-02-08.pdf

2 Global Anti-Base Erosion Proposal ("GloBE") – Pillar Two // OECD. URL: https://www.oecd.org/tax/beps/public-consultation-document-global-anti-base-erosion-proposal-pillar-two.pdf.pdf

- the concept of the beneficial owner of income already contains measures aimed at achieving the goals proposed by the second component of the OECD global reform, since the information confirming "lack of tax savings on subsequent transfer of income" can be taken into consideration when identifying the individual having actual right to receive income.[1]

Thus, Russia's accession to the OECD recommendations regarding Pillar Two is premature. First, the second component contains a large number of legal ambiguities (for example, the algorithm for calculating the minimum tax rate is still unclear). Second, its rules may duplicate provisions already included in tax legislation. Third, the accession suggests that Russia renounces part of its tax sovereignty, which is unacceptable in the current environment of intense international economic competition. With regard to Pillar Two, in our opinion, Russia should only monitor now the progress of the discussion related to the OECD initiative.

4. The mechanism for determining the companies' tax residency is not in compliance with digital realities: the criterion for incorporating a company is formal, while the place of effective company management (hereinafter – POEM – Place of Effective Management), being the basis of the economic criterion, can be easily switched to a low-tax country amid globalization and the growing use of digital technologies for communication and management.

OECD (UN) standpoint: notwithstanding that since the 90s, this issue has been the subject of consideration by both the OECD and the UN, the place and role of the concept of the legal entities residence in digital environment is still being discussed.

Situation in Russia: currently, according to Article 246.2 of the Tax Code of the Russian Federation, only two categories of companies can be recognized as Russia tax residents: Russian organizations belong to the first category; the second category suggests recognition of a foreign organization as a tax resident when identifying the place of its effective management in Russia[2]. Besides challenges of uncertainty in the interpretation of the existing criteria[3] tending to aggravate in digital environment, following the chosen approach, in our opinion, is against Russia's sovereign interests. This is due to the fact that despite the policy of deoffshorization and establishment of special administrative regions (SAR), the role of foreign companies owning Russian assets remains significant, which is especially important for digital business focused on global markets.[4]

1 Letter of Tax and Customs Policy Department of the Russia Ministry of Finance of April 9, 2020. No. 03-08-05/28323 "On determining the beneficial owner for purposes of taxation// Guarantor. URL: https://www.garant.ru/products/ipo/prime/doc/73927000/

2 To fulfill it, compliance with at least one of the conditions presented is required: governance of organization is maintained "regularly" by an executive body in Russia, or the organization is managed by chief executives mainly in Russia.

3 Both the Tax Code of the Russian Federation and the Letters of the Ministry of Finance of Russia do not clearly answer the question of what is considered "regular" management of a foreign organization. Likewise, there is no answer as to what is meant by "preferential" management of the organization by officials in Russia.

4 Between deoffshorization and globalization // SPARK. URL: https://www.spark-interfax.ru/articles/mezhdu-deofshorizatsiey-i-globalizatsiey

By virtue of Russia's accession to the BEPS Multilateral Agreement, the implementation of a mutual agreement procedure between the competent authorities can become a mechanism for resolving situations of companies' dual residence in the event of a conflict thereof. Such an analysis based on all facts and circumstances most fully meets the sovereign interests of Russia, while its effectiveness may be low without the improvement of Russian legislation in the following areas:

- developing a mechanism for determining the place of effective management aimed to give more weight to the economic functions performed in each country, as well as determining the residence of the majority of top managers or those who make the most important decisions (location of their centers of vital interests), issuing detailed recommendations and analyzing specific situations (a similar trend is particularly typical for South Africa[1]);
- introducing objective criteria into national legislation that would indicate the existence of a stable economic relationship between the company and Russia (for example, analyzing geographical distribution of assets between countries) and the subsequent recoding in the agreements of those factors that will be taken into account in the event of disputes. It should be emphasized that the OECD MC (2017) makes it possible to supplement the corresponding provision by specifying factors that are relevant for determining the residence of a legal entity.[2]

5. The current mechanism for taxing royalties at the source on a gross basis is not economically feasible for a foreign licensor, since the entire amount of paid royalties is subject to taxation, excluding the costs of the licensor for development of an intangible asset.

<u>OECD (UN) standpoint:</u> international organizations note the existence of this problem, however, it is recognized that the solution runs into overcoming the contradiction in economic interests between developed and developing states. The transition to taxation of the calculated value, which would more fully take into account the real fiscal result of the licensor's activities, can be carried out through the following mechanisms[3]:

- "non-final" withholding tax, when a non-resident is entitled to set off all possible or only particular expenses against the income received;
- withholding tax at a rate calculated based on the expected profitability;
- a tax from the legally established part of the gross amount of payment (part of the gross amount).

1 Interpretation Note: No. 6 (Issue 2) [Electronic resource] // South African Revenue Service. – URL: https://www.sars.gov.za/AllDocs/LegalDoclib/Notes/LAPD-IntR-IN-2012-06%20-%20IN%206%20Resident%20-%20Place%20of%20effective%20management%20(companies).pdf

2 Articles of the Model Convention with respect to taxes on income and on capital (2017) // OECD. - URL: https://www.oecd.org/ctp/treaties/articles-model-tax-convention-2017.pdf

3 *Trepelkov, A., Tonino, H., & Halka, D*. (Eds.). 2015. United Nations Handbook on selected issues in protecting the tax base of developing countries. UN.

Situation in Russia: today, gross income is subject to a withholding taxation at a rate of 20% upon payment of royalties to a foreign recipient. The geographical structure of royalties outgoing from Russia is dominated by "transit jurisdictions" with their R&D expenditures vs received worldwide royalties being abnormally high[1], and Russia's tax treaties providing for a reduction of the withholding tax rate to zero.

Thus, it can be assumed that companies of such jurisdictions are integrated into economic chains only to obtain unjustified tax benefits, while the intangible asset benefiting from royalties paid from Russia is established and maintained in other jurisdictions.

Based on the actual regulatory conditions, the taxation of royalties originating from Russia requires an adjustment towards an increase in the withholding tax, which is in line with the fiscal interests of Russia and presents a response to the challenges related to withdrawing profits through royalty payments to low-tax jurisdictions.

Other types of income (for example, dividends) can be paid under the guise of royalties, which is relevant in the context of an increase in the withholding tax on dividends and interest up to 15% in agreements with transit jurisdictions.[2] Growth in the withholding tax rate when transferring royalties to residents of "transit jurisdictions" will increase tax revenues and create a barrier to profit withdrawal. The implementation of this measure also corresponds to the UN MC recommendations[3], as well as to the experience of BRICS countries, where royalties are mainly taxed at a nonzero rate[4].

Such a mechanism can be balanced through offsetting a part of the costs incurred to create an intangible asset in Russia. It is assumed that a foreign taxpayer could deduct all incurred expenses (or part of them) when creating an asset (implementing R&D) in Russia.

Foreign companies may show interest to developing an intangible asset in Russia, knowing that granting licenses to use it in the future will result in a legitimate tax benefit in Russia. This incentive measure can be enhanced by introduction of a mechanism for preliminary disclosure of tax information (according to recommendations of Action 12 BEPS), giving the opportunity to a foreign taxpayer to provide Russian tax authorities with relevant data in advance for tax control purposes "in real time".

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1 *Berberov A.*, *Milogolov N*. Assessment of the scope of tax base erosion in Russia // Financial Journal. 2018. No. 6 (46). p. 54.

2 *Milogolov N*. Impact and recommendations analysis for supplementing and implementing measures announced by the President of the Russian Federation in terms of taxation at a rate of at least 15% of dividends and interest paid to "transit" jurisdictions /Monitoring of economic situation in Russia: trends and challenges of socio-economic development. 2020. No. 10 (112). April / Gaidar Institute for Economic Policy, The Russian Presidential Academy of National Economy and Public Administration 211 p. URL: http://www.iep.ru/files/text/crisis_monitoring/2020_10-112_April.pdf, p. 114.

3 United Nations Model Double Taxation Convention between Developed and Developing Countries (2017) // UN. URL: https://www.un.org/esa/ffd//wp-content/uploads/2018/05/MDT_2017.pdf (date of reference 2020-15-05). p. 299.

4 Treaty Rates // Deloitte. URL: https://dits.deloitte.com/#TaxTreatySubMenu