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# E-Commerce Taxation in Russia: Problems and Approaches

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**ABSTRACT**
The purpose of this article is to describe a mechanism for taxing e-commerce profits of multinational corporations (MNCs). Our research hypothesis is that the new economic reality, where digital transactions are on the rise, requires new mechanisms for taxation of MNCs' profits. Our research methodology relies on a systemic approach aimed at embracing the complexity and dynamics of the above phenomena. We analyze the feasibility and possible outcomes of the introduction of the indirect digital services tax in Russia, in particular its potential impact on the tax burden distribution and economic growth. Special attention in the article is given to the definition and criteria of virtual permanent establishment. We propose a definition that emphasizes the non-physical nature of permanent establishments in e-commerce and does not include any subjective criteria. Since the Russian tax system is not sufficiently synchronized with the global digital trends, especially regarding taxation of e-commerce profits of tech giants, which means that the introduction of a digital services tax in Russia may be premature due to its possible negative influence on the tax burden redistribution, competition, business profitability, employment, personal income and innovation. Russia will be able to participate in the process of allocation of MNCs' profits if the mechanism of direct taxation is developed and the institution of virtual permanent establishment is introduced into the national tax legislation. These measures will enable the Russian state to realize its taxing rights in relation to MNC's profits and benefit from the international trends in profit-allocation. Our critical analysis of the OECD's unified approach has shown its weaknesses and led us to the conclusion that a simple and more transparent taxation mechanism is necessary based on the formulary apportionment of MNCs' total revenues rather than residual profits among the relevant jurisdictions. In our view, Russia should move ahead with the unilateral measures for taxation of MNCs in accordance with the mechanism described above. Unlike the majority of research, we propose to use only objective value indicators, which cannot be distorted by subjective interpretations, and exclude the risk degree indicator from the set of allocation keys. It also makes sense to use a formula for allocation of profit among the countries rather than corporate structures, as it will enable tax authorities to take into account the impact of federal and regional tax preferences to investors.

**KEYWORDS**
tax risks, virtual permanent establishment, significant presence, digital services tax

**JEL** B41, B49, H32

**УДК** 336.02 *Оригинальная статья*

# Налогообложение электронной предпринимательской деятельности в России: проблемы и подходы

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**АННОТАЦИЯ**
Цель исследования – разработать механизм налогообложения прибыли от электронной предпринимательской деятельности транснациональных компаний,

адаптированный к условиям цифровой экономики. Гипотеза исследования заключается в том, что новая экономическая реальность, которая характеризуется интенсификацией цифровой предпринимательской деятельности, требует адаптации механизмов и инструментов налогового регулирования деятельности транснациональных компаний. Методология исследования основана на теории научного познания, системном подходе к исследуемым проблемам, раскрытии их во взаимосвязи и динамике. Проведен анализ и дана оценка целесообразности введения в России косвенного налога на цифровые услуги транснациональных компаний в аспекте его влияния на распределение налогового бремени и экономический рост страны. Систематизированы критерии и сформирована дефиниция виртуального постоянного представительства. В результате исследования выявлено, что российская налоговая система еще недостаточно синхронизирована с цифровой трансформацией экономики. Не сформирован механизм налогообложения в России прибыли транснациональных корпораций от электронной предпринимательской деятельности. В работе обоснован вывод о преждевременности введения налога на цифровые услуги в России. Раскрыты возможные негативные последствия его влияния на экономику по таким направлениям, как перераспределение налогового бремени, развитие конкуренции, рентабельность бизнеса, занятость и личные доходы населения, инновации. Для включения России в процессы разделения глобальной прибыли транснациональных компаний от цифровых операций обоснована необходимость развития механизма прямого налогообложения. Для этого предлагается ввести в законодательство России институт виртуального постоянного представительства. Его наличие является необходимой правовой основой распространения налоговой юрисдикции России на цифровые компании с учетом изменения международных фискальных подходов в цифровой экономике. На основе имеющихся в научной литературе подходов предложено авторское определение виртуального постоянного представительства. Его отличие в том, что оно отражает свойство нематериальности постоянного представительства в электронной коммерции и не содержит субъективно оцениваемых критериев. На основе критического анализа Единого подхода ОЭСР к налогообложению цифровых компаний обоснована целесообразность более простого и прозрачного механизма их налогообложения. В отличие от идей предшественников, в работе предложено формульное разделение между юрисдикциями всех глобальных доходов транснациональных компаний, а не только «остаточной прибыли» от цифровых операций. Обоснована целесообразность использования предложенного механизма налогообложения в России в одностороннем порядке применительно к виртуальному постоянному представительству. В качестве ключей распределения, что отличает от распространенных научных идей, предлагается отказаться от показателя оценки рисков. Обосновано использование только объективных стоимостных показателей, которые не искажаются субъективным анализом. Предлагается также использовать формулу для распределения прибыли транснациональных компаний между странами, а не между структурами компаний. Это позволит учесть действие федеральных и региональных льгот инвесторам.

**КЛЮЧЕВЫЕ СЛОВА**
риски налогообложения, виртуальное постоянное представительство, существенное присутствие, налог на цифровые услуги

## 1. Introduction

At the current stage of digital transformations characterized by rapid development of telecommunications and information technologies, it is difficult to find any aspect of legal or economic relations that would be untouched by these processes, the international tax system being no exception.

In the Digital Economy and Society Index (DESI), the main international ranking of countries' digital performance, Russia now occupies only a modest 43rd position. However, as far as the digital economy's growth is concerned, Russia is in the top ten. In part, this is a result of its federal program 'Digital Economy'. It is predicted that in future, the digital

economy will account for up to 10% of the country's GDP [1].

The digital revolution and rapid development of cyberphysical production systems have led to a dramatic increase in cross-border business activity, in particular with respect to the following: '(i) the intangibles on which the digital economy relies heavily, (ii) users, and (iii) business functions as a consequence of the decreased need for local personnel to perform certain functions as well as the flexibility in many cases to choose the location of servers and other resources'[1].

Companies involved in international trade of goods, services and capitals discover new opportunities of minimizing their tax liabilities. In their turn, countries and international organizations strive to prevent tax base erosion and disruption of competition. In 2013, as a part of its Action Plan on Base Erosion and Profit Shifting (BEPS), the OECD embarked on devising new approaches to taxation in the digital sector, although so far, no universal agreement regarding the OECD's proposals has been achieved[2]. In the absence of uniform international guidelines, national tax systems are developing digital taxation independently of each other.

One of the most popular initiatives is the introduction of the indirect tax on digital services or the so-called *digital services* tax (DST)[3]. This tax provides a simple solution to the problem of how fiscal interests of different states, including Russia, could be met. A certain caution should be exercised, however, as this measure may negatively affect the participants of fiscal relations and the overall economic development of the country.

Taxation of e-commerce profits of multinational corporations (MNCs) has lately become a focus of discussion, which added urgency to international debates. The recent OECD documents have addressed the problem of virtual permanent establishments while the tax policies of different countries, including Russia[4], have explicitly set the goals of ensuring that profits should be taxed where economic value is created[5]. Currently the international discussion centres around the introduction of new rules that would allow countries to tax digital-service providers in jurisdictions where these companies are not physically present but where their users (clients) are located or, in other words, jurisdictions in which value creation occurs.

The notion of permanent establishment (PE) is used in international taxation practices to denote the connection between a company and a foreign country as its place of business. This connection should be substantial enough to make the latter entitled to taxing this company's profits. In this sense, the PE concept does not have a civil or legal status but is used to justify the rights of the income source state to tax the profits of tech giants from their e-commerce activities in the territory of this state. At the same time the fiscal rights of the residence state are limited [2]. The PE concept serves as a tool for allocating MNCs' taxable profits among the states.

[1] BEPS Action 1: Address the Tax Challenges of the Digital Economy. Public Discussion Draft. OECD; 24 March 2014 – 14 April 2014.

[2] 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. DOI: 10.1787/9789264241046-en; Organisation for Economic Co-operation and Development, Action Plan on Base Erosion and Profit Shifting. Paris: OECD; 2013. DOI: 10.1787/9789264202719-en, supra note 2.

[3] KPMG. Taxation of the digitalized economy. updated Mar. 21, 2020. Available at: https://tax.kpmg.us/content/dam/tax/en/pdfs/2020/digitalized-economy-taxation-developments-summary.pdf

[4] Addressing the Tax Challenges of the Digital Economy. Available at: https://read.oecd-ilibrary.org/taxation/addressing-the-tax-challenges-of-the-digital-economy-action-1-2015-final-report_9789264241046-en#page1; Tax Challenges Arising from Digitalisation – Interim Repory 2018. Available at: https://read.oecd-ilibrary.org/taxation/tax-challenges-arising-from-digitalisation-interim-report_9789264293083-en#page1

[5] Website of the Ministry of Finance of the Russian Federation. Key Areas of the Budget, Taxation and Customs Tariff Policy in 2020 and the Planned Period of 2021 and 2022: Available at: https://www.minfin.ru/common/upload/library/2019/10/main/ONBNiTTP_2020-2022.pdf

The classical definition of *permanent establishment* is specified as a set of criteria in the OECD's Model Tax Convention on Income and Capital[6], in international tax agreements and in the legislation of the majority of countries, including Russia. These criteria include the following: there should exist a fixed place where a company is doing business in a foreign state; the company should own tangible property such as facilities, equipment and so on in this country; and, finally, the company should be engaged in entrepreneurial activity [3].

The existing rules of PE recognition, however, do not allow countries to align taxation with value creation as efficiently as their governments would like to. The problem arises from the fact that digital companies may sell their services in foreign markets, where their physical presence (or the presence of their staff and equipment) is not required. In this paper, e-commerce is understood as buying and selling of goods and services by legal and physical persons through processing and transfer of digital data, including textual, audio- and video-information, via an open network (such as the Internet) or closed networks which can connect to the open network[7]. Thus, MNCs' profits cannot be taxed by countries where their e-services are sold. Digital transformations of the economy have led experts and policymakers to doubt the effectiveness of the tax regulations which have been in force for the last one hundred years as it has become obvious that these rules are no longer applicable in the digital era.

The OECD Model Convention as well as national legislations (including Russian) still lack a comprehensive definition of virtual PE that would reflect the specificity of e-commerce [4].

Another problem that needs to be addressed is the procedure for taxing virtual PE's profits. At present national tax systems rely on separate entity accounting, which means that in accordance with the arm's length principle, digital multinationals have separate revenue and expense accounts for their entities (PEs or subsidiaries) operating in foreign tax jurisdictions. The arm's length principle determines the allocation of MNCs' taxable profits among the countries and has been for quite a while rightfully criticized in research literature. There are, however, no universal national or international approaches and guidelines regarding taxation of profits from digital services. The unified approach to taxation of such profits proposed by the OECD[8] currently undergoes public scrutiny and its subsequent approval by individual country members is far from imminent.

The absence of the concept of virtual PE from the Russian tax legislation and the corresponding methods of taxing it deprives Russia of the possibilities, grounds and tools for extending its tax jurisdiction to such companies. Thus, Russia is excluded from profit allocation in the digital sphere, which creates considerable risk of tax revenue losses. To avoid this situation, it is necessary to introduce the concept of virtual PE, its definition, criteria and taxation methods into the Russian legislation.

Development of adequate taxation mechanisms and tools that would make the Russian state entitled to some part of the taxable profits of digital multinationals is a task of utmost importance. It is also a crucial factor of tax-risk management.

The purpose of this study is to describe a mechanism of taxing MNCs' profits that would be adequate to the reality of the digital economy.

Our hypothesis is that this new economic reality engendered by the rise of e-commerce requires a thorough revision and adaptation of policies for tax regulation of digital companies.

The article comprises an introduction, literature review, the main part divided into sections, and conclusions. The

[6] Model Tax Convention on Income and Capital. Committee on Fiscal Affairs; Organisation for Economic Co-operation and Development. Paris: OECD; 2014.

[7] Policy Brief No. 1-1997: Electronic Commerce. OECD; 1997.

[8] Secretariat Proposal for a 'Unified Approach' under Pillar One, Public consultation document. OECD Publishing; Oct. 2019.

introduction outlines the problems of taxation of MNCs' profits, the goal, objectives, research questions and outcomes. The section devoted to literature review summarizes the past research efforts and discussion points related to the topic. The main part of the article contains several subsections that deal with different aspects of the problem and correspond to the objectives set in the introduction. The final part of the paper describes the research outcomes and conclusions and discusses the implications and possible avenues for future research.

## 2. Literature review

Digitalization of the economy and its impact on taxation became a focus of academic debate in the 1990s. Rapid development of the Internet and telecommunications challenged the existence of the permanent establishment (PE) concept and required national governments to devise suitable tax policies and rules.

As governments of developed and developing states are pushing for a change, the OECD responds to their demands by driving forward the international digital tax agenda. Countries seek to maximize their fiscal revenue or at least maintain its current level, which requires them to define the concept of PE and its characteristics.

At the turn of the millennium, OECD experts split into two groups regarding their understanding of *permanent establishment*: experts of the first group adhered to the view that the existing international taxation norms and the classical understanding of PE are broad and flexible enough to encompass e-commerce. Scholars from the second group, for example, R. Doernberg [5], L. Hinnekens [6], and D. Pinto [7], on the contrary, rightfully argue that e-commerce has special implications for taxation due to the high level of mobility and no or insignificant level of physical presence of digital companies in the countries where they do business. Therefore, new rules and approaches are required to the definition of permanent establishment. At that point, the OECD considered several alternative approaches to taxation of e-commerce profits: source-based taxation; the 'base-erosion' approach; and formulary apportionment[9].

The concept of a special virtual PE emerged at the end of the twentieth century. A virtual PE appears when a foreign organization gets a website hosted by a server in a foreign state to engage in entrepreneurial activity[10]. For instance, D. Pinto justifies source-based taxation of profits in relation to virtual PEs [7].

The OECD's Committee on Fiscal Affairs supported the view of the first group of scholars that traditional rules of PE taxation can be applied to e-commerce and do not require any radical adjustments of the tax system. This position was described in the 2000 report and included in the commentaries to the OECD Model Tax Convention of 2003, which stated that the server on which a company's web-site is stored or computer equipment which has a specific physical location may constitute a 'fixed place of business' of this company and, therefore, a permanent establishment[11].

In Russian research literature, a similar debate unfolded between proponents of the traditional approach and those who advocated a special approach to the concept of permanent establishment in e-commerce. A.V. Kastelskaya [8], M.A. Danilkevich [9], L.V. Frolova [10], M.E. Ismailov [11], R.E. Khusnetdinov [12] and L.V. Kadyleva [13] accept the approach proposed by the OECD in 2000 and do not see the idea of a virtual PE as pertinent. These authors, however, do point out some challenges connected to the traditional understanding of PE in taxing e-commerce.

The classical definition of PE, which includes physical requirements necessary

[9] Discussion Draft. Are the Current Treaty Rules for Taxing Business Profits Appropriate for E-commerce? OECD; 2003. Available at: http://www.oecd.org/ctp/treaties/20655083.pdf

[10] Dismantling the barriers to global electronic commerce. P. 26. Available at: http://www.oecd.org/sti/2751237.pdf

[11] Model Tax Convention on Income and Capital / Committee on Fiscal Affairs; Organisation for Economic Co-operation and Development. Paris: OECD; 2004.

for doing business in a local jurisdiction (e.g. a foreign company's web-site hosted by a local server or specialized equipment located in this country's territory), proves to be inadequate in the case of e-commerce, which can be illustrated by the following example. If a foreign company removes the servers which host its website or other equipment from the country's territory, the recognition of its PE will be impossible and so will be the taxation of its e-commerce profits.

We share N.G. Skachkov's view, who rightfully emphasizes the impossibility to apply classical PE criteria to e-entrepreneurship since these criteria require a foreign company's physical presence in the country of business [14].

A special approach is proposed by O.Y. Konnov, who rejects the concept of PE in relation to the digital sphere and argues in favour of source-based taxation of e-commerce profits [15]. In our view, since the Russian taxation system currently lacks the concept of PE, the country has no right to tax profits from e-commerce. O.Y. Konnov's approach, however, shows the crisis of the classical understanding of PE.

An interesting interpretation is offered by A.V. Koren [16], who points out the non-physical nature of PEs in e-commerce and elaborates on the three main criteria of a virtual PE: the registration criterion (registration in the corresponding domain zone); language criterion; and consumer criterion (which territory accounts for the largest share of payments). This author's ideas agree with our arguments about the failure of the classical PE concept to reflect the specifics of the digital economy, which points to the need to devise special 'non-physical' criteria of a virtual PE [17].

In recent years, the European Commission has been actively developing the concept of profit taxation in the digital sphere, which led to debates about the new tax reform and new international rules that would define significant taxable digital presence in a jurisdiction. As a result, the European Commission recommended to supplement the PE concept with virtual (or digital) PE[12]. This new type of PE is going to be included into the Common Consolidated Corporate Tax Base (CCCTB). Such approach agrees with the one proposed in this paper, which centres around taxation of a virtual PE consolidated with the group of companies it belongs to.

In line with the European Commission's recommendations, the OECD reconsidered its earlier approaches to the standard of significant presence. In 2019, the OECD proposed that MNCs' profits' should be taxed predominantly in the countries where users of their digital services are located[13]. The key features of a virtual PE include the following: the profit MNCs make in jurisdictions without being physically present there; MNCs' digital presence in these jurisdictions (for example, through a local domain name or a specific payment method); and, finally, the number of users in these jurisdictions[14].

N.Y. Andreev [18] proposes the following definition of a digital PE: 'a place of business where an enterprise conducts some or all of its activities, including the state or territory of its digital presence where this enterprise has the main source of its customers and which, therefore, is the place where this enterprise earns its main revenue'. In our view, this definition is quite vague and abounds in subjective criteria, which, in turn, require their own definitions to exclude multiple interpretations. It is not quite clear how 'digital presence', 'the main source of customers' or 'main revenue' should be understood and

[12] Communication from the Commission to the European Parliament and the Counila. Fair and Efficient Tax System in the European Union for the Digital Single Market. EC. Brussels, 21.9.2017 COM (2017) 547 final. Available at: https://ec.europa.eu/taxation_customs/sites/taxation/files/1_en_act_part1_v10_en.pdf

[13] Addressing the Tax Challenges of the Digitalisation of the Economy – Policy Note, OECD/G20 Base Erosion and Profit Shifting Project. OECD; 2019. Available at: https://www.oecd.org/tax/beps/policy-note-beps-inclusive-framework-addressing-tax-challenges-digitalisation.pdf

[14] Bunn D. Tax competition of a different flavor at the OECD. Tax Foundation. March 19, 2019. Available at: https://taxfoundation.org/tax-competition-of-a-different-flavor-at-the-oecd

in the case of the two latter terms, what share of customers or revenue will qualify them as 'main'. Moreover, the phrase 'place of business' appears to contain an assumption that there is some kind of fixed place (a similar assumption underpins the classical definition of PE), which, however, contradicts the reality of a *digital* PE. Moreover, the author does not specify whether this definition should be used in the OECD's Model Convention or whether it is intended exclusively for revised tax legislation of the Russian Federation. We believe that the definition of PE should be formulated more clearly to eliminate any possibility of ambiguity or doubt for participants of legal tax relations.

Taxation of digital multinationals based on the arm's length principle and separate accounting is justly criticized in research literature. The question of how these companies should be taxed, however, still remains open for debate. Proponents of the tax reform advocate the transition to unitary taxation of MNCs' total global revenue. Proponents of the classical arm's length system, on the contrary, argue in favour of the unitary allocation of residual profit generated by digital assets and operations of MNCs in several jurisdictions. At the same time experts of the second group admit that the arm's length methods are not always suitable for taxation of digital companies: for example, J.C. Fleming and R.J. Peroni [19] contend that in the current system of taxation it is difficult to identify the actual source of income of MNCs. Tax-savvy multinationals often shift their incomes to low-tax jurisdictions, despite transfer pricing regulations. Andrew Mold [20] demonstrates that the unitary tax system based on formulary apportionment eliminates the incentives for multinationals to shift their profits to low-tax jurisdictions. In his view, this system is more transparent and allows countries to increase their tax revenues.

S. Picciotto wrote a series of articles on the unitary approach to taxing multinationals [21–24], arguing that the independent entity principle and the arm's length principle are impractical for taxing MNCs and no longer correspond to the contemporary economic reality. Under unitary taxation, digital multinationals will be taxed 'according to the genuine economic substance of what they do and where they do it. This would be far more legitimate and simpler to implement than the current system', Picciotto argues.

In our previous publications we also addressed this problem [17]: among other things, we showed the feasibility of a consolidated approach to taxing global profits of multinational companies and proposed a profit allocation formula with such keys as weighted profit, costs of labour and capital.

V.N. Zasko and D.Y. Shakirova argue that multinational companies should be considered as a separate group of taxpayers eligible for a special tax regime [25]. Their approach is based on applying different tax regimes to MNCs depending on the country of origin of the capital. This approach, however, does not agree with the principles of taxation. Moreover, the authors do not explain how the imputed income, which plays a key role in their approach, should be calculated, although, quite obviously, it is going to be a quite complicated procedure.

N.S. Milogolov [26] observes that the tax rules devised in the early twentieth century are no longer applicable to the contemporary economic reality, especially in relation to cross-border intangible assets.

Reuven S. Avi-Yonah [27] points out the challenges of the profit split method for regulation of transfer pricing. He believes that this method frequently results in a residual when dealing with intangibles and proposes a formula that he considers as optimal for allocating the residual. This formula is based 'entirely on the destination to which the goods and services that the MNE provides are sold'.

Highlighting the need to reform the taxation system and to tax the profit of MNCs in market/user jurisdictions, the OECD proposed a new three-tier profit allocation mechanism (*Pillar 1 Project*) in November 2019. The so-called *Unified Approach* is partially based on the use of

an formulary apportionment[15]. In this article, we present a critical analysis of the OECD's approach and the accompanying risks of taxation.

Questions related to the introduction of the *digital services tax* (DST) were discussed by G. Kofler and J. Sinnig [28], M. Bauer [29], and W. Richter [30]. They warned that the introduction of the DST may pose a threat to the economic growth of countries, to innovation and digitalization in general.

The proposal to introduce a digital tax, which was put forward by the European Commission in 2018[16], was not followed by any assessment of its impact on the European economy or on the tax burden distribution.

K.A. Ponomareva [31] studied the European model of the DST and reasonably concluded that it resembles a turnover tax much more than an income tax.

One of the recent studies of the DST and the possible consequences of its introduction in Russia conducted by A. Sinitsyn et al.[17] showed that this additional indirect tax could be a feasible solution as it would enable the country to protect its fiscal interests in the absence of international agreement about the unified approach proposed by the OECD[18].

The Federation Council of the Federal Assembly of Russia also supported the introduction of the DST in Russia[19]. The public discussion, however, did not touch upon the question about the impact of such tax on organizations and physical persons as well as on the inducements to produce, invest and consume.

To conclude, our literature review has shown that the majority of researchers and experts agree that a separate type of PE and the corresponding criteria should be defined in relation to e-entrepreneurship and that these definitions could be further used for devising a mechanism of taxation of virtual PEs. There is, however, no commonly accepted definition of virtual PE that would reflect its intangible nature. Likewise, the mechanism of its taxation and taxation of MNCs' global profits has not been yet specified. Neither has been justified the economic feasibility of introducing the DST, similar to the one enacted in European countries, for countries like Russia.

Therefore, we consider it a pertinent task to investigate the possible impact of the DST for economic development and innovation in Russia. It should be noted that this tax would also affect Russian tech companies that contribute to the country's innovative development, which is why in the main part of this paper we are first going to investigate the feasibility of this measure, paying special attention to the issues overlooked in previous research.

## 3. Rationale for the introduction of the DST in Russia

The digital services tax is a national tax charged on revenues of MNCs from sales of digital services. This tax varies significantly across countries depending on the breadth of the tax base and tax rate (2–7.5%). This tax is usually applied to digital giants whose global profits exceed 750 million euro per year. Some countries have already introduced this tax, others were planning to do so but had to put

[15] Secretariat Proposal for a 'Unified Approach' under Pillar One, Public consultation document. OECD Publishing; Oct. 2019; Bunn D. Tax competition of a different flavor at the OECD. Tax Foundation. March 19, 2019. Available at: https://taxfoundation.org/tax-competition-of-a-different-flavor-at-the-oecd

[16] European Commission, Proposal for a Council Directive on the common system of a digital services tax on revenues from the provision of certain digital services, COM (2018) 148 final, Brussels, March 21, 2018. Available at: https://ec.europa.eu/taxation_customs/sites/taxation/files/proposal_common_system_digital_services_tax_21032018_en.pdf

[17] Sinitsyn A., Hayrapetyan L., Surkova A. Digital tax in Russia: introduction perspectives. Available at: https://www.csr.ru/upload/iblock/5ef/5ef5a7831553dc062605b281a53e4350.pdf

[18] Secretariat Proposal for a 'Unified Approach' under Pillar One, Public consultation document. OECD Publishing; Oct. 2019.

[19] Federation Council proposed to introduce a tax on consumers of digital products. RIA. Available at: https://ria.ru/20200520/1571747330.html

it on hold after the US threatened trade sanctions[20].

In Russia, revenues of digital companies are currently taxed through the VAT. According to Article 174.2 of the Russian Tax Code, on-line services subject to VAT include advertising and consulting services[21]. Since 2019, all foreign organizations that have consumers in Russia have been obliged to pay VAT on digital services. Such foreign organizations have to register with the Russian tax authorities and their tax administration relies on voluntary 'virtual' registration and filing a special tax declaration.

To decide whether Russia should move ahead with the DST reform, the following questions need to be addressed:

1. How will the DST burden be distributed and what consequences will this lead to?

It is important to bear in mind that by its nature the DST is a turnover tax, which means that the tax burden will be in fact shifted by providers of digital services – large digital companies – to their clients – SMEs and then to final consumers. There is evidence that indirect taxation may lead to an increase in prices, which will exceed the initial tax rise [32]. The smaller is a specific market and the lower is the competition in this market, the higher will be the price rise caused by the tax. Since companies subject to this tax are actually digital giants and innovative leaders, it is highly probable that a significant part of the DST burden will be shifted to consumers.

The introduction of the DST may have a substantial impact on companies that are highly dependent on digital services provided by tech giants. This measure may also influence the general effective tax burden, in particular the tax burden on companies with low profitability or loss-making companies, which, in its turn, will be detrimental to their paying capacity. The impact of the DST burden transfer is much more important for those companies that will be left with no options but to shift the tax burden to their own consumers.

2. How will the DST affect SMEs in Russia?

Russian small- and medium-sized businesses (SMEs) are interested in selling their products on-line via such platforms as Google and Facebook. SMEs benefit the most from the marketing opportunities offered by these platforms. Moreover, these platforms enable businesses to lower the costs of market entry.

When the tax burden is shifted to consumers of on-line services – consumers in the B2B sector, this usually has a negative influence on corporate clients in other economic sectors and on final consumers of both digital and non-digital goods and services. Services of on-line platforms are mostly in demand among SMEs with weak profitability and few opportunities for shifting the tax burden to consumers. Therefore, these companies are likely to suffer most from this situation as they risk their profitability and paying capacity. For large tech companies it is easier to shift their tax burden to their clients – SMEs, which often find themselves in a weak position when negotiating the cost of services.

Therefore, there is a likelihood that the DST will change the balance in the competition between large and smaller companies in favour of the former.

3. How will the introduction of the DST affect the country's economic growth and innovation?

New digital companies take an active part in the development of different economic sectors. The real economic value produced by Google, Facebook and other companies implementing digital business models are created not only in the countries where these companies are located. The value is also created where their services and innovations are consumed, that is, in the countries of residence of their clients and users. One of the reasons is

[20] Taxation of the digitalized economy. KPMG; Mar. 21, 2020. Available at: https://tax.kpmg.us/content/dam/tax/en/pdfs/2020/digitalized-economy-taxation-developments-summary.pdf

[21] The Tax Code of the Russian Federation (2 part) dated August 05, 2000 No 117-FZ (add. on December 25, 2018). Available at: http://www.consultant.ru/document/cons_doc_LAW_28165/

that digital multinationals have a positive influence on employment and personal income of people in these countries. The introduction of the DST may lead to a decline in digital business, which, in its turn, will affect employment and tax receipts from companies using digital technologies (for example, SMEs). It may also have a negative influence on revenue from personal income taxes paid in the digital industry and other spheres.

Thus, the obvious question that arises in this respect is whether Russia really needs the DST or not. The DST will supplement VAT on digital services and replace the tax on profits from digital activities. In view of the fact that users of e-services contribute to the value chain of digital companies and, therefore, to the economic growth of Russia as these users' country of residence, a separate digital tax may have a negative influence on this growth.

As for the administration of the DST in Russia, the following should be noted. The Russian tax authorities have accumulated sufficient experience of administration of foreign companies which pay VAT on digital services, provided that the latter agree to register in Russia. This model of administration can be used for the DST as well since only a digital company itself has access to the full data on its users and sources of revenue. A reasonable solution would be to identify a 'responsible taxpayer' in relation to a group of affiliated companies. The role of such responsible taxpayer could be played by an entity which is already VAT registered. The problem of tax administration, especially in what concerns gathering the data on users of digital services and profits of a digital company, can be addressed with the help of the country-by-country reporting, which implies automatic exchange of information between tax authorities on cross-border corporate structures.

Since the DST is an indirect tax, it does not guarantee just allocation of the rights to multinationals' taxable profits and even if this tax is introduced, it still leaves countries wherein digital users reside without adequate taxes on the profits generated by digital companies from these users.

We believe that the problem of profit allocation can be addressed through specific taxation mechanisms. The solution to this problem, however, cannot be merely reduced to the introduction of a turnover tax, whose impact on economic entities is fundamentally different.

The problem of profit allocation, as it was mentioned in the introduction, can be tackled through the concept of permanent establishment, which, in its turn, requires to define exactly what constitutes a virtual permanent establishment, that is, bring to light the specificity of e-commerce. In the following section we will formulate our own definition of virtual permanent establishment and describe its main criteria.

## 4. The concepts of PE and virtual PE

In Russia, the definition of PE and its criteria based on the physical presence of foreign companies' property and staff in the country of business correspond to the classical understanding described in the OECD Model Tax Convention. The Tax Code of the Russian Federation defines PE as 'an office, branch, department, bureau, agency or any other separate subdivision or another establishment of this organization through which this organization regularly conducts entrepreneurial activity on the territory of the Russian Federation'[22].

This definition is obviously outdated and does not reflect the reality of digital entrepreneurship. Sale of digital services does not require a creation of fixed place of business of a foreign company in Russia. Such classical criteria as the presence of a company's property base or staff in the country are inapplicable in the case of digital companies. Digital trade companies can sell their goods and services overseas and this is where the market for their goods and services is formed. This is where the goods are sold, where Internet consumers are located, where value is created and profits are generated. Therefore, the country where the market of

[22] The Tax Code of the Russian Federation (2 part) dated August 05, 2000 No 117-FZ (add. on December 25, 2018). Available at: http://www.consultant.ru/document/cons_doc_LAW_28165/

digital services is located has a right to tax profits from digital transactions. In this light, the OECD's 'Pillar one' proposal[23], which stipulates that some types of taxable e-commerce profit can be allocated to market jurisdictions, makes perfect sense.

OECD experts[24] recommend to use the criterion of a provider's significant virtual presence in the country where the consumers of its e-services are located. The presence may be deemed 'significant' depending on the number of Internet users, contracts, the volume of digital sales and so on.

Drawing from the general approaches to the concept of virtual PE described in research literature, we propose the following definition that can be used by tax policy-makers in Russia: a virtual permanent establishment is an entrepreneurial activity such as sale of goods (works, services) to customers on the territory of Russia through digital data processing and transfer via an open telecommunication network (similar to the Internet) (or closed networks that can connect to the open network) conducted by a foreign organization.

This definition highlights the three key criteria of a virtual PE because it connects 1) entrepreneurship with 2) digital activity of a foreign company 3) on the territory of Russia as a country of residence of its consumers. This definition eliminates the dependence between taxation and a foreign company's physical presence in Russia (the requirement that a company should have a particular fixed location from which it operates). In our view, it is important to emphasize the non-physical nature of a PE in e-commerce.

Complicating this definition further will only obscure it meaning. We propose to introduce additional criteria in the form of keys for the formula that would be used to apportion the profit of digital multinationals. A mathematical formula based on objective, measurable indicators is much more suitable in this situation than any subjective evaluations and interpretations.

Defining a PE and a virtual PE is but a first step towards taxation of MNCs. In the following section we are going to look at the methods of generation of a virtual PE's taxable profits and the corresponding tools that can be applied by the Russian state to realize its taxing rights.

## 5. Fiscal potential of the OECD's unified approach to taxation of digital companies in Russia

In this section, we are going to start with a brief overview of the new rules for taxation of MNCs proposed by the OECD.

According to the classical approach, a PE does not have a civil law status but is considered as a part of a foreign company operating on the territory of another state. For taxation purposes, however, it is considered as an independent entity operating in accordance with market rules. Thus, in the majority of countries that adhere to the concept of permanent establishment, PEs' profits are understood as a diffe-rence between income and expenditures attributed to this or that PE on the basis of separate entity accounting and the arm's length principle.

The OECD's 'unified approach' presented in November 2019[25] follows the arm's length principle and proposes a three-tier profit allocation mechanism. These rules will allow the jurisdictions where users of e-services are located to claim a part of MNCs' profits regardless of their physical presence in these jurisdictions:

1) a share of multinationals' profits generated through digital assets and operations in several jurisdictions. These profits are determined by applying the criterion of remote taxable presence and through calculations of residual profits. The supernormal (or residual) profit, according to the OECD, is the profit generated in excess of the normal profit. The normal (or routine) profit is calculated as the required rate of return on business in-

[23] Secretariat Proposal for a 'Unified Approach' under Pillar One, Public consultation document. OECD Publishing; Oct. 2019.

[24] Ibid.

[25] Secretariat Proposal for a 'Unified Approach' under Pillar One, Public consultation document. OECD Publishing; Oct. 2019.

vestments. Profits are considered to meet the normal rate of return when the revenues from the company's investments in products and sales cover their costs and meet the minimum level of profitability. Residual profits will be allocated among countries on the formulary basis by using a set of allocation keys. These keys can include several indicators, such as the company's investment into marketing its product among the clients in another jurisdiction or the company's global profitability. Profits can be also allocated by using the data on users and their participation in value creation (users of free services can generate value, for example, for advertisers) [33].

2) a fixed remuneration for baseline marketing and distribution functions that take place in the market jurisdiction and are determined by using the baseline profit from the company's market transactions (marketing, sales, number of users, etc.);

3) any additional profit gained by digital companies through the use of arm's-length methods and dispute settlement mechanisms, when in-country functions exceed the baseline marketing and distribution activity.

As MNCs are expanding to the Russian market, their profits are bound to grow and if the OECD's unified approach comes into force, Russia will be able to claim its share in the multinationals' profits generated by Russian users.

In this paper, we propose an approach to quantitative evaluation of additional tax revenue that would be gained by Russia if all the countries endorse the unified approach.

The statistics show the growing profits of foreign IT-companies in Russia (Fig. 1).

The above ranking shows the profits of foreign IT-companies (e.g. Apple, Huawei and Microsoft) selling such goods as smartphones and other devices, software and so on in the Russian market. These data possibly do not include profits from selling specific digital services (such as Apple Music subscription and subscriptions for specific apps, for cloud storage services of Google and Microsoft) because these services are usually provided by foreign groups affiliated with these companies.

After the residual profits are allocated, a part of the revenue from these services will be subject to taxation in Russia because they are bought by Russian consumers, which creates an additional tax nexus of the group in Russia. For example, if we build a simplified model by using the 2018 data on Apple's sales in Russia, the company's profit from selling the services to Russian users will be as follows[26]:

$$RS_{Rus} = \frac{RP_{Rus} \cdot RS_{Glob}}{RP_{Glob}} = \frac{3000 \cdot 9981}{52919} =$$

$$= 566 \text{ mln dollars US } (\approx 41318 \text{ mln rbs}),$$

where $RS_{Rus}$ is the profit of *Apple's* services sales; $RP_{Rus}$ is the profit of *Apple's* product sales in Russia; $RS_{Glob}$ is the global profit of *Apple* from services sales; and $RP_{Glob}$ is *Apple*'s global profit from product sales.

In all likelihood, the resulting figure is the minimum value since *Apple* also sells its products to the Russian market via distributors. It should be noted, however, that not all of these profits will be taxable in Russia but only residual profits, that is, the profits generated in excess of the 'normal' level of profitability (it is planned to set this level at 10–20%) and after the residual profit is allocated according to the formula, for example, based on intangibles, capital and the corresponding risks[27].

The OECD[28] forecasts that tax revenue will be mostly allocated to countries with low and middle income (according to the World Bank's classification of countries), Russia included. Therefore, the unified approach to taxation of MNCs will allow Russia to obtain very significant tax receipts for the public purse.

As Förster et al. [34] reasonably argue, the unified approach calls for a new

[26] Apple Inc. 2018. Q4 2018 Unaudited Summary Data. Available at: https://www.apple.com/newsroom/pdfs/Q4-18-Data Summary.pdf

[27] Secretariat Proposal for a 'Unified Approach' under Pillar One, Public consultation document. OECD Publishing; Oct. 2019.

[28] Economic Analysis & Impact Assessment. Available at: https://www.oecd.org/tax/beps/webcast-economic-analysis-impact-assessment-february-2020.htm

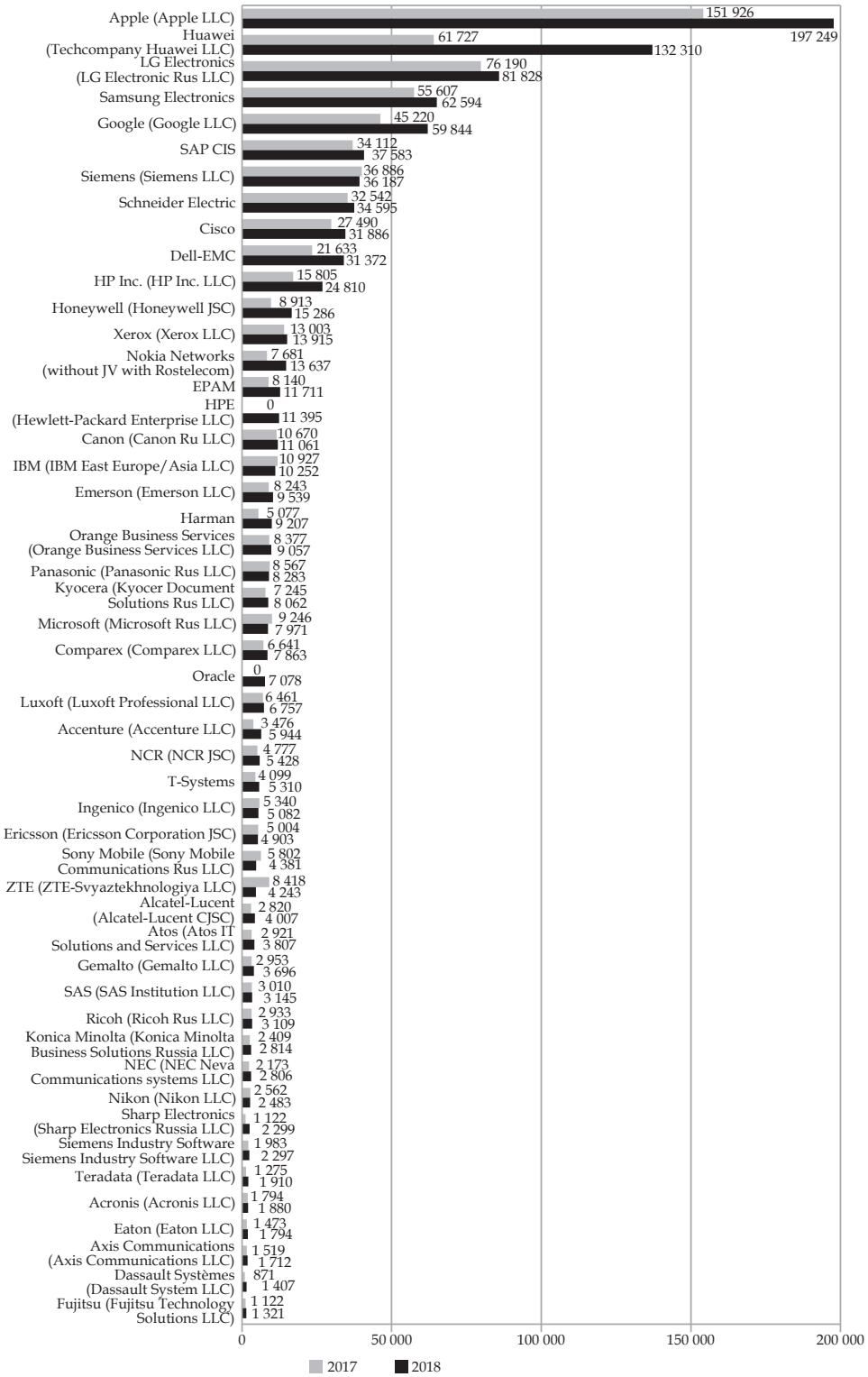


***Fig. 1.* Profits of Russian representative offices of foreign IT companies (mln rbs)**

*Compiled by the authors based on the data of Ranking TAdviser: 50 most profitable representative offices of foreign IT companies in Russia. 2019. Available at: http://www.tadviser.ru/index.php*

understanding of the notion of *tax nexus* in the tax legislation: in other words, a new nexus rule should be envisaged that would not depend on physical presence of companies in the countries where they sell their products and services. Thus, regardless of whether Russia decides to join the OECD's 'unified approach' initiative or not, its policy-makers would still have to consider the possibility of introducing the concept of virtual PE into the country's Tax Code and develop the rules of its taxation. These measures will enable Russia to gain the status of a jurisdiction of Internet users' residency and tax the profits of foreign digital companies.

A comprehensive evaluation of the unified approach should focus not only on its advantages but also predict the negative implications of this approach for the tax system of Russia and other countries. In the following section, we are going to conduct a critical analysis of the OECD's unified approach, describe and systematize the practical impediments to its introduction and implementation.

## 6. Critical analysis of the unified approach and impediments to reaching international consensus on this matter

The changes that the implementation of the unified approach will bring about involve a number of tax risks for Russia. These changes will also lead to dramatic transformations of the international system of profit taxation. The key elements of the new regulations should be agreed upon by more than 130 member countries of the BEPS project, including Russia[29].

A failure to arrive at a consensus regarding the taxpayers to whom the new rules will apply can lead to tax revenue losses. This will happen if the agreed threshold values exceed those reflecting the companies' actual performance in the Russian market. The OECD's initiative may cause an outflow of investment from Russian digital companies because they may be caught by the new rules and it would increase their tax burden in other countries.

One of the key goals of the OECD's initiative is to minimize the costs of tax administration resulting from the introduction of the new rules. There is, however, a lack of clarity as to how this can be achieved because some elements of the new rules include complex and at times ambiguous concepts, parameters and implementation mechanisms.

The unified approach requires a thorough revision of the tax system where the arm's length principle is applied to some parts of the taxable income and other parts are handled differently. The approach proposed by the OECD means that supernormal profit cab be allocated differently so that market jurisdictions could also benefit from it. There are murky areas even in the existing rules concerning the calculation of taxable profit, for example, it may be difficult to determine which profit is normal and which is supernormal. There are disagreements between tax authorities and companies concerning the current taxation methods, leading to disputes and, therefore, adding to the complexity of tax liability determination in each particular country[30].

The debates surrounding transfer pricing show how complicated and costly may be the existing system. The new methods proposed by the OECD are likely to deepen the disagreements between the states concerning the profits that should be taxed and in which jurisdictions. The OECD's initiative will thus aggravate the uncertainty in the international tax sphere.

The unified approach will make fiscal accounting and administration even more complicated not only during the transition period but also in the ensuing years. Companies will have to revise their approaches to transfer pricing, which have already been adjusted in view of the BEPS plan. In addition, companies will also have to bear extra administrative burden and ensure compliance with the rules of the unified

[29] OECD Members of the OECD/G20 Inclusive Framework on BEPS. Available at: https://www.oecd.org/tax/beps/inclusive-framework-on-beps-composition.pdf

[30] OECD, Mutual Agreement Procedure Statistics for 2017, 2018. Available at: https://www.oecd.org/tax/dispute/mutual-agreement-procedure-statistics.htm

approach. All of the above may lead to revision of the preliminary pricing agreements and re-organization of the new system of tax administration.

In the OECD project, financial accounting is expected to provide a starting point for determining how the profit will be split among countries, which is a significant deviation from the current practice. The difference between taxable and accounting income can be quite substantial. For instance, the pre-tax income does not include the net operating losses and capital investment, which are recognized by countries for taxation through a wide range of methods[31]. Moreover, the differences in the US and European financial accounting standards may pose a real challenge when it comes to measuring profitability.

Broadly speaking, any kind of international consensus regarding the unified approach will require countries to give up some of their tax sovereignty. Not only will this situation create new levels of distortions but it will also undermine the progress which has already been achieved by many countries, including Russia, engaged in fierce tax competition and pursuing business-attraction policies and programs.

Furthermore, the new rules will require new efficient tools for avoiding double taxation. So far no such tools have been chosen. It also remains unclear whether the OECD's proposal can be realized through the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS[32] or they will require a new solution such as an intergovernmental platform for collaboration on tax [35].

In its current state, the unified approach is unlikely to be supported by the US, which came up with a 'safe harbor' proposal of its own, meaning that companies should be able to opt into or out of the 'unified approach'. This proposal still remains in discussion stages[33]. We believe that the safe-harbor approach will exacerbate the problem of double taxation and the problem of distortion of business investment and tax decisions by the corporate tax.

The analysis of the relevant US experience can shed light on the possible consequences of this measure for international tax competition as well as on the consequences of the introduction of the formulary approach to profit split. The states being autonomous in their choice of corporate taxation policies, the application of the formulary apportionment method has brought to light tax receipts' sensitivity to such choice. The autonomous approach thus intensified tax competition between the states [36]. Thus, the American experience shows that if the formulary approach is applied on a global scale, coordination in the choice of harmonized formulae and other aspects of tax policies becomes crucially important. Therefore, complete consensus is essential for the success of the OECD's initiative.

## 7. Taxation of digital multinationals in Russia

The development of e-commerce, which is mostly understood as transactions conducted over the Internet, makes it difficult to determine the specific territory which this or that transaction can be attributed to [18] or the actual source of income [19]. In this light, separate accounting and taxation of tech giants' profits (especially, of their virtual PEs) through the arm's length principle have proven to be all but impossible. A viable alternative in this case would be a formulary apportionment method, like the one in the OECD's

[31] Kaeding N. Taxable income vs. book income: why some corporations pay no income tax. Tax Foundation. May 2, 2019. Available at: https://taxfoundation.org/why-corporations-pay-no-income-tax

[32] Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS. OECD. Available at: https://www.oecd.org/tax/treaties/multilateral-convention-to-implement-tax-treaty-related-measures-to-prevent-beps.htm

[33] Statement by the OECD/G20 Inclusive Framework on BEPS on the Two-Pillar Approach to Address the Tax Challenges Arising from the Digitalisation of the Economy. OECD; 2020. Available at: https://www.oecd.org/tax/beps/statement-by-the-oecd-g20-inclusive-framework-on-beps-january-2020.pdf

unified approach. As our critical analysis of the latter has shown, however, a more simple and transparent taxation mechanism is needed and this is the task we are trying to address in this article.

We believe that it would make sense to move away from the three-tier unified approach, where different taxation methods are applied to specific fractions of profit. A broader look should be taken at the problem of the common dissatisfaction with the arm's length principle in taxation of MNCs' profits.

If we take a somewhat broader perspective, it becomes apparent that these companies can be treated as consolidated taxpayer groups. Thus, instead of applying the formulary apportionment strategy only to deemed residual profit from digital transactions, we can apply it to MNCs' total global revenue. In this case the presence of a company's branches or offices in a certain country, including its virtual PEs, is bound to draw a share of the company's global profits to this country.

To determine the global profits of digital multinationals, financial accounting can be used, provided that it is standardized in accordance with the established international rules and procedures. The basic criteria or allocation keys used to split the profits should only be objective value indicators since such indicators are commonly used in register records and similar documents and cannot be distorted by subjective interpretations in the course of a functional or factual analysis. The set of indicators (with the corresponding weights) could include labour costs, the cost of tangible or intangible assets, profit, or the number of Internet users.

We do not support the widely spread argument that the risk factor plays the key role in any profit distribution system (including the methods of transfer pricing regulation). In our opinion, this factor should not be included in the formula. In the corporate context, risk can be seen as dependence on the possible loss of financial or economic assets (gains). Risk can be also seen as stemming from the decision to follow a particular course of action or not. In general, risk is determined by the negative impact that several obvious sources of uncertainty have on profitability. Even if it is possible to determine which part of the enterprise is most likely to take the most risk, accurate assessment of the degree of such risks is impossible.

MNCs' global profits allocated to countries (or regions of federal states) can be reduced by the amount of tax preferences and taxed at the rate set by the national legislation.

Since the digital economy now pervades all spheres of life and business models, the above-described approach will provide a sensible and viable solution not only for taxation of digital companies but to other types of multinationals as well.

The formulary (or unitary) approach to profit allocation can serve as an alternative to the arm's length principle, which is inapplicable in the conditions of the digital economy.

Like the OECD's unified approach, the proposed mechanism of taxation will be more effective if it is adopted by the majority of countries and common financial accounting standards are agreed upon. However, it is worth remembering that consensus decision-making is a time-consuming process.

In Russia, taxation of a virtual PE based on the above-described mechanism may be possible and feasible on a unila-teral basis. This measure will satisfy the country's fiscal interests and at the same time ensure that taxes adequately reflect the actual economic profits of digital companies.

In anticipation of the possible counterarguments, it has to be mentioned that similar approaches to determining PEs' profits were used in Russia until 1 January 2002[34]. These approaches were also described in Article 7 of the OECD Model Convention (until 2010). They can still be found in several international agreements following the UN Model Convention and in some countries' legislation.

[34] Instruction of the State Tax Service of Russia of 06.16.1995 No. 34 'On Taxation of Profits and Income of Foreign Legal Entities'. *Bulletin of Normative Acts of the Ministries and Departments of the Russian Federation*. 1995;(12).

## 8. Conclusions

With the advent of the digital era, the international community has faced the need to reconsider the principles behind the allocation of MNCs' profits. The lack of the necessary instruments for taxation of such companies in the Russian tax system is fraught with risks for the participants of tax relations. Our study has brought to light a number of important economic problems and their possible solutions, showing the need to introduce a new indirect tax on digital services in addition to VAT, the concept of virtual PE and the corresponding tools for taxing digital companies in Russia.

This measure, however, should not be taken prematurely and should be preceded by a thorough analysis of its implications for the country's economic growth, in particular such aspects as the tax burden redistribution, competition, business profitability, employment and personal income.

We propose to develop instruments of direct taxation to enable Russia to benefit from the allocation of the global tax base of digital companies. In our view, it is necessary that the Russian legislation should include the concept of virtual PE, for which end we proposed our own definition and criteria.

The critical analysis of the OECD's unified approach has shown that a simpler and more transparent mechanism of taxation would be a better solution. In a broader perspective, the much-discussed problem of the arm's-length method crisis can be solved by identifying digital multinationals as consolidated taxpayer groups. A viable approach would be to adopt the formulary apportionment strategy, dividing MNCs' total global revenue rather than their residual profits between the jurisdictions. For allocation keys, we propose to apply objective value criteria, which are commonly used in register records and accounts, instead of subjective criteria. We believe that Russia should move forward with the unilateral national initiative for taxation of virtual PEs in accordance with the mechanism described above.

To be taken to an international level, our approach requires a multilateral consensus and, therefore, involves the same problems as the OECD's unified approach. Our approach, however, has a number of theoretical and practical advantages because it helps address the tax challenges arising from digitalization and establish fiscal control over the changes in the global revenue of tech giants. Moreover, the proposed approach will help reduce the stimuli to minimize tax liabilities. Not only does this approach facilitate tax administration but it can also be efficiently implemented in the future by using blockchain and big data technologies. In the future, the proposed measures will lead to increased certainty and transparency of taxation and minimization of risks for the participants of legal relations.

The evidence presented in this study can be used by policy-makers to improve the current Russian tax legislation in relation to digital multinationals. Our conclusions and proposals can be used for further research, including quantitative and qualitative studies of the DST's impact on the Russian economy; the concept of virtual PE, and methodological approaches to taxation and tax administration of digital companies.

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