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Taxation of Self-Employed in Russia: Potential Discrimination



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Abstract

In 2018 the Russian government introduced an option for the self-employed to pay a newly designed professional income tax instead of the ordinary personal income tax. This new tax regime has been widely examined by Russian scholars; however, the potentially discriminatory nature of the tax has not been studied. The tax is based on citizenship, and the authors' principal hypothesis is that it conflicts with the fundamental principles of Russian tax law because it is not consistent with the principle of non-discrimination in Russian law. The article studies the issues arising from taxing the self-employed (i.e. the professional income tax) in a cross-border scenario and the potential for tax discrimination on grounds of nationality, tax nexus, and citizenship in taxing the self-employed in Russia. Moreover, the article raises the question of "general" tax discrimination among employees caused by the professional income tax. The authors use academic studies and judicial findings to examine the way other countries define the relationship between citizenship and taxation in order to clearly establish the discriminatory character of the professional income tax, and they conclude that the citizenship or nationality of the taxpayer is primarily a political connection rather than an economic one. The tax reflects an economic connection and should be understood as a payment for the "consumption" of public goods. In the contemporary understanding of taxation, the citizenship-based approach should be regarded as discriminatory in principle. The political ambitions of Russia in promoting integration across the EAEU cannot justify the restriction of the self-employed status only to citizens of EAEU member states. The authors recommend redesigning the professional income tax on the basis of residence and revising treaties pertaining to dual taxation in order to extend their provisions to the professional income tax.



Keywords

self-employment tax, self-employed, citizenship and taxation, professional income tax, tax discrimination.

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Introduction

In 2018 the Russian government introduced an option for the self-employed to pay a newly designed professional income tax instead of the ordinary personal income tax.¹ The taxation of the self-employed is a difficult issue for the Russian authorities because self-employment income might easily be hidden from them. The digitalization of the Russian economy has allowed the government to improve tax administration and introduce favorable tax rules for the self-employed based on modern information technologies. All actions required of taxpayers may be carried out through the My Tax app, which might be used for reporting sales as well.

Despite the clear advantages for taxpayers from decreasing tax and administrative burdens, the self-employment tax employs a citizenship-based approach that has reduced the attractiveness of tax compliance for potential taxpayers. The citizenship-based design of the professional income tax has not yet been studied by Russian scholars even though the new tax regime has been broadly highlighted in Russian literature.

The principal hypothesis of this article is that the current structure of the newly introduced professional income tax is inconsistent with the principle of non-discrimination. Such matters as tax discrimination, tax nexus, and citizenship as they pertain to taxing the self-employed will be examined to support the initial hypothesis; the article is therefore structured around these considerations. Furthermore, the article raises the question of whether a kind of general tax discrimination against employees has been established by the professional income tax.

The authors have chosen to examine the field of self-employment as it is impacted by taxation because the self-employed have relatively low income and are consequently afforded only weak protection by market forces and the law.

¹ The professional income tax is formally a new tax. As one of Russia's special tax regimes, it is a substitute for paying of personal income tax and individual property tax (on a portion of business property). Pursuant to Russia's Tax Code, a tax that must be paid by the applicant via a special tax regime is a separate federal tax parallel to the personal income tax. Before the introduction of the professional income tax, all the self-employed had been required to pay the personal income tax of 13% (for Russian residents) or 30% (for non-residents).

1. Review of the literature on self-employment and taxation

Self-employment as a social and economic phenomenon has been studied by scholars and researchers from many different disciplines including economics, law, sociology, psychology, and other humanities. Self-employment grew rapidly in the second half of the twentieth century. Steven Balkin [Balkin S., 1989] studied self-employment as an opportunity and means to gain income for low-income persons. He described self-employment theories and contrasted self-employment with entrepreneurship, which he understood as an incorporated business. Another researchers [Müller W. and Arum A., 2004] studied self-employment as a social structure in advanced economies. They have examined factors that account for differences in self-employment across countries and concluded that the main factors are the extent to which labor markets are regulated and the degree to which intergenerational family relationships are a primary factor structuring social organization.

Self-employment has often been studied as an element of labor market structure. For that purpose, such various characteristics of the self-employed as skills, education, age, ethnic origin, and others have been investigated [Hakim C., 1998]. The results of a comparative study of self-employment across countries have been published in: [Müller W., and Arum A., 2004]. This research highlighted self-employment under conditions of social stratification. Many of the results of this work are still relevant today.

Many different aspects of self-employment and taxation, especially practical ones, have been examined by: [Hennig C. et al., 2013: 435–442]; [Polhemus J., 2003: 87–95]. These studies have been devoted to the narrowly national features of tax treatment for the self-employed and have not dealt with fundamental issues of principle and generalized approaches to taxing self-employment income.

The issue of self-employment and taxation has been studied by Zsófia Bárány [Barany Z., 2017] who showed that, if the self-employed evade income taxes, then the choice to be self-employed is more sensitive to tax rates on wages than to tax rates on income from self-employment. The issue of correlation between health insurance contribution incentives and self-employment in the US has been studied by Tami Gurley-Calvez [Gurley-Calvez T., 2011: 441–460] who has showed that equalizing the health insurance contributions from salaried workers and the self-employed would decrease the probability of exit from self-employment.

Analysis of published research on self-employment and on taxation and regulation of the activities of the self-employed in Russia and post-Soviet countries points to their fragmented character [Borisova A.M., 2020]. The studies oriented toward finance [Konobevtsev F.D., 2012]; [Mikhailov A.J., 2016] consider the self-employed primarily as a segment of the shadow economy. The papers that Russian scholars in finance or law [Lyutova O.I., 2020: 56–67]; [Goncharenko L.I., Advo-

katova A.S., 2020: 131–140] have produced on the professional income tax, deal mostly with its descriptive and practice-oriented nature.

2. The current legal framework for taxing self-employment income in Russia

To be self-employed is to be a person who works for himself/herself and is not a shareholder of an incorporated company or an employee. Different approaches to the definition of self-employment as a social and economic phenomenon exist and depend on aims, spheres of relationships, occupations, structure of the economy, etc.

The OECD since 2020 defines self-employment as the employment of employers, workers who work for themselves, members of producers' co-operatives, and unpaid family workers. Pursuant to the EU Directive 2010/41/EU, self-employed workers are all persons pursuing a gainful activity for their own account and under the conditions laid down by national law. In the *Jany* case, the Court of Justice of the European Union (hereinafter ECJ) stated that a self-employed person works or provides services outside any relationship of subordination concerning the choice of that activity, working conditions and conditions of remuneration; under that person's own responsibility; and in return for remuneration paid to that person directly and in full.² All national legal rules, in general, are based on the statement that there are two main forms of gaining income in the market economy — working for yourself directly; or indirectly through a legal entity. Balkin has defined self-employment as disintermediation by comparing entrepreneurship and self-employment: if a company acts as a “go-between”, the self-employed “merely works directly for the market rather than for an employer” [Balkin S., 1989: 13].

Relying on different criteria, the study by the European Foundation for the Improvement of Living and Working Conditions in 2010 has maintained that it is possible to identify five basic categories of self-employment depending mainly on such factors as:

existence of employees — whether the self-employed run their business with the help of employees or not, and if so, whether such employees are family members or not;

character of occupation — regulated or unregulated, skilled, or unskilled occupations in which the self-employed work.

These five categories arranged by labor force and occupation criteria reflect the most comprehensive view of self-employment. According to this approach, there are five categories of self-employed in Russia:

² *Jany and others*. ECJ Case C-268/99. 11.10.2001. Available at; <http://curia.europa.eu/juris/showPdf.jsf?jsessionid=55F7B7C9DAC76483454FF327B1E8A614?text=&docid=46850&pageIndex=0&doclang=en&mode=lst&dir=&occ=first&part=1&cid=2733787> (accessed: 3.02. 2021)

Individual entrepreneur is the most popular and common form of self-employment. This form is a universal form of sole proprietor business arrangement that may be fit for any kind of occupation except for services by notaries and lawyers. This form requires registration and may be combined with standard and preferential tax regimes. An individual entrepreneur may have employees.

Notary — a specific form of self-employment in a strictly regulated occupation. This form may be combined only with the standard tax regime.

Lawyer working in a lawyer's office but not in a company or firm — a specific self-employment category requiring registration and the standard tax regime as well. Both notaries and a lawyers may have employees.

Farming household — a specific form of self-employment that may comprise up to five persons (workers) predominantly connected by family ties. Such a household is run by a householder who has the status of an individual entrepreneur. This form may be combined with the standard and special preferential tax regimes.

All other self-employed persons, including craftworkers, housekeepers, child-care workers, etc. The standard tax regime is suitable for these remaining forms of self-employment. However, a new preferential tax regime has been offered for the self-employed in this category due to non-compliance with the standard tax treatment (personal tax).

These groups of self-employed might be likened to individuals who are shareholders, but that category of taxpayer gains income from passive activity, whereas the self-employed gain income exclusively from active work. All the self-employed gain income regularly, whereas shareholders may receive income irregularly.

Russian legislation (including tax law) does not use a term corresponding to “self-employed”. All individuals who gain active or passive incomes may be subject to personal income tax. The professional income tax may be applied for only by those who are self-employed or persons registered as individual entrepreneurs, and the tax does not make any distinction between income from labor or other regular activities and capital gains. This tax is levied only on professional income which is narrowly defined by the legislation. Pursuant to the law, professional income has been defined as: income derived by a person who is not an employee and does not have other employees, and income derived from the use of property. This tax regime can be used by individual entrepreneurs whose occupation may be rental activity or participation in partnerships which are recognized as legal entities in Russia. Some kinds of passive incomes are not covered by professional income tax; for example, income from the sale of real estate or corporate shares. In general, capital gains are taxed by personal income tax because in most cases they are irregular. The special tax regime's preferential aspect aims at taxation of income that is obtained by regular professional activity. Another specific feature of the Russian approach to the definition of self-employment for tax purposes is limitation of annual income and prohibition on use of this special tax regime by ordinary employees receiving employment income.

Taxing self-employed persons is currently a problem for the Russian authorities because the self-employment segment of the economy is hidden from the sight of tax authorities. An ordinary self-employed person is subject to a personal income tax. The design of Russian personal income tax does not contain any specific rules for the self-employed. Thus, taxation rules for employees and the self-employed are applicable to both except for the manner of computing and paying taxes. An employee pays the tax through a tax agent, but the self-employed must compute and pay it themselves. This taxation system does not work properly because self-employed persons often do not declare their income and pay personal income tax at all.

The problem is exacerbated by three factors: Russia still has a predominately cash economy.

Heavy administrative burdens from taxation. Self-employed taxpayers must compute revenues and expenses and file a tax return by themselves in accordance with imperfectly drafted and vague rules.

Heavy tax burden. For a self-employed person the standard tax rate of 13% may be onerous because in Russia there is no provision for any income to be exempt from tax, no reduction in tax rates depending on family situation, and no other substantial tax deductions.

The digitalization of the Russian economy has partially solved these problems and created a more convenient environment for taxing the self-employed [Ponkratov V.V. et al., 2020: 2385]. Instead of personal income taxation the government has offered an experimental system of taxation on professional income as a preferential tax regime. In 2017 the tax on professional income was introduced in several regions of Russia as an experiment.³ The collection of the tax has been facilitated by the My Tax app and by electronic exchange of information between banks and tax authorities. Both the administrative burden and tax burden have been decreased. Tax authorities are charged with calculating the tax, and the tax rates applied are 4% for income earned from transactions with persons and 6% for income earned from transactions with companies and individual entrepreneurs.

The justification for the distinction between employees and the self-employed for tax purposes might be questioned. An employee's income tax must be withheld by the employer at the standard personal income tax rate of 13%, while the self-employed who have chosen the tax regime under discussion are to pay a professional income tax of only 4% or 6%, and these lower rates have been arrived at in view of the significantly decreased administrative burden in computing revenues and costs for tax purposes. The fundamental principles of fairness and horizontal equality in taxation should be considered in implementing different tax treatments for employees and the self-employed. What is the actual difference between employees

³ Federal Law of 2017 "On the experimental tax on professional income" // SPS Consultant Plus.

and the self-employed that might justify a difference in tax treatment? Most developed countries do not have any preferential regimes for the self-employed, and this fact should be carefully pondered. If a country's income tax system is based on a schedular approach, there would probably be a difference between tax treatment for employees and the self-employed [Freedman J. and Chamberlain E., 1997: 87–118], although countries that operate under a global income tax system rather than a schedular one often do not apply any special rules for the self-employed.

In Russia employees are subject to a 13% tax rate, while employers incur obligations for withholding both that tax and social insurance contributions. A self-employed person under certain conditions may incur a tax liability at a 4% or 6% tax rate without any requirement to make social insurance contributions even though that person remains a beneficiary of social insurance benefits, except in the event of temporary disability. If we take as an example a teacher at a school and a teacher providing “private” teaching at home or on Skype, what is the principal difference between these types of labor? The teacher who is an employee works uses an organization's facilities and equipment, while the self-employed teacher has to provide any equipment for themselves. Although the employee does not bear the burden of expenses required for work purposes, the self-employed person does. The employee might enjoy such labor law guarantees as paid annual leave, a limited work week, and double pay for overtime work, while the self-employed person has no such advantages and the lack of such labor law benefits increases the cost of services or other deliverables provided by the self-employed. In addition, self-employment is inevitably exposed to substantial risks, while employment is relatively risk-free. Self-employment is considered by some academic experts on the topic as a kind of entrepreneurship that should be encouraged by tax incentives as well as by other preferential treatment. The correlation between lower taxes and self-employment growth is proven by [Folster S., 2002: 135–145]; [Stenkula M., 2012: 77–97], among others. To what extent do all these differences in work conditions serve to justify the current difference in tax treatment? Are these distinctions sufficient justification for setting the self-employment income tax at 4% or 6%? The authors maintain that all these differences in work conditions fall short of being justification enough and that introducing the professional income tax has undermined the principle of tax fairness. The self-employed who are paying the professional income tax are not currently paying their “fair share” of taxes. Even though the income tax for the self-employed should recognize the difference in costs incurred between the employed and the self-employed, the difference in tax rates should not be so large. The standard tax regime for individual entrepreneurs allows the opportunity to deduct business expenses, and the same deductions should also be considered for the purpose of self-employment income tax. Nevertheless, it would be worthwhile to consider Balkin's understanding of self-employment as an occupation distinct from entrepreneurship and typically yielding income so low in

comparison with personal income tax that it might be justifiable to apply the minimum taxable income for personal income tax to the self-employed.

A more plausible motivation for the introduction of the professional income tax may have been to bring the self-employment sector of the national economy within the scope of tax collection. That tax is primarily aimed at taxing self-employment income that is hidden from the tax authorities. The government introduced the tax as a necessary fiscal measure for reducing tax evasion by offering income tax rates favorable to the self-employed. Thus, decreasing the tax rate for the self-employed and increasing the standard personal income tax rate means shifting the tax burden from the self-employed to employees, or from easily hidden income to easily discovered formal employment income. However, limiting the application of the professional income tax to those with annual gross income less than 2.4 million Russian rubles means that a progressive income tax system has in fact been created for the self-employed. Furthermore, the professional income tax could be deemed a preferential regime, and this fact will be important for further analysis.

The introduction of the professional income tax may have many economic and legal effects. On the one hand, this tax may increase genuine self-employment by encouraging compliance and simplifying taxes. In addition, there are many non-tax factors, such as individual abilities, family background, occupational status, liquidity constraints, and ethnic enclaves, which prompt an individual to choose self-employment instead of standard employment [Le A., 1999: 381-416]. On the other hand, this tax may increase the rate of artificial self-employment because it is more advantageous and convenient to apply the professional income tax regime instead of the standard one for both the employee and especially for the employer. Applying the professional income tax significantly decreases costs of mandatory contributions for the employer. This kind of negative effect has been revealed and described broadly by scholars for several decades [Rocen D., 1990: 95-102]. Despite all the direct and indirect effects, the government has introduced the professional income tax because not to do so would have led to a complete failure in collecting taxes.

2. Professional income tax in a cross-border scenario

There are two core conditions to qualify for professional income tax:
a person is a citizen of Russia or another Eurasian Economic Union (hereinafter EAEU) state (e.g. Armenia, Kazakhstan, Belarus, or Kyrgyzstan);
economic activities are carried out in Russia.

Making citizenship, or nationality, a principal tax nexus is quite unusual in most countries, and it is currently used mainly in the USA. The citizenship criterion is irrelevant to the application of the standard personal income tax in Russia, but for some reason citizenship has been chosen as a condition for the professional income tax.

Even though the professional income tax is a federal tax, it is not at present being collected everywhere in the country but only in certain regions because it is still considered an experimental tax. The location of economic activities is the basis for determining the region whose taxes will apply. The Tax Code does not define the term “the location of economic activities”, and the tax authorities have taken the stance that for distance or remote work the self-employed may choose for themselves whether the location of economic activities is the location of the self-employed person or the customer’s location.⁴

For instance, an individual could be a Russian citizen residing outside Russia and working as a teacher communicating on Skype with students living in a Russian region where the professional income tax has been introduced. In that case, the taxpayer would be eligible to use the location of customers as the location of economic activities for tax purposes, no matter where the taxpaying teacher resides. This is an example of applying both the destination-based and citizenship-based approaches at the same time because the taxpayer does not reside in Russia either as a source country for the services provided or a country in which personal political and voting rights are held.

A second example would be a Russian citizen who resides in a foreign country along with their students. If the taxpayer has a home in Russia and status as a permanent resident, the location of the taxpayer might be chosen in order to qualify for professional tax and would then be permitted to apply the special tax regime that is under discussion here. In both of the aforementioned cases, we can observe that double taxation that would be avoided. If the relief from double taxation of personal income is not granted by the country of residence, there would be no sense in paying the professional income tax at all because the taxpayer is not a Russian tax resident and the place of providing services on internet for tax purposes would be determined in the country of residence. This thesis is correct only for active income; for passive income such as rent receipts, Russia could be a source country where the real estate is located and therefore be entitled to tax the rent income at the rate of 13%.⁵

On the one hand, using a citizenship-based approach instead of a residence-based one permits the government to expand the tax base and generate more revenue because the citizenship approach covers more taxpayers than the residence-based one in a cross-border scenario.⁶ On the other hand, there are no obvious reasons for any Russians who are not Russian tax residents to pay the professional

⁴ Letter of the Federal Tax Service of 12.10. 2020 No. AB-4-20/16632@ “About Review of an Application” // SPS Consultant Plus.

⁵ As a rule, active income is subject to the professional income tax; however, some kinds of passive income, such as rent payments, may be subject to the tax.

⁶ The irrelevance of the professional income tax to tax resident status was stated by the Finance Ministry of the Russian Federation in the ruling of 16.10. 2020 No. 03-11-11/90435.

income tax. The Finance Ministry of the Russian Federation has explained that Russia's double taxation treaties (hereinafter DTTs) do not cover this tax, therefore, they provide no relief from double taxation.⁷ However, if a country of residence provides relief from double taxation through provisions in its domestic tax law, expanding Russia's right to tax active income earned by Russian persons living abroad would be reasonable.

In a third situation, a taxpayer could be a foreign citizen living in Russia who is a Russian tax resident and is therefore not eligible to apply the professional tax regime concerned because of their foreign nationality. In this case the taxpayer must pay either the personal income tax at a rate 13% or the simplified tax at 6%. The simplified tax is a special tax regime like the professional income tax, but for small companies or officially registered individual entrepreneurs and not for the self-employed. This simplified tax regime requires regular reporting, and both Russian citizens and foreign citizens who are individual entrepreneurs may qualify for it. This provision as it applies to foreign citizens may work to the Russian government's disadvantage. If foreigners decide to register as individual entrepreneurs, they will not be able to rely on the Russian tax treaties, if any, to avoid double taxation. And the beneficial professional income tax regime would also be unavailable to them.

3. Citizenship as a nexus for general tax purposes

Citizenship is usually regarded as a political and legal connection between an individual and a state, through which the individual is granted primarily the right to vote and benefit from the state's protection. While the Federal Law "On Russian citizenship" of 2002⁸ and currently in force defines Russian citizenship as a sustained *legal* connection between the person and the Russian Federation providing reciprocal rights and obligations, the USSR law of 1990 concerning citizenship in the USSR defined it as a sustained *political and legal* connection between the person and the Soviet State providing reciprocal rights and obligations. Thus, the current Russian legislation provides a broader scope for citizenship by including all aspects of legal connection.

Christian Joppke [Joppke C., 2010] has studied citizenship and identified different theories of citizenship: social citizenship, national citizenship, post-national citizenship, and multicultural citizenship. Joppke assumes that citizenship has three common dimensions — status, rights, and identity — whilst citizenship as a status is membership in a political community [Orgad L., 2011: 596]. Erik Ros has

⁷ The Finance Ministry of the Russian Federation's ruling of 20.10. 2020 No. 03-08-06/91252.

⁸ Federal Law on Russian Citizenship dated 05/31/2002 no 62-FZ // Sobranie Zakonodatelstva Rossiiskoi Federatsii. 2002. No. 22. Art. 2031.

pointed out that “[c]itizenship is comprised of a number of diverse elements. The minimum basic characteristics of citizenship are protection from the state through basic rules, the right to move freely within the state, the duty to obey the laws of the state, the right of suffrage and the right to receive welfare protection” [Ros E., 2017: 89]. Nino Mamasakhlisi has studied citizenship as an element of personal constitutional status in Russia and has concluded that the contemporary understanding of citizenship is based on the legal ties between a person and a state, whilst political factors impact this tie and make it both political and legal in nature [Mamasakhlisi N., 2018: 11]. The thesis that citizenship involves a primarily political connection rather than an economic one is indirectly supported by the UK’s instruction on the functioning of the Youth Citizenship Commission, which was directed to facilitate political activities among young citizens. The Commission’s establishment was first signaled in the Governance of Britain Green Paper, which was introduced by the government as an attempt to “forge a new relationship between government and citizen and begin the journey towards a new constitutional settlement” [Tonge J. and Mycock A., 2010: 184].

If income or inheritance taxes are imposed by a government primarily based on an individual’s connection to a country as in Russia, that is termed a residence nexus, and the taxation system is following a residence-based model. If those taxes are imposed as in the USA via a citizenship nexus, then that taxation system would be following a citizenship-based model. If such taxes are imposed by a government based on the connection of the tax base to the country as in Hong Kong, the taxation system would be following a source-based model of direct taxation. In most countries, citizenship is not currently applied as a factor indicating a connection that would empower the government to tax individual’s income. That criterion is widely out of favor and is used mainly by the USA, but it persists despite all the arguments against it [Beretta G., 2019]. A tax system using citizenship as a basis may proclaim a worldwide taxation system in contrast with residence-based taxation. The residence approach to taxation also relies on a worldwide principle, although the term “worldwide” is used in different contexts. In the case of the citizenship-based approach, the term refers to unlimited tax liability, regardless of whether a citizen taxpayer resides in a particular state or not. For the residence-based approach, the term “worldwide” refers to a global tax base for arriving at the amount of tax, i.e. the tax that must be paid regardless of where the tax base was formed. Due to the current understanding of tax as a payment for public goods, the residence-based approach is favored throughout the world over the citizenship-based one. However, citizenship does define a political connection between an individual and a state and, at least when first acquired, permits an individual to enjoy active and passive voting rights. In the countries like Russia where a residence-based approach is applied, an individual could be a citizen with voting rights and other constitutional guarantees without any tax liability if they lack physical presence or

sources of income within the country. Thus, an individual could be a citizen, but at the same time they might not be a taxpayer in the country of citizenship. That outcome could be justified by a particular understanding of tax fairness, which is regarded as a fundamental principle for design of a tax system in its entirety and thus predetermines the approach to taxation of income.

Using citizenship as a criterion for worldwide tax liability is debatable from the viewpoint of tax fairness. On the one hand, whether the potential benefits — political rights and freedoms, a lack of entry restrictions, etc. — gained by a non-resident citizen are sufficient for unlimited tax liability can be questioned. On the other hand, to what extent should a taxation system follow the principle “no taxation without representation”? [Huber G., 2015]. The argument from benefits is that the tax is a payment in return for public goods, including an opportunity to vote, be elected to government bodies, and potentially be protected by the state’s authorities. Thus, US citizens overseas — so-called “accidental” citizens — must pay taxes for political benefits even without any economic connection to the USA. The benefit argument has been rejected by followers of taxation theories based on the ability to pay, who maintain that it is impossible to compute the amount of “benefit” related to a given taxpayer. However, the benefit theory has been modified by Richard Musgrave who suggested that there are three branches to government — allocation, distribution, and stability — meaning, respectively, provision of public goods, distribution of resources, and ensuring macroeconomic stability [Stewart M., 2015: 17]; [Musgrave R., 2008: 334-339]. Public goods funded by taxes which implement the model of a tax state could be understood differently. Potential military protection might be deemed as much a public good as consumption or benefit from roads, public schools, or hospitals, and that view would support the US approach to worldwide individual income taxation. However, tax liability of an economic nature is based more on an economic connection, the so-called tax nexus, between the taxpayer and the government. One such instance would be property that is physically within the borders of a government’s jurisdiction and implies no political connection. Although citizenship is mainly a set of political guarantees regardless of economic connection and a citizen is eligible to exercise their political rights without having participated in a country’s economic life, tax is incurred on part of a person’s income earned through economic activities regardless of that person’s political status.

This same approach is applied by the Russian government for currency exchange. A Russian citizen is regarded as a currency resident, but if a person resides outside Russia for more than 183 days in a year, that person is regarded as a specific resident and is not subject to currency exchange restrictions. In the absence of an economic connection, there are no legal grounds nor any reason for currency restrictions or obligations, such as a resident’s obligation to notify the tax authorities about foreign bank accounts. A Russian citizen who primarily lives overseas is in-

volved in a foreign country's economy rather than the Russian one and so has shed any economic connections with Russia. Both in currency exchange and in taxation, Russia follows the residence-based approach rather than the atypical taxation based on citizenship. However, the professional income tax has been introduced as an exception based on the citizenship approach.

The issue of the relationship between citizenship and taxation has seldom been raised by Russia's higher courts. The Russian Constitutional Court in 2016 has recognized payment of taxes as a relevant circumstance for the purposes of migration law. That fact should be taken into account when migration law is being applied in cases of violence by a foreign citizen.⁹ In another case, the Court stated that, if a purchaser of exported Russian goods resides abroad, that purchaser's citizenship in Russia is not grounds for applying VAT to the export transaction. VAT should not apply to exported goods regardless of the importer's citizenship.

In 2018, the Constitutional Court examined the place of foreign citizens in the social insurance system.¹⁰ While tax resident status is not clearly defined in the Russian Tax Code, the status of social insurance beneficiary is based on status under migration law. In accordance with the Federal Law "On mandatory pension insurance" of 15.12.2001 (in the version valid through 1.01.2012), foreign citizens were designated social insurance beneficiaries provided that they resided in Russia permanently or temporarily. Foreign citizens who temporarily "stayed" in Russia in order to work could not be designated pension insurance beneficiaries whether they were citizens of an EAEU country or not. The Constitutional Court stated that this provision was consistent with Russia's Constitution because foreign citizens temporarily staying in Russia in order to work have the option to be beneficiaries of voluntary pension insurance. Therefore, the Court found that such a restriction on mandatory pension insurance was not an instance of non-discrimination.

4. Tax discrimination on grounds of nationality

Tax discrimination is regarded as a breach of taxation equality. Andrew Morris has pointed out that "United Kingdom law forbids two types of discrimination, direct and indirect. One discriminates *directly* by treating another person less favorably on the grounds of race or gender. *Indirect* discrimination... is more subtle" [Morris A., 1995: 199].

⁹ The Russian Federation Constitutional Court's. Ruling (Postanovlenie) of 17.02.2016 No. 5-P // Collection of Federal Legislative Acts of Russia (Sobranie zakonodatelstva Rossiiskoy Federatsii). 2006. No. 9. Art. 1308. The position was supported by Russia's Supreme Court in Ruling N 4-KA/20-20-K1 of 16 December 2020.

¹⁰ The Russian Federation Constitutional Court's Decision N 1486-O dated 28 June 2018. The document has not been published.

The non-discrimination principle can be worded in two different ways, "...either by the enunciation of a general principle or particular principles of equality, or by the enunciation of a general principle, or particular principles, of non-discrimination" [Santiago B., 2009]. Russia has established the general principle of equality in Article 19 of its Constitution, but ensuring that equality in matters such as taxation will require supplementing that general principal with a principle of non-discrimination, which requires, for example, that taxpayers with the same income incur the same tax liabilities. Equality here must be reached by differentiating among taxpayers based on such non-arbitrary objective criteria as total annual income. This is often referred to as horizontal equality and entails equal rights and obligations for all members of each of the differentiated groups. Horizontal equality applies both to private individuals including taxpayers and recipients of grants and investment from government budgets, and also to public entities such as national, regional (state), and local governments..

The issue of discrimination by Russian taxation arises mostly in international taxation cases. For example, this issue was broadly examined in the fundamental *Severnyi Kuzbas* case,¹¹ in which the taxpayer stated that the thin capitalization rule conflicts with Russia's tax treaties with Cyprus and Switzerland because that national anti-avoidance measure may discriminate against resident companies that have foreign investments and foreign loans. It is important that the different tax treatments which countries often apply to residents and non-residents do not result in non-discrimination. There are different tax rates in Russia for residents' and non-residents' taxable income, and the amount of that taxable income is calculated differently as well. Providing social exemptions, deductions, or other tax benefits only for resident individuals is a common practice, which is regarded as fair because a resident's taxable base typically includes worldwide income while a non-resident's base includes only the income earned in the country. Non-residents also "consume" fewer public goods than residents, and this is another justification for a difference in tax treatment when tax bases are different.

Tax discrimination in Russia has been surveyed by Andrei Savitskiy, and he concluded that the citizenship criterion began being applied to Russia's taxation of individual income along with the residence criterion in 2010. This dual approach came about in connection with the 13% tax rate for non-residents who are foreign citizens working on the basis of a patent.¹² Savitskiy [Savitskiy A.J., 2019: 302] has pointed out that this Tax Code provision has a discriminatory impact on Russian non-resident citizens who must pay a 30% personal income tax.

¹¹ Supreme Arbitrage Court of the Russian Federation. Postanovlenie Prezidiuma of 15.11.2011. No. 8654/11.

¹² According to Russian legislation, a patent establishes a foreigner's legal right to work in Russia.

As Ruth Mason and Michael Knoll [Mason R., Knoll M., 2012] have observed, “Although the concept of tax discrimination is ill-defined and poorly understood, its influence seems continually to expand. It has become particularly important in the EU, where tax cases constitute about 10% of the ECJ’s caseload.” In 1998, the ECJ issued a precedent-making decision concerning discrimination on grounds of nationality. Mrs. Gilly was a Germany-born teacher residing in France, who had nationality in both countries. She worked at a public school near the German border; and Germany as the source country of her income taxed it, while France as the country of her residence taxed the same income. Her tax burden in Germany was greater than in France because of Germany’s more progressive tax brackets, while France in its capacity as Mrs. Gilly’s country of residence allowed her a tax credit that was less than the German tax she actually paid. The ECJ established that the case concerned a German national, who acquired French nationality by her marriage, working in Germany but residing in France. Mrs. Gilly claimed that Germany failed to take her personal and family circumstances into account. The ECJ held that this practice was in line with the Schumacker principle inasmuch as Germany, as the state of employment, was not required to consider Ms. Gilly’s particular circumstances because they were taken into account in France, the state of residence, which is, in general, in the best position to assess those circumstances.¹³

In the aforementioned extremely important Schumacker case of 1995,¹⁴ the ECJ declared that the fact that a state does not grant to a non-resident certain tax benefits which it grants to a resident is not, as a rule, discriminatory because those two categories of taxpayer are not in a comparable situation. However, when a non-resident earns a major part of their worldwide income in the source country and relatively little in the country of residence, the situation changes. Both a non-resident and a resident with high proportions of foreign-earned income and less income in the country of residence would actually be in a comparable situation, and therefore the principle of non-discrimination demands that they fall under the same tax regime. This precedent-setting case has shown that the actual conditions should be examined in order to verify that the principle of non-discrimination is being followed, and even such a formal criterion as residence status does not always serve as sufficiently objective grounds for differing treatment. Furthermore, discrimination based on different tax treatment for residents and non-residents is often regarded as discrimination on grounds of nationality.

There are significantly fewer cases concerning discrimination in national taxation, especially in individual taxation, than in international taxation. However,

¹³ FR: ECJ, 12 May 1998, Case C-336/96, *Gilly v. Directeur des services fiscaux du Bas-Rhin*, Case Law IBFD (accessed: 10.02. 2021)

¹⁴ DE: ECJ, 14 Feb. 1995, Case C-279/93, *Finanzamt Köln-Altstadt v. Roland Schumacker*, Case Law IBFD (accessed: 10.02. 2021)

sometimes this issue is raised by higher courts in Russia, primarily by the Constitutional Court of the Russian Federation. The Court has repeatedly made reference to compliance with the requirement of equality and to the inadmissibility of different tax treatment unless the differentiation is based on objective criteria. For instance, in 2016 the issue of rate differentiation and discrimination was studied by Russia's Constitutional Court.¹⁵ The Court found that the imposition of different pension insurance contribution rates depending on the amount of income and the procedure for determining the amount of income based on the tax regime were not discriminatory because the different contribution rates were based on objective criteria and provided for increasing pension benefits in proportion to increasing pension insurance contributions or taxable income. In 2018 the Court stated that tax advantages for individuals who have children are meant to prevent potential discrimination toward individual taxpayers with children. Thus, the Court has recognized having children or even one child, as an objective criterion, for differentiation.¹⁶

The Supreme Court applies the discrimination principle the same way. In case *310-KG18-7101*¹⁷ of 2018, Russia's Supreme Court found that restricting a company's exemption of movable property subject to property tax on the grounds that the taxable property had been previously received from an associated company was discriminatory. The Court stated that, if the affiliation does have an influence on tax consequences, the imposition of such a restriction without the examination of all the actual circumstances would be discriminatory. If the property in question had not been taxable before its transfer from an associated company to another affiliate, then it should not have been subject to further taxation, and the taxpayer would have been entitled to the tax exemption despite the affiliation factor. The Court observed that the entitlement to tax exemption would not be called into question if the same property had instead been purchased from any other seller under the same conditions. The restricted exemption is an instance of tax discrimination and arbitrariness.

Differentiation of tax treatment based on objective criteria (the objective criterion test) should be followed as a requirement of non-discrimination, and reasonable differentiation may be achieved by setting different tax rates, tax advantages, deductions or exemptions, preferential regimes, and other components of tax treatment. The Constitutional Court in 2018 declared that introducing a tax advantage is an exceptional power of the legislature, which is solely empowered to

¹⁵ The Constitutional Court of the Russian Federation's Decision of 30 November 016 No. 27-P // *Sobranie Zakonodatelstva*. 2016, No. 50, Art. 7170.

¹⁶ The Constitutional Court of the Russian Federation's Decision of 27.03.2018 No. 13-P. *Ibid.*, 2018. No. 15 (Part V), Art. 2237.

¹⁷ The Supreme Court's Ruling of 29.10.2018 No 310-KG18-7101. The document has not been published.

introduce a tax advantage.¹⁸ Therefore, any tax advantage introduced should meet the non-discrimination principle; and if a potential tax advantage has not been introduced, that lack does not constitute discriminatory tax treatment.

5. Citizenship as a nexus for the professional income tax

The professional income tax has not yet been reviewed by the judiciary for its conformity to the non-discriminatory principle established by Article 3 of Russia's Tax Code, under which the introduction of tax advantages or preferences based on the citizenship criterion are prohibited. The non-discrimination principle demands that comparable situations be treated similarly unless a difference in treatment can be objectively justified, whereas citizenship or nationality are not regarded as objective factors. Although the non-discrimination provision has not had an authoritative interpretation, there appear to be two potential outcomes.

The first might be based on a literal interpretation of the provisions in Article 3. The design of the professional income tax would be assumed not to have any tax advantages, whereas the tax itself could be considered a preferential regime offering an alternative to personal income tax. The Russian tax system includes a few *special* tax regimes that are alternative to ordinary regimes. Every such tax regime is a set of specific tax rules along with the construction of a separate federal tax imposed on a distinct category of taxpayers. Thus, a preferential regime based on the citizenship criterion is formally non-discriminatory under a narrow interpretation of the provisions at issue.

The second outcome that we can suggest would be based on an essential interpretation. The core purpose of a special tax regime is to replace a set of federal or regional taxes with one uniform tax and consequently reduce tax or administrative burdens. The separate application of such a uniform tax should not be regarded as creating an autonomous tax on a par with ordinary taxes, and therefore the imposition of a preferential regime must not be based either on the citizenship criterion or on other tax advantages within the scope of ordinary taxes. Any taxpayer who meets such requirements for a preferential tax regime as the amount of annual revenues, the limit on employees or a lack of employees, the size of the undertaking, etc., is entitled to be subject to the preferential regime so long as they continue to meet to those requirements. If there is a breach of the requirements, then the taxpayer must fall under the ordinary taxpayer category. In keeping with this, the Russian government has created progressive income taxation for certain entrepreneur groups, for instance, farmers, individual entrepreneurs, and small businesses. These rules refer to the progressive scale for income taxation of businesses, and the current design of

¹⁸ The Constitutional Court of the Russian Federation's Ruling of 17.07.2018 No 1713-O // SPS ConsultantPlus.

the professional income tax based on the citizenship approach may be considered a breach of the non-discrimination principle under the objective criterion test.

Citizenship can be used as either a principal or a supplementary tax nexus. As it has been mentioned before, the US government applies it as a principal criterion for tax purposes, although this criterion is more usually applied for cross-border taxation when the status of a tax resident is to be determined. According to the OECD Model Convention of 2017,¹⁹ nationality should be applied as a supplementary connecting factor if a person does not fit the criteria of permanent home, center of vital interests, or habitual abode. In some countries citizenship or nationality can be used for establishing domicile. Because it is a civic nexus, domicile status can be based on citizenship or nationality. For example, Japan presumes a person is domiciled if they reside in Japan continuously for more than one year in the light of such circumstances as whether they have Japanese nationality, or whether they have relatives who share the same livelihood with that individual in Japan have Japanese nationality, or whether they have their occupation and assets in Japan.²⁰ Beretta [Beretta G., 2019] provides another example of citizenship as a supplementary nexus in analyzing the practices of EU countries in exit taxation aimed at preventing tax avoidance by changing citizenship or nationality through emigration. A country's tax rights may be expanded even in the context of bilateral tax treaties by a *saving clause* that may apply to non-resident citizens [Kallergis A., 2021], and this provides one more example of how the citizenship criterion may be employed to modify a tax nexus.

If citizenship can function as a principal or supplementary tax nexus, is citizenship a principal or supplementary nexus for Russia's professional income tax? One can arrive at two possible answers depending on how the characteristics of the tax itself are classified. If the professional income tax is distinct from personal income tax, then the citizenship connection should be recognized as principal. However, in this case design of the professional income tax makes no sense because there is no reason to pay the tax at all without tax residence status in Russia. Consequently, the only reasonable answer may be that the citizenship factor is a supplementary nexus within the professional income tax when it is regarded as an alternative tax to the personal one. In this case the citizenship criterion serves as a restriction on a category of taxpayer. Therefore, every individual who is a self-employed tax resident must pay personal income tax on a worldwide basis, except for citizens of EAEU countries, who are the only tax residents entitled to pay income tax at 4% or 6% instead of 13%. Currently, individuals who are not citizens of EAEU countries but are living and undertaking economic activities as self-employed in Russia, for

¹⁹ Available at: https://read.oecd-ilibrary.org/taxation/model-tax-convention-on-income-and-on-capital-condensed-version-2017_mtc_cond-2017-en#page32 (accessed: 16.11.2020)

²⁰ Available at: <https://www.oecd.org/tax/automatic-exchange/crs-implementation-and-assistance/tax-residency/Japan-Tax-Residency.pdf> (accessed: 16.11.2020)

instance, citizens of Ukraine living in Russia, are not eligible for the professional income tax because of their citizenship. This differentiation cannot legitimately qualify as objective, and the difference in tax treatment cannot be accepted as reasonable even with the explanation that the Russian government is employing it to strengthen economic integration within EAEU countries.

Political and economic integration processes affect domestic tax law, *inter alia*, as part of direct taxation. For instance, the impact of fundamental human rights and freedoms, including the non-discrimination requirement, on direct taxation in the EU has been studied by K.A. Ponomareva [Ponomareva K.A., 2020: 185–206]. She observed what has been called *negative* harmonization in personal income taxation, which has meant protecting the Union's fundamental premise predominantly through judicial proceedings, as opposed to *positive* harmonization, which would require the creation of supranational positive law as in indirect taxation or corporate taxation [Panayi Ch., 2005: 487]. In Russia any impact of EAEU integration processes on direct taxation is still weak; however, a few provisions in the Tax Code concerning corporate taxation exemplify the EAEU's integration tendencies. For instance, in accordance with Article 25.13-1, the foreign-controlled company rule is not applied when a foreign-controlled company is incorporated in an EAEU member state. In the expectation that the ECJ and EU countries' national judicial practices will be followed as a model,²¹ we assume that in the future Article 269 of the Tax Code will be amended to limit the coverage of the thin capitalization rule to tax residents of EAEU countries. Interest payments would then be permitted for companies that are Russia's tax residents to foreign companies that are tax residents of other EAEU member states without further reclassification of them as dividends that would increase tax liability.

The distinctive features of EU countries' individual taxation are determined by both internal markets and EU citizenship. The *Schempp* case²² is one clear example. The ECJ examined the rights of Mr. Schempp as an EU citizen²³ with respect to the German income tax system, under which the taxpayer is entitled to deduct maintenance payments for an ex-spouse if those payments are included in that recipient's tax base, regardless of whether the recipient is a tax resident of Germany or an-

²¹ UK: ECJ, 13 March 2007. Case C-524/04. *Test Claimants in the Thin Cap Group Litigation v. Commissioners of Inland Revenue*, Case Law IBFD.; France: Conseil d'État (Supreme Administrative Court), 30 December 2003, Case 233894, *SA Andritz (the taxpayer) v. Ministre de l'économie, des finances et l'industrie (the tax authorities)*, Case Law IBFD; Spain: Tribunal Económico Administrativo Central (Central Economic-Administrative Court), 20 December 2007, *Company, name not disclosed (the taxpayer) v. Administración (the tax authorities)*, Case Law IBFD.

²² DE: ECJ, 12 July 2005, Case C-403/03, *Egon Schempp v. Finanzamt München V*, Case Law IBFD.

²³ Under Art. 20 (1) of the TFEU, 'Citizenship of the Union shall be additional to and not replace national citizenship'.

other EU member state. Mrs. Schempp moved to Austria where such payments are not taxable, and consequently the German tax authorities refused Mr. Schempp's tax deduction. The plaintiff asserted that the non-discrimination principle would be breached if he could not deduct these payments while other German residents could. The ECJ decided this did not involve any breaches of EU guarantees of citizens' rights. Determinations of which EU member state's taxation should apply have been made only through residence status but not through nationality or citizenship. It is important to note that the German tax rules in question are aimed at keeping the tax base inside EU territory, while the citizenship nexus as it applies to the professional income tax is meant to restrict a potential taxpayer group.

It is useful to look at the design of the professional income tax in light not only of the non-discrimination principle set by national tax legislation and case law, but also with respect to the non-discrimination principle stipulated by tax treaties of the Russian Federation. The Double Taxation Treaty (DTT) between Russia and EAEU non-member Azerbaijan of 1997 includes a non-discrimination provision in Article 24, under which citizens of a contracting state shall not be subjected in the other contracting state to any taxation, or any requirements connected therewith, which are other or more burdensome than the taxation and related requirements which apply or may apply to nationals of that other state in the same circumstances — in particular with respect to residence. Article 2 of the Treaty stipulates that all provisions may be applied not only to the taxes explicitly listed in the DTT and in force at the time of signature, but also to identical and analogous taxes that may be imposed in the future. As previously mentioned, Russia's Finance Ministry has maintained that the professional income tax is not covered by DTTs because the tax in question was not listed.

This issue has often been raised by foreign courts. For instance, the Federal Court of Australia²⁴ in 2018 judged a case on discrimination against a British citizen who had a working holiday visa and was a tax resident in Australia. The tax authorities rejected the claim of the tax-free threshold and reassessed the tax liability based on a working holiday visa. The Federal Court held that the taxpayer, who was an Australian resident, was claiming to be entitled to a different rate of tax than an Australian resident who was a national of Australia solely because she was on a working holiday visa and that this was exactly the type of discrimination that was prohibited by Article 25 on non-discrimination of the DTT between Australia and the United Kingdom.²⁵ Use of the tax-free threshold was denied because it was

²⁴ Federal Court of Australia, 30 October 2019, QUD 108 of 2018, Catherine Victoria Addy v. Commissioner of Taxation, Case Law IBED.

²⁵ Art. 25 of DTT between Australia and United Kingdom corresponds to Art. 24 of the OECD Model Convention on Income and on Capital and the Art. 24 of DTT between Azerbaijan and Russia that was previously mentioned.

supported only by a kind of visa for foreign citizens, and that differentiation did not meet the objective criterion test.

The ECJ arrived at the same position concerning the non-discrimination principle prescribed by EU law. In 2011 the ECJ held that granting an exemption, subject to certain conditions, only to Greek nationals and persons of Greek origin constituted direct discrimination based on nationality and was prohibited by EU law.²⁶

The introduction of the professional income tax as currently formulated might also have adverse effects. First, EAEU non-citizens living in Russia who are self-employed persons will probably not pay any income tax because there is no incentive to comply; second, the risk of tax avoidance will increase because any preferential tax regimes open the way to potential tax avoidance or evasion; third, the citizenship-based approach is dubious from the viewpoint of constitutionality.

Conclusion

The article indicates that the professional income tax based on EAEU citizenship is presumably discriminatory. The Russian Tax Code's non-discrimination provision as it applies to the professional income tax is subject to varying interpretations. On the one hand, the non-discrimination provision prohibits differentiation solely for rates or incentives as tax components. On the other hand, if the professional income tax is interpreted as a preferential regime which constitutes an alternative to personal income tax and functions as part of the entire income taxation system, the professional income tax would be discriminatory.

Tax discrimination has been understood by Russia's high courts as the imposition of different tax regimes based on biased criteria. Although resident status might be considered an objective and fair criterion for differing tax treatments, nationality or citizenship cannot. Moreover, the prohibition of discrimination on grounds of nationality is explicitly set forth by the Tax Code of the Russian Federation.

Citizenship or nationality is primarily defined as a political connection rather than an economic one, whereas the tax reflects an economic connection and should be understood as a payment for the consumption of public goods. Within the contemporary understanding of legitimate taxation, the citizenship-based approach would be regarded as discriminatory in nature.

If the professional income tax is considered as an alternative tax regime to personal income tax, it should be based on the same residence-based approach. The self-employed who are Russian tax residents but of different citizenship should not be treated differently. A self-employed person who meets all the criteria except

²⁶ ECJ, 20 January 2011, C-155/09. *Commission of the European Communities v. Hellenic Republic*. Case Law IBFD.

citizenship should not be denied eligibility for the same tax regime as Russian nationals or citizens of other EAEU countries. That would balance personal income tax and the professional income tax with each other and improve the collectability of the professional income tax both inside the country and outside.

If the Russian government intends the new professional income tax to expand the tax base available from self-employment — especially as it pertains to cross-border services provided by the self-employed — a review of DTTs from the viewpoint of coverage for personal income tax would be useful. In any event, the design of the professional income tax should be reconsidered both in order to make it an effective component of current Russian external policy and also to align it with the fundamental principles of tax law.



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