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Implementation of the Rights of Taxpayers: Digital Companies under Double Tax Avoidance Agreements

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The article discusses the implementation of the right of taxpayers-digital companies in the framework of the double tax avoidance agreements (hereinafter referred to as the DTAA) to exemption from taxation in the state-source of income. As a result of the analysis of the norms contained in international agreements on the avoidance of double taxation, ways to address the issue of taxation of digital companies in the framework of international tax legislation are proposed. The authors of the article proved the need to amend the provisions of the DTAA and, in particular, change the term 'permanent establishment' and proposed the introduction of the concept of a 'digital' permanent establishment for the purpose of establishing the tax presence of a company in the relevant jurisdictions, with reference to the location of users and customers of such companies.

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All international treaties that in one form or another regulate tax issues can be divided into two groups. The first group includes international agreements in which tax issues are resolved along with others (Vienna Convention on Diplomatic Relations 1961,[1] Vienna Convention on Consular Relations of 1963,[2] treaties on location of international organizations, trade agreements, investment protection agreements). The second group includes international agreements, the main subject of which are tax issues (agreements on international information, administrative and legal co-

[1] Vienna Convention on Diplomatic Relations of 18.04.1961 // Vedomosti of the Supreme Soviet of the USSR. 29 April 1964 No 18, pp. 221–246.

[2] Vienna Convention on Consular Relations of 24.04.1963 // Collection of international treaties of the USSR, Vol. XLV - M., 1991, pp. 124–147.

operation in the tax sphere, double tax avoidance agreements) [Шахмаметьев, p. 112]. This article will examine the implementation of the rights of taxpayers – digital companies (companies providing electronic services) precisely in the framework of the double tax avoidance agreements (hereinafter referred to as the DTAA).

The DTAA are international treaties between states, governments, or individual territories aimed at agreeing on their rights to levy taxes [Finnerty et al., 2007, p. 11]. In a broad sense, the goal of the DTAA is to create conditions for cross-border trade and investment by removing tax barriers to capital flows [Arnold, Mcintyre, 2002, p. 104].

This general objective is complemented by more specific goals. As their name implies, double tax avoidance agreements are concluded with the aim of preventing double taxation [Finnerty et al., 2007, p. 13], first of all, international legal double taxation, which is understood as the levy of comparable taxes in two (or more) states on the same taxpayer in relation to the same object for the same period of time [Baker, 1994, p. 12]. By fair remark of J.F.A. Jones, in modern conditions of cross-border trade and investment "taxpayers are becoming global" [Jones, J.F.A., p. 37]. The economic inappropriateness of double taxation in such conditions is quite obvious: it creates negative consequences for the taxpayer and thereby impedes the movement of capital from one country to another [Пепеляев, 2015, p. 484].

However, just as double taxation creates barriers to international trade, the double tax exemption creates an unfair competitive advantage in such trade. In this regard, the designated goal of the DTAA is supplemented and balanced by another goal – prevention of tax evasion [Finnerty et al., 2007, p. 13; Arnold, Mcintyre, 2002, p. 106]. This also needs to be taken into account when considering taxpayer rights under the DTAA. In addition, the goals of the DTAA are separation of tax revenues between states, preventing discrimination in taxation of foreign individuals and non-residents [Baker, 1994, p. 13] and exchange of information between tax authorities [Finnerty et al., 2007, p. 107; Пепеляев, 2015, p. 445]. It seems that when considering the rights of the taxpayer under the DTAA (including the rights of taxpayers-digital companies) it is necessary to take into account all of the above goals and objectives of the DTAA.

Parties to the DTAA are states[3] (their territories[4]) or governments.[5] As in the case of other international treaties, a literal reading of the DTAA suggests that they create rights and obligations primarily for the contracting parties themselves [Arnold, Mcintyre, 2002, p. 104].

However, the DTAA should be attributed to international treaties, which, upon entry into force, also create rights for private entities. The DTAAs are concluded between states (governments, territories), but the addressees of its provisions are taxpayers. Along with the principle of fulfillment of the contract in good faith by its subjects (contracting parties), it is appropriate to assume that the principle of legal expectations should also be taken into account by the taxpayers themselves [Хаванова, 2015, p. 34]. The DTAAs delegate rights to taxpayers, as well as indirectly form the obligations arising in connection with such rights (e.g.

[3] For example, the Agreement between the Russian Federation and the Federal Republic of Germany on the double tax avoidance with respect to taxes on income and property of 29.05.1996 as amended by the Protocol of 15.10.2007. Collection of Legislative Acts of the Russian Federation, 23.02.1998, No. 8, art. 913; Collection of Legislative Acts of the Russian Federation, 17.08.2009, No. 33, art. 4065.

[4] For example, the Agreement between the Government of Jersey and the Government of the Hong Kong Special Administrative Region of the People's Republic of China on the double tax avoidance and the prevention of tax evasion in respect to taxes on income of 15.02.2012. Website of the Jersey Government: https://www.gov.je/SiteCollectionDocuments/Tax%20and%20your%20money/LD%20HongKongDTA%2020120312.pdf (accessed: 02.11.2019).

[5] For example, the Convention between the Government of the Russian Federation and the Government of the Kingdom of Denmark on the double tax avoidance and the prevention of tax evasion in respect to taxes on income and property of 02.08.1996. Collection of Legislative Acts of the Russian Federation, 05.05.1997, No. 18, art. 2106.

to justify the existence of the right to receive appropriate benefits under the DTAA).

The most general and key taxpayer right under the DTAA is the right to eliminate the double taxation in relation to its income and property. In order to exercise this general right, the DTAA secures certain more detailed taxpayer rights: the right to tax exemption or the deduction of tax paid in the state of tax residency, the right to non-discriminatory taxation, rights under the procedure for the exchange of information between tax authorities, rights under a mutually agreed procedure between tax authorities.

In the context of the implementation of the rights of taxpayers-digital companies under the DTAA, the most interesting is the right to tax exemptions in the state-source of income. This right allows a taxpayer who is a resident of one state to be freed from the obligation to pay tax on income received (arising) in another state (state-source of income). This taxpayer right applies to certain types of income (profit, property) specified in the DTAA.[6] In particular, income from entrepreneurial activity is subject to exemption in the state-source of income, unless the taxpayer has created a significant level of tax presence in the state-source of income, i.e. such an activity is not carried out through a permanent establishment (постоянное представительство in Russian) in that state.[7]

A similar condition applies to the exercise of a taxpayer right to tax exemption or the application of a preferential tax rate on profits in the form of dividends, interests and royalties.[8]

The term 'постоянное представительство' itself appeared as a result of the translation of the English term 'permanent establishment', which does not reflect the essence of the phenomenon under consideration, however, by now it has finally entered the tax terminology and is generally recognized [Коннов, 2012, p. 7].

The definition of 'permanent establishment', as a rule, is contained in art. 5 the DTAA [Lang, 2013, p. 91]. Based on the above definition, in order to exercise the right of a taxpayer to be exempted from taxation of profit from entrepreneurial activity in a state-source of income, such an activity in this state should not be fully or partially carried out, and profit should be obtained through a fixed place of business.

The definition of 'entrepreneurial activity' in the DTAA is absent, but the term can be interpreted from the context of the DTAA [Lang, 2013, p. 91]. The definition of a fixed place of business in the DTAA is also absent, however, there is an opinion that in this case the key is the existence of a significant economic relationship with another state [Vogel, 1996, p. 237] or the presence of a physical location at a taxpayer's permanent disposal [Arnold, Mcintyre, 2002, p. 21].

Thus, in order to exercise the taxpayer right to tax exemption from entrepreneurial activity in the state-source of income on the territory of such a state, and in particular, there should be no registered office, branch, factory, workshop, mine, oil or gas well, quarry or any other mineral extraction sites.[9] as well as a construction site or an assembly facility, the duration of which exceeds the period fixed in the DTAA.[10]

From the content of paragraph 5 of art. 5 of the OECD Model Tax Convention, it also follows that in order to exercise the right to tax exemption, the activities of a taxpayer in another state should not be carried out through a dependent agent who is entrusted with and regularly uses the authority to conclude contracts on behalf of the taxpayer.

At the same time, the taxpayer, through a fixed place or a dependent agent, carries out activities to maintaining stocks of products and goods belonging to the taxpayer's enterprise explicitly for

[6] In future, the provisions of the Model Tax Convention of the Organization for Economic Co-operation and Development (hereinafter referred to as the OECD Model Tax Convention) shall be used as an example, as well as the provisions of individual DTAAs concluded by the Russian Federation.

[7] See paragraph 1 of art. 7 of the OECD Model Tax Convention.

[8] See paragraph 4 of art. 10, paragraph 5 of art. 11 and paragraph 3 of art. 12 of the OECD Model Tax Convention.

[9] See paragraph 2 of article 5 of the OECD Model Tax Convention.

[10] See paragraph 3 of article 5 of the OECD Model Tax Convention.

the purpose of storage, demonstration, delivery, their processing or processing by another company, and the use of a fixed place of business or dependent agent solely for the purpose of procurement for the enterprise of the taxpayer of products or goods or the collection of information for him/her, as well as the implementation of preparatory and auxiliary activities for the enterprise does not lead to the establishment of a permanent establishment and does not affect the execution by the taxpayer of the right to tax exemption.[11] Similarly, the exercise by a taxpayer of activities in another state through a commission agent, broker, or other independent agent does not affect the exercise of this right, provided that such persons act within the framework of their usual activities.[12]

At the same time, the traditional concept of 'permanent establishment' ceases to correspond to the conditions of development of the modern digital economy. Linking only to the 'physical presence' of companies in the state-source of income becomes insufficient to taxation of the profits of digital companies.

Modern digital companies can be registered and have a registered office and physical presence only in offshore or low tax jurisdictions having favourable tax regimes (e.g. Ireland, Luxembourg) and at the same time carry out activities worldwide. In such a situation, digital companies may also not form a permanent establishment in the states-source of their income and are taxable only in the offshore or low tax jurisdiction of which they are a tax resident.

In order to avoid a situation where digital companies are not subject to taxation in the states-source of income, a number of countries are already introducing so-called 'taxes on digital companies'. In particular, the corresponding tax with an applicable rate of 3% has already been retrospectively introduced in France on 1 January 2019 [*France: Digital services*...]. The introduction of a similar tax at the national level is planned in a number of other jurisdictions, in particular in the UK [*UK: Proposal for*...], Italy [*Italy: Digital services*...], Austria [*Austria: Legislation introducing*...], the Czech Republic [*Czech Republic: Digital*...], Turkey [*Turkey: Legislative proposal*...].

At the same time, the introduction of such taxes at the level of individual jurisdictions may not be a completely effective solution, and it may also lead to a situation where one and the same company will be subject to multiple taxation in different jurisdictions due to the difference in approaches and wordings used for taxation of digital companies. This, in turn, can also lead to a violation of the rights of taxpayers-digital companies under the DTAA.

In this regard, since May 2019 the OECD has been working on a unified approach to taxation of international digital companies, the result of which is a draft proposal published on 9 October 2019 on this issue [*Secretariat Proposal for*...]. It is expected that this project, along with comments received from interested parties, will be discussed at the OECD level at the end of 2019.

The key idea of the proposal developed within the OECD is to grant the right to tax the profit of digital companies in those countries where users of the services provided by the digital companies are located, even if the companies themselves do not have a physical presence in these jurisdictions.

Taking into account the administration costs, such an approach is intended to be extended only to large consumer-facing businesses that exceed a certain revenue threshold (e.g. a threshold of EUR 7 million is planned to be set in EU member states) and a threshold based on the number users (in the EU member states it is planned to use a threshold of 100,000 users) [*Secretariat Proposal for*...].

First of all, the new approach is supposed to be applied to companies whose important business element is remote contact with users, work with digital data and marketing. In particular, these may include IT companies, online stores, search engines, social networks, as well as companies providing services for online advertising, access

[11] See paragraph 4 of art. 5 of the OECD Model Tax Convention.

[12] See paragraph 6 of art. 5 of the OECD Model Tax Convention.

to virtual ('cloud') data warehouses and even paid distance learning courses (online learning).

It is assumed that a new approach to taxation in relation to the location of the users of services should not extend to mining companies. Also, the initiative to exclude the extension of the new approach to some other areas is discussed, in particular, the financial industry (at the same time, the application of this approach can be extended to online banks).

In this case, one of the key issues in the application of the new approach to taxation at the place of the users of the services is the procedure for determining the share of profit that will be taxable in each individual jurisdiction. This aspect can play a key role for digital companies operating and providing their services in a significant number of jurisdictions.

Possible criteria for assigning a certain share of the profit of such digital companies to certain jurisdictions could be the number of local users or customers, the number and volume of online sales (e.g. for online stores), the presence and support of the website in the corresponding national language. Also, since all the information on the distribution of the total income in the context of individual jurisdictions is fully owned only by the digital companies themselves, the starting point for the distribution of taxable income could be the distribution of profit in the context of the jurisdictions and the payments provided by the companies themselves (which can subsequently be adjusted on the basis of the above criteria).

The indicated OECD initiative on the taxation of digital companies is also relevant for the taxation of income of digital companies operating in and providing their services on the territory of Russia. In turn, Russian companies providing digital services in other countries can also become subjects to taxation in the respective jurisdictions as part of the OECD initiative.

Currently, Russian lawmakers are already closely monitoring the OECD initiative. So, in the Guidelines for the budget, tax and customs tariff policy for 2020 and for the planning period 2021 and 2022, approved by the Ministry of Finance of the Russian Federation (hereinafter referred to as *The Guidelines*), the need to develop "new approaches to taxation of companies in this sector so that income tax is paid to the budgets of those jurisdictions where profit is generated" has already been noted in connection with the global development of the digital economy sector [Основные направления бюджетной...].

In *The Guidelines*, it was indicated that significant deficiencies in the principles of taxation of digital companies result in the fact that the effective rate of taxation of profits of such companies is significantly lower than for companies in other industries, since digital companies, as a rule, do not have a physical presence or have an insignificant physical presence in the jurisdictions where users and consumers of their services are located. It is emphasized that in order to prevent budget losses, it is necessary to carefully study the provisions of tax legislation that would allow, for tax purposes, for attributing income to those jurisdictions where users and customers of digital companies are located and where income arises as a result of attraction, interaction and contributions of the users, as well as for developing new rules for the distribution of income between jurisdictions for the use of intangible marketing assets. In this regard, *The Guidelines* also note that a number of states have already revised the principles of taxation of digital companies and are introducing new taxation tools. Consequently, the development of new approaches to taxation of income of digital companies will have to be carried out taking into account the international experience of such states [19].

At the same time, in order to solve the issue with taxation of the digital companies within the framework of international tax legislation, amendments to the provisions of the DTAA and, in particular, a modification of the term 'permanent establishment' and a move away from binding exclusively to the physical presence of companies in the relevant jurisdiction will certainly be required. In this regard, it is necessary to introduce the concept of a 'digital' permanent establishment for the purpose of establishing the tax presence of a com-

pany in the relevant jurisdictions with reference to the location of users and customers of such companies.

In particular, it seems possible, along with the traditional definition of permanent establishment in the DTAA, and in some cases instead of it (depending on the position in the text of the DTAA of the contracting parties), to introduce the following definition of 'digital' permanent representation: *A place of business through which a company fully or partially regularly conducts entrepreneurial activities (including digital presence), as well as in which it has a source of users and an income-generating place*.

The preservation of the wording 'place of business' in the definition is due to the fact that, within the framework of the mechanisms used in the modern system of taxation and tax administration, in any case, a territorial binding is necessary (otherwise, a radical revision of the approach to the concept of tax sovereignty of the states and individual jurisdictions would be required).

The need for a more detailed definition and explanation of the wording 'digital presence' as part of the definition of 'digital' permanent establishment in the texts of the DTAA themselves is the subject of additional analysis, as well as coordination of the positions of the states-contracting parties to the DTAA. It seems that the starting point for establishing a 'digital presence' could be criteria such as access to a web page, mobile application (application on another portable device) on the territory of the relevant jurisdiction, or remote access to relevant programmes or devices (e.g. in the case of using virtual ('cloud') data warehouses). In this case, both should be considered: the availability of technical access (e.g. absence of website blocking, application or remote access to the programme in the relevant jurisdiction) and the presence of other factors indicating the intention of the digital company to extend access to its services to the market of the relevant jurisdiction (e.g. availability of access to the site, application, programme in the national language of the state).

In addition, contracting parties under the DTAA can also agree and fix in the text of the DTAA themselves or within the framework of separate protocols or memoranda of approaches to determine the share of profit of digital companies, which will be taxable in each jurisdiction. As mentioned earlier, the criteria for this can be determined by the number of local users (customers) or the number and volume of online sales (the starting point in this case could be data on profit distribution by individual jurisdictions and payments provided by taxpayer companies themselves).

Thus, on the one hand, the modification of the traditional definition of 'permanent establishment' in the DTAA and the exclusion of binding to physical presence should make it possible to extend the tax sovereignty and the right to tax income for jurisdictions in which digital companies render their services, have users (customers) and generate profit. On the other hand, the aforementioned change in the term 'permanent establishment' in the DTAA, agreed upon by the contracting states-parties to the DTAA, will allow taxation of the income of digital companies in accordance with the national legislation without violating the rights of taxpayers under the DTAA.

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