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The Concepts of Legal Status of the Permanent Establishment in the Era of Digital Economy

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The purpose of the article is to identify the key features of the proposals to modify the concept of permanent establishment in digital economy, as well as their differences from the traditional concept of permanent establishment. The subject of the study is a comparative analysis of the concepts of digital presence, aimed at finding new factors for the distribution of tax revenues between the states in which digital enterprises operate. The development of the digital economy necessitates the revision of traditional approaches to the taxation of permanent establishment in the doctrine of tax law and in tax legislation.

The article considers doctrinal approaches to the concept of permanent establishment in the digital economy, as well as the proposals of the OECD and the European Commission. The core of the debate is the question of whether the classical concept of permanent establishment remains a basis for source taxation for multinational digital enterprises. A comparative analysis of international and European practice shows that the concept of permanent establishment is based on the minimum level of presence of a non-resident in the country required for taxation. This is due to the fact that the main feature of the functioning of digital enterprises, important for tax law, is the absence of the need for their physical presence in the state.

Keywords: tax law, permanent establishment, significant economic presence, digital economy, corporate taxation, OECD, European Union, BEPS Action Plan.

Research area: financial law, tax law, budget law.

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Introduction

The objective of the present study is to analyse various proposals on alternative formulations of the permanent establishment (hereinafter — PE) concept in order to find out if they are similar or if there are differences between them. The scope of the research is the comparison of different concepts of digital presence, aimed at finding the new factors that raise issues for the allocation of profit among states in respect of digital business.

The study provides an overview of different digital PE concepts and puts these into the context of international efforts to determine a multinational approach to this issue. It emphasizes how outdated the traditional nexus approach is in digital economy.

Theoretical framework

The core of the current debate around digital economy taxation is the issue of distributing the taxing rights among states in respect of digital business models. The study raises the following problems:

- the difficulty of establishing a nexus within a particular taxing jurisdiction;
- the difficulty of allocating profit once a nexus has been found.

The objective of the present study is to analyse various proposals on alternative PE concept formulations to see how they align with or differ from each other.

Since these issues can lead to broad discussions, it is appropriate to concentrate on rather narrow aspects of direct taxation. Through the comparison of the new concept with the traditional one, the author aims to find out which new factors might be introduced by the new concepts. The scope of the study is to clarify the issues, to check whether the proposals meet their declared targets, and to compare them with each other, but first of all, with the traditional PE concept.

Problem statement

Digital economy development has significantly changed the development of tax policy around the world. One of the most important questions is whether the current corporate tax system is appropriate for digital business models. The problem is relevant at the national, European and global levels. Tax avoidance schemes are getting increasingly complex, posing challenges to tax authorities around the world. On one hand, tax avoidance deprives the state of tax revenues. On the other hand, it gives foreign digital companies advantages over their domestic competitors. In this regard, the competent authorities are getting increasingly concerned about the fact that these problems require new coordinated solutions.

The importance of the digital economy in the context of the BEPS Action Plan (OECD Action Plan..., 2013) to combat tax base erosion and profits withdrawal is emphasized by the fact that the solution to the digital economy tax problems is presented as paragraph one of the BEPS plan. Taxation of digital transnational companies faces the following problems:

- is taxation of the digital economy fundamentally different from that of the traditional economy?
- to what extent the draft acts of the Organisation for economic cooperation and development (hereinafter — OECD), the European Union (hereinafter — EU), as well as measures enshrined in national legislation, will solve the issues arising from the development of the digital economy?
- are there other tax solutions that could sufficiently solve the problems of the digital economy (e. g. country-by-country reporting)?
- does the classical PE concept remain the solution for determining the right to withholding tax in the digital age?

We believe it is necessary to highlight the features of digitalization that play an important role in tax policy: dependence on data, spread of multifaceted business models, as well as the tendency to monopolize this sector of the economy.

It is proposed to focus on the problems of PE taxation and issues of tax avoidance of digital business models.

Methods

The methodological basis of the research consists of both general scientific methods (dialectical-materialistic method, induction, deduction, analysis, synthesis) and interdisciplinary methods (simulation method and sociological method), as well as specific legal methods of study.

The research is based on the principle of truth, unity of theory and practice; the principles of objectivity, comprehensiveness and complexity of the study; the principle of interdisciplinary research (using the achievements of legal and economic science); systematic approach principle.

The specific legal methods are the formal legal method and the comparative method. The formal legal approach allows to identify the information array to be further analysed. The information will be accumulated and delimited based on the criterion of compliance with the subject of legal regulation.

The comparative legal study method makes it possible to prepare the empirical base for the study of the unification and harmonization processes of the cross-border tax relations' legal regulation. It is also interesting for further analysis of Russian legal institutions.

Discussion

Permanent establishment is a complex category of tax law, the purpose of which is “to establish a fair procedure for taxation of the activities of a foreign organization in the territory of the source state. In the system of tax elements, permanent establishment has the closest relationship with the taxpayer, as it is one of the conditions under which a foreign organization becomes obliged to pay tax”.

According to V. A. Gidirim, “at present, the permanent establishment concept is a generally recognized criterion for differentiation of the tax rights of different states and a guiding principle of international tax policy. It is based on the concept of economic belonging” (Gidirim, 2017: 511). O. Iu. Konnov defines permanent establishment as a means to determine the degree of presence of a foreign organization in the territory of the state of business and determine its tax status in this regard (Konnov, 2001: 13).

There are two defining features of the PE in Russian legal science:

PE is a fiction (Kucherov, 2007: 122): it is not a legal entity; moreover, its being more an activity than a structural subdivision of a legal entity creates a special feature for this entity to be taxed by the state (Iarullina, 2016: 65);

PE is a non-resident (Kopina, 2016: 142). In this regard, PE is close to the concept of tax residence of legal entities.

The question of the PE legal nature is closely related to the categories that are basic in international and European practice, but have no analogues in the Russian language and Russian tax legislation. First and foremost, this is the category of nexus (tax reference) and threshold (threshold value, lower limit of taxation). As noted by B. Arnold, PE is the minimum degree of presence of a non-resident in the country, necessary for the collection of tax. Nexus rules and source determining rules are the minimum line or face establishment principles; they create a binding that makes it possible for a non-resident to be taxed in the state (Arnold, 2003: 477).

The *nexus* term describes a situation in which an enterprise is taxable in the territory of a state because of its association with it. Researchers note that the list of tax bindings, providing the necessary connection of the subject with the state, includes: citizenship (nationality); domicile or residence; presence or conduct of business in

the country; finding property in the country or the implementation of transactions or transactions, as a result of which income is received, in the country (Gustafson, Peroni, Pugh, 2006: 15).

The state must decide whether to tax the entire income of the non-resident, or whether the tax obligation is considered to have arisen only after the minimum threshold has been exceeded. Professors B. Arnold, J. Sussville and E. Zolt formulated four types of thresholds that delimit the rights of states to tax the business income of non-residents: 1) the principle of permanent establishment; 2) the degree of physical presence; 3) the volume and nature of activities and 4) income in monetary terms (Arnold, Sasseville, Zolt, 2003). If the minimum threshold for the occurrence of a tax liability is reached, it is necessary to legislatively determine the amount of profit of a non-resident from activities in the country subject to taxation.

The main characteristic of the digital economy is the reduced need for physical presence in the markets (Hongler & Pistone, 2015: 13; Martín Jiménez, 2018: 620–638).

In the digital economy, value is created through user interaction and is concentrated in intangible assets which can be easily transferred to tax havens to minimize taxable profits. Corporate tax systems are still based on the economic reality of the 1920s, when the current tax systems based on taxation on territorial and residence principles were created. As a result, there is a mismatch between the places of profit creation and taxation.

In this regard, the digital PE is an effective legal tool of taxation of digital MNEs. N. Iu. Andreev understands digital PE as a place of business through which the company operates in whole or in part, including the state or territory of the digital presence providing its main source of users, the main source of income (Andreev, 2018: 15). However, the definition does not specify the territory of digital presence. That is why it is necessary to appeal to the concept of nexus.

In 2018, the OECD presented an Interim report on the tax challenges posed by digitalization (OECD, *Tax Challenges...*, 2018). The document acknowledges that the changing world economy calls into question the adequacy of the two basic concepts underlying the current tax system. This is a profit sharing problem and a nexus problem. The final OECD report on Action 1 of the BEPS States that the new nexus requires “changes in key international tax standards” (OECD, *Addressing the Tax Challenges of the Digital Economy, Action 1–2015 Final Report*), although at this stage there is no clarity about changes in the international principles for the allocation of tax rights.

The OECD considered the following tax options for the digital economy:

- taxing nexus in the form of a significant economic presence;

- income tax on certain types of digital transactions;
- equalization levy established on the turnover of non-resident enterprises with a significant economic presence as a means of ensuring equal treatment for domestic and foreign enterprises.

On 13 February 2019, the OECD published a Policy Note to examine proposals involving the two pillars which could form the basis for consensus to reach a new long-term solution in 2020 (OECD/G20 Base Erosion...).

The first pillar focuses on the allocation of taxing rights, and the second pillar discusses the remaining issues associated with BEPS and uncoordinated unilateral actions of States. According to the OECD, this two-pillar approach acknowledges the wide prevalence of the economy digitalization and the range of issues it involves.

The paper contains three proposals for revising the profit allocation and nexus rules in response to the challenges posed by digitalization:

- “user participation” proposal which focuses on the value created by certain highly-digitalized businesses through developing an active and engaged user base, and soliciting data and content contributions from them;
- marketing intangibles alternative;
- significant economic presence alternative (OECD/G20 Base Erosion and Profit..., 2019).

Apart from the OECD initiative, the European Commission is considering digital economy taxation as a part of single digital market initiative and intends to regulate this area at the EU level (European Commission 2018, Proposal for a Council Directive laying down rules relating to the corporate taxation of a significant digital presence, COM/2018/0147 final — 2018/072 (CNS): 9).

Under the Commission’s proposal for a longer-term reform, the digital platform supplying digital services would be deemed to have a taxable “digital presence” in an EU Member State. Profits would be attributed to a virtual PE on the basis of its economically significant functions, namely its activities through a digital interface related to data and users (European Commission, 2018: 9).

The Commission identified such long-term objectives as confirmation of the added value creation assignment, as well as adjustment of the international tax rules of the permanent establishment. Short-term solutions are similar to the OECD proposals: levy on turnover of digital companies, income tax on digital transactions, tax on income derived from the provision of digital services or advertising. The short-term proposals of the Commission are critically evaluated by scholars (Kemmeren, 2018: 72–73;

Martín Jiménez, 2018: 620–638): given the differences in the positions of countries reflected in the OECD interim report on taxation of the digital economy, the EU is trying to impose a solution to the OECD member countries.

According to Article 4 of the Directive proposal, a company that provides digital services will be deemed to have a taxable “digital presence”, i. e. a virtual permanent establishment in an EU member state. The profit will be distributed to the virtual permanent establishment based on economically significant functions, namely its activities through a digital interface associated with data and users. These activities are considered to be economically significant and include collection, processing and sale of user data; collection, processing and display of user content; sale of advertising space on the Internet and third-party content supply to the Internet market (Articles 5(3), 5(5) of the draft Directive).

Taxable “digital presence” in a member state shall be recognized if considered to exist in a member state during the tax period, if the business carried on through such period consists wholly or partly of digital services supply through a digital interface and if one or more of the following conditions is met with respect to the supply of those services by the entity carrying on that business, taken together with the supply of any such services through a digital interface by each of that entity’s associated enterprises in aggregate:

(a) the proportion of total revenues obtained in that tax period and resulting from the supply of those digital services to users located in that member state in that tax period exceeds EUR7,000,000;

(b) the number of users of one or more of those digital services located in that Member State in that tax period exceeds 100,000;

(c) the number of business contracts for the supply of any such digital service concluded in that tax period by users located in that Member State exceeds 3,000.

This approach would expand the PE definition to include digital footprints as a taxable nexus. However, since such activities do not involve any physical assets, this concept is based on such factors as number of active users, revenue, and frequency of contact with customers (which is in line with the Action 1 Final Report) — to measure significant digital presence.

Considering this, it may be concluded that the OECD and the European concepts are both in line with BEPS Action 1 Final Report and one can assume that the European Commission could decide to choose another terminology to prevent the confusion between the Directive proposal and the OECD concept. The Commission has carried

out a large amount of work and has worked out thresholds for digital presence establishment.

According to European researchers, the decision to focus the proposal on users and their data as determinants of value for most highly differentiated business models is a positive step, but this should be followed by a thorough study of the value creation process within these business models and an analysis of the place of economic activity (Kofler, Mayr, Schlager, 2018: 125).

The introduction of the concept of digital permanent establishment, in our opinion, is the preferable way of taxing the companies engaged in the digital economy, given the possible conflict of these rules with fundamental freedoms. The problem with the concept of digital permanent establishment is that its application requires entering into agreements with third countries.

Revenue alone is not a sufficient factor for establishing a tax peg, and therefore, as reflected in the proposal of the European Commission, it should be supplemented by other factors. In addition, the use of income as a factor can provide a high degree of tax certainty for cross-border activities. On the other hand, the proposal will facilitate redistribution of taxes from member states with small user bases (where large digital enterprises are often resident, such as Ireland) to large member states. Some member states (Ireland, Luxembourg, Malta, Netherlands) are sceptical about digital tax reform because it could undermine their status as competitive tax jurisdictions.

The launch of the BEPS Action1 also accelerated the pace of adoption of national measures on the taxation of digital business. The OECD interim report states that unilateral approaches can be grouped as follows: alternative uses of the threshold for recognition of permanent establishment, turnover taxes, withholding taxes and specific regimes targeting large MNEs.

Thus, the growth of the digital economy raises questions about the revision of traditional approaches to the taxation of permanent establishment both in the doctrine of tax law and in tax legislation. The comparative analysis of international and European practice shows that the concept of permanent establishment is based on the minimum level of presence of a non-resident in the country required for tax collection.

Conclusion

Summarizing the proposals to reform the PE concept, which, looking at the active work of the OECD and the European Commission, will be probably implemented in

the acts of these organizations, it can be stated that the general criteria for determining the permanent establishment as significant economic presence in the state include:

- 1) implementation of activities to provide digital services;
- 2) reaching the threshold of the number of users in a given state;
- 3) achievement of a temporary threshold of regularity (duration) of activity in the given state;
- 4) reaching the minimum income threshold.

Further research is necessary to avoid confusion between the real economy and the digital economy. To the extent that there are any changes to the PE definition and any new nexus based on the criteria for “significant economic/digital presence”, there should be a clear threshold in each country under which no PE is created. Without such a minimum threshold, a business model may create a scenario where, under the proposed options, there are numerous small PEs across multiple countries.

The key differences of all the concepts from the traditional PE concept is obviously the lack of physical presence. According to the OECD, the basis of a significant economic presence is that revenue will be generated on a sustained basis from a country, and by this form a significant economic presence if combined with other relevant factors. This is more of a qualitative economic presence test, rather than a quantitative based test. These factors are presented in the BEPS report and consist of revenue factors, digital factors and user factors.

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Концепции правового статуса постоянного представительства в условиях цифровой экономики

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Цель статьи — выявление особенностей предложений по модификации концепции постоянного представительства в условиях цифровой экономики, а также их отличий от традиционной концепции постоянного представительства. Предметом исследования является сравнительный анализ концепций цифрового присутствия, направленный на поиск новых факторов распределения налоговых доходов между государствами, в которых действуют цифровые предприятия. Развитие цифровой экономики обуславливает необходимость пересмотра традиционных подходов к налогообложению постоянного представительства в доктрине налогового права и в налоговом законодательстве.

В статье рассмотрены доктринальные подходы к концепции постоянного представительства в условиях цифровой экономики, а также предложения ОЭСР и Европейской комиссии. В основе дискуссии лежит вопрос о том, остается ли классическая концепция постоянного представительства основанием налогообложения у источника для транснациональных цифровых предприятий. Сравнительный анализ международной и европейской практики показывает, что концепция постоянного представительства основывается на минимальном уровне присутствия нерезидента в стране, необходимом для налогообложения. Это связано с тем, что основной особенностью функционирования цифровых предприятий, важной для налогового права, является отсутствие необходимости их физического присутствия в государстве.

Ключевые слова: налоговое право, постоянное представительство, существенное экономическое присутствие, цифровая экономика, корпоративное налогообложение, ОЭСР, Европейский Союз, план BEPS.

Научная специальность: 12.00.04 — финансовое право, налоговое право, бюджетное право.
