

## TAXATION OF CROSS-BORDER DIGITAL TRANSACTIONS: DEVELOPMENT OF APPROACHES TO INCOME CLASSIFICATION\*\*

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The subject. The developing approaches towards the classification of various types of income received as a result of electronic transactions for the purposes of domestic tax legislation and double tax treaties at the level of international tax governance and at the level of Russian tax legislation and practice.

The aim of this paper is to test the hypothesis that the legal approach and criteria developed in the course of work of global tax governance institutions (OECD and UN) towards income classification from cross-border transactions in electronic form can be used as a basis for legal approach towards this issue in Russia.

The authors use the methods of comparative legal analysis and logical-analytical method. In particular authors perform the detailed review of the related provisions of OECD and UN Model Tax Conventions, commentaries to them and global tax governance expert group's position and contrast it against the Russian legal practice relating to the subject.

The main results, scope of application. Uncertainty in the income classification may arise for almost any type of digital transactions, since income received can fall under at least three different categories. Incorrect legal classification may result in double taxation, non-taxation and distortion of neutrality. There is still ambiguity in the development of international consensus approach towards the issue. There are developing approaches to the characterization of income in the comments to the OECD and UN Model Tax Conventions, however, they can hardly be called fully elaborated due to the specific nature of the digital transactions. The similar situation can be observed in Russian tax legislation where the issue of digital transactions creates a lot of uncertainty. The analysis of domestic court practice indicates the absence of the national approach to the classification of income due to the small number of court cases. On this basis, an attempt was made to form a theoretical and methodological model of classification of digital payments for the purpose of applying the corporate income tax, based on the provisions of domestic law and recommendations of OECD and the UN.

Conclusions. The authors find that despite of the presence of some guidance towards characterization of income from digital transactions at the level of OECD and UN a stable legal framework is strongly needed in the domestic tax law. The approach towards classification proposed in this article can be used as a reference point for further academic and practical discussion.

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1. The problem of income classification for tax purposes in the context of digital business transformation

In the context of the development of the digital economy, there is a transformation of the economic and legal consequences of applying the current tax rules to changing business models. This leads to legal uncertainty, disrupting the neutrality between traditional and digital businesses, and creating opportunities for tax evasion. An example of such a transformation in law enforcement is the classification of various types of income received as a result of transactions in electronic form for the purposes of domestic tax legislation and bilateral tax agreements. Uncertainty in the classification arises, for example, in the provision of cloud services or 3D printing services, the essence of which is not reflected in either the OECD Model Convention (2017) or the UN Model Convention (2017) [1, p.2]. Potentially, remuneration for the provision of such services can be interpreted as three different forms of income at once:

royalties, especially if the definition of "royalties", according to the tax agreement, includes payments "for the use or right to use industrial, commercial or scientific equipment»;

payments for technical services, if the tax agreement contains similar provisions (for example, an article similar to Article 12A of the UN IC (2017);

profit from doing business.

The importance of an unambiguous legal classification is explained by the fact that, in accordance with most tax agreements, profits from business activities are subject to taxation in the source country only if there is a physical presence of a foreign enterprise there. Some other income, such as royalties or fees

for the provision of technical services, may be taxed in the source country, even if there is no physical presence there. Thus, depending on which category the income is assigned to, the tax rights of the contracting States may differ significantly [2, p.408]. Such a feature also affects the position of taxpayers: incorrect legal classification of digital income, which is often "hybrid" in nature [3, p. 4], can lead to double taxation [4, p. 10] and to the risk of additional charges as a result of a tax audit.

2. Classification of e-commerce revenue: developing OECD approaches.

2.1 Royalties or business activities?

Although the comments to the OECD MC (2017) or UN MC (2017) and the texts of the model tax conventions themselves do not contain an unambiguous classification of income from operations in digital form, this issue has nevertheless been consistently discussed over the past 20 years. back In 2001. The Technical Advisory Group (TAG) of the OECD Committee on Tax Affairs found that the taxation of all typical transactions in electronic form may mainly fall within the scope of two articles of agreements: Article 7, which regulates the taxation of business activities, or Article 12, which regulates the taxation of royalties. Royalties are formed when an essential condition of the transaction is the provision of copyright to the content. This is possible, for example, when the publisher of the book plans to use the image as the cover of the book, i.e. it acquires the rights to use the copyright. In turn, income is income from business activities, if:

the essence of the transaction is something other than using or obtaining the right to use copyright;

the client is given a narrow set of rights that are necessary only for the normal

functioning of the product on a computer or other device.

Despite the fact that some experts point out the complexity of the division between revenues from the provision of digital services, that the differences between the two types of income look "illusory" [5, 34], the TAG document provides other examples that reveal the difference between them in more detail. You can select a payment from the site operator to the content provider for providing content in order to attract users. If the copyright of the content remains with the content provider, the payment will be a royalty to the extent that the display of the content is part of the copyright of the content owner. However, if in the future the copyright for such content passes to the site operator, the payment is income from business activities. Also, according to TAG, it is necessary to classify other payments from typical digital transactions, for example, for the purchase and download of a digital product for your own use and consumption, commission to the operator of an online store, and other payments.

## 2.2 Provision of know-how (equipment) or provision of services?

A separate set of questions arises when considering whether income from digital transactions can be considered as royalties if the definition of royalties in a tax agreement includes "payments for the use or right to use industrial, commercial or scientific equipment". TAG provides an example of temporary provision of software or other digital products. according to experts, income from digital operations will not fall under the definition of "royalties" for the following reasons:

Digital products cannot be considered as "equipment" because the term "equipment" can only be applied to a tangible

product (the fact that a digital product is provided on a tangible medium does not change that the object of the transaction is the acquisition of rights to use digital content, and not rights to use a tangible medium); or because the term "equipment" in the context of royalties refers to property that is intended to play a supporting role in an industrial, commercial or scientific process;

Some digital products (such as games, music, or videos) cannot be considered in the context of an "industrial, commercial, or scientific" nature, at least when they are provided to a private consumer.

in addition, when attributing income from digital transactions to an article of tax agreements, the question may arise whether the content of such a transaction falls within the scope of "know-how", given that the payment for "information relating to industrial, commercial or scientific experience" may constitute royalties. the question is relevant when providing technical consulting services to clients, which will not represent the transfer of "know-how", and, therefore, the remuneration received will not be royalties. forming a similar conclusion, tag analyzed various definitions of the concept of "know-how", from which it follows that the key difference between services, among other important criteria, from the transfer of "know-how" is the use of one of the parties of the usual skills, accumulated experience, to perform work for the other party.

The intersection with the problem of "know-how" is also noticeable in the classification of income received as a result of remote access to professional advice. Based on the fact that providing advice on request is a service, TAG was asked to attribute such income to business income. In theory, these revenues can serve as remuneration for the provision of technical services, according to Article 12A of the UN IC (2017), used, for example, in the

Russian-Indian DTT. However, its fundamental principle is the use by the service provider of "specialized knowledge, skills or experience on behalf of the client" or "transfer of knowledge, skills or experience to the client", except for the transfer of information covered by the definition of "royalty". Considering the situation of users' access to a site with content for a periodic fee, TAG notes that such income will form an income from business activities, since the payment is intended to interact with the site for personal use, and not because of the provision of any services of a "technical, managerial or consulting nature".

### 2.3. Cloud services: analysis for classification purposes

Despite the rapid growth in the use of cloud services [6, p. 229], the comments to the OECD MC (2017) or the UN MC (2017) do not directly address the issue of attributing income from the provision of cloud services to the articles of tax agreements. Taking this into account, the experts propose to proceed to the development of a special tax article, the purpose of which would be to regulate cross-border taxation of cloud services [7, p. 35]. Such calls do not look utopian, but the OECD's view is that the results of the work carried out are still relevant. In this regard, you can again refer to the TAG study, to determine the type of services that most fully corresponds to cloud services. In our opinion, these are hosting services. Considering the essence of such operations, TAG notes that their provision leads to income from business activities, and not royalties:

the service provider remains the owner of the equipment on which data is stored, and also has the right to replace it at will;

the provider provides access to the equipment for many customers, not just for one customer;

the customer does not receive any right

of ownership or control over such equipment.

TAG was the possibility of applying to such income the provisions allowing them to taxation as remuneration for technical services, however, if the essence of this service is identical to "simple storage" and its implementation does not require special technical knowledge, such payment cannot constitute consideration for providing technical services. A similar position, in particular, can be found in Indian judicial practice, where it was pointed out that simply making transactions through the eBay platform should not be interpreted as providing technical services, since the platform provides only a standard level of convenience available to all [8].

Contracts for the provision of cloud services usually include a whole list of services. The comments to article 12 of the OECD MC (2017) develop the line set out by TAG that the total amount of remuneration paid under mixed contracts should be broken down based on the information contained in the contract, and the corresponding tax regime should apply to each individual part. however, if one element "certainly represents the main purpose of the contract" and the other "is only of a subsidiary and largely unimportant nature", then the entire amount paid should be considered as relating only to the main element. the question of whether a contract should be split has significant practical implications:

if the taxation of the main element of the contract requires withholding tax at source, then the entire payment will be taxed at source;

if the contract can be split, the withheld tax will only apply to a portion of the income.

This approach, in particular, is used by American tax legislation [9], however, in our opinion, in practice it is difficult to distinguish the main and auxiliary elements and apply the tax regime of the main part to the remaining parts of the contract, for example, in a situation where the software is embedded in the

supplied hardware [10, p.23]. Attributing income to a particular article of tax agreements will require the taxpayer to understand specific operations and should begin with a deep analysis of the terms in the contract [11, p. 469], which should, in particular, consider any references to the distribution of intellectual property rights and rights to use equipment.

3. Development of Russian law enforcement practice on the classification of income from transactions in electronic form.

3.1 The analysis of emerging approaches in judicial practice and tax legislation

In Russian judicial practice, there are several cases in which, due to the lack of an unambiguous approach in the legislation to the classification of income from transactions in electronic form, legal uncertainty arose, leading to tax disputes. The causes of disputes are both the ambiguity of the legal nature of intellectual property objects, and the imperfection of legislative norms in general. Appeal to the civil law allows to detect only a vague definition of "service", according to which under the provision of services refers to "certain acts or carry out certain activities".

A more specific idea of "services" is not given by reading the tax legislation, where the service is recognized as an activity whose results do not have material expression, are realized and consumed in the process of carrying out this activity. A few years ago, the Tax Code of the Russian Federation introduced Article 174.2, which reveals the concept of services in electronic form, according to which "provision of services in electronic form" is recognized as the provision of services through an information and telecommunications network, including through the Internet, automatically using information technologies. However, there were also legislative gaps. In

particular, the question arises whether, based on the provisions of this article, it is possible to consider electronic services provided online, if the Internet is used only as a method of transmitting information or data, and the contractor takes a significant personal part in the process [12]. Moreover, this article is aimed at regulating the taxation of value-added tax exclusively for foreign organizations and does not provide explanations regarding the legal classification of income from digital operations of Russian companies, as well as the applicable regime for their taxation with taxes other than VAT.

The court in the case of "Bloomberg L. P." tried to answer the question of how the activities of the Moscow office, Bloomberg was identical to the activities of the American company Bloomberg in General and, therefore, to prove that it was essential to generate revenues of American companies from Russia and was not "ancillary" or "preparatory", and accordingly exempted from the definition of permanent establishment in accordance with sub. 5 of the treaty between the Russian Federation and the united states (1992). According to the court, the main activity is usually understood as an activity that is significant and important based on the content of the business goals and objectives of the organization, thus, the maintenance of a permanent place of activity in the Russian Federation by specialized information agencies for the purpose of collecting, processing and reselling information to customers should also be considered as a permanent Thus, the court, as a result of the analysis, reduced the activities of the American company Bloomberg in Russia to the activities of a specialized information agency, although there are reasons to believe that the services provided by a foreign company have a broader economic content, being a classic example of SaaS. So, in particular, the services provided by the American company in

the Russian market included:

- providing clients with access to specialized analytical computer programs (developed by the company) on the evaluation of financial products and electronic databases of financial information and news;
- electronic information services;
- electronic trading services in financial instruments;
- electronic database services;
- analytical programs and programs for the evaluation of financial instruments.

This case has a negative outcome for the taxpayer, which increases tax risks and increases the violation of neutrality between traditional and digital businesses in the absence of a well-developed methodology for assigning income from digital activities to one or another category.

3.2 Potential of development of approaches to classification of operations in digital form in Russia in the context of international experience.

The starting point for the development of the methodological approach is the analysis of the definition of certain types of income taxed at source in the Russian Federation. Thus, according to clause 4, Article 309 of the Tax Code of the Russian Federation, income from the use of intellectual property rights in Russia received by a foreign organization that is not related to its business activities in Russia is subject to tax in Russia. In particular, such income includes payments of any kind received as compensation for the use or for granting the right to use any copyright in works of literature, art or science, any patents, information relating to industrial, commercial or scientific experience. This definition generally corresponds to the same definition set out in the tax agreements of the Russian Federation, with some exceptions. The main forms of documenting the transfer of rights to

the results of intellectual activity are the license agreement and the contract of alienation of the exclusive right. During the implementation of the latter, the owner of the object transfers all rights and obligations to the acquirer. Income from the full transfer of rights to an object does not fall under Clause 4, Article 309 of the Tax Code of the Russian Federation, but may theoretically fall under other articles related to the taxation of income from capital gains.

At the same time, there is uncertainty as to what category the income received by a foreign organization falls within the scope of license agreements, which fix the "limits" for the use of the result of intellectual activity or means of individualization by the licensee. The presence of a reference to the limits and forms the complexity of a reliable definition of income. First, in most cases, any transfer of rights may be a transfer of (1) partial or full rights to the underlying copyright (2) partial or full rights to a copy of the program (3) know-how or secret formula. Secondly, in the situation of mixed contracts, it should be remembered that it is necessary to analyze the contract for its "main purpose" or, in its absence, apply the appropriate tax regime to each part of the contract.

Some experts, starting from the division of income of a foreign organization into income of an active and passive nature, suggest paying attention to what exactly is transferred at the conclusion of the contract – ownership rights to the product or rights other than ownership rights [13, p. 143]. Reference to foreign experience shows a similar logic. According to American court practice, if the client receives a copy of the program, but does not acquire any rights (or is granted "de minimis" rights), then such payment cannot be classified as royalty [14, p. 716]. Similar logic is used in Singapore, Indian [15] and Israeli [16] legislation.

The definition of royalties, according to the Tax Code of the Russian Federation, also

includes payments for information related to industrial, commercial or scientific experience. On the one hand, according to the OECD, e-commerce transactions that lead to payments for know-how are relatively rare. On the other hand, in some transactions, it is still necessary to distinguish whether it is the provision of services or the provision of "know-how". In our opinion, the definition of "know-how" set out in civil legislation is conceptually similar to the position laid down in Model Conventions - this is also indicated by the parallel classification of services "mimicking" under "know-how" according to the OECD MC (2017) and the UN (2017) and the Tax Code of the Russian Federation.

This position is not dogmatic. For example, obtaining a closed list of clients, as well as obtaining confidential information that reveals the principles of forming a program, may constitute "know-how". Therefore, a reliable definition of the income category depends on the specific conditions laid down in the contract. A similar logic can be applied in a situation where the contract provides for the provision of a whole list of services (as already noted above, in such a situation, it is suggested to pay attention to the essence of the contract, namely its main purpose). According to paragraph 4, article 421 of the civil code, the parties are entitled to conclude contracts containing elements of various contracts: in this case, the relations of the parties under this agreement are applied in corresponding parts rules about the contracts which elements contain in the mixed contract. It can be assumed that in the case of tax classification of

income, a similar logic is applied. However, the Ministry of Finance of the Russian Federation notes that the application of the VAT benefit is illegal when concluding a license agreement other than a license agreement. It remains unclear whether the taxpayer should analyze the main purpose of the contract, and, therefore, it is relevant to develop a national methodological approach aimed at identifying contracts in the context of income tax.

#### 4. Conclusion

The problem of unambiguous characterization of income is just one of the problems faced by digital companies and tax authorities. On the one hand, TAG has been suggested to change the comments in the OECD MC in order to remove ambiguity about the income characterization. On the other hand, in our view, the OECD's work alone is not sufficient to provide an unbiased characterization of the revenue generated by digital companies. Such issues can be resolved through the gradual building of a stable legal framework [17, p. 140], including on the part of national legislation [18, p. 106], and in the long term, tax harmonization between revenues from the provision of digital services [19, p.733]. In this regard, as a starting point, in conclusion, we attempt to classify digital transactions, according to paragraph 2, Article 174.2 of the Tax Code of the Russian Federation, for profit tax purposes. As with the OECD view [20, p. 10], in our view, most payments for digital transactions should be classified as business income.

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