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# PARADIGM SHIFT FROM PERMANENT ESTABLISHMENT TO VIRTUAL ESTABLISHMENT

ESAKKI AMMAL.K

## ABSTRACT

*Technological advancements made have resulted in a global economy, facilitating easier cross border transaction with targeted markets in various countries. Noted as an important contributor to globalisation, technology has enabled business to operate in various countries in the absence of physical premises or physical activity without an impact on the delivery of goods and services. The maintenance of a digital existence by business, in countries where targeted markets are located, has enabled transacting to occur electronically between business and targeted markets through electronic commerce .This brought challenges to the systems of taxation applied in India. The determination of a place of effective management, used in the classification of businesses as residents in India for income tax purposes, has been affected by business operating in e-commerce as reliance is placed on the physical presence of a business in India. Not only India, globally the chaos has been surfaced. Thus this paper tries to study the shortcomings in the definition of "Permanent Establishment" through various judicial pronunciations and to suggest altercations that shall be made to include virtual transactions within its ambit , in order to resolve the problem of tax avoidance .*



**KEYWORDS:** ***Globalisation- Permanent Establishment- Digital Existence- Cross Border Transaction- Tax Avoidance.***

# INTRODUCTION

Internationally two methods are used in order to tax income. The first being the source method and the second is the residence method. The two tenets, to be specific, "Situs of residence" and "Situs of source of salary" have seen disparity and contrast in the field of international taxation.

The rule "Residence State Taxation" offers supremacy to the nation of the residency of the assessee. This principle proposes taxation of global income and global capital in the nation of residence of the juridical person. The "Source State Taxation" rule gives power to tax to a specific income, to the State/nation where the source of the said pay is found. It is very much settled that the source based taxation is acknowledged and applied in international taxation law. When transactions are conducted across nations, double taxation is inevitable when both these methods are at play and this led to the development of the concept of Double Taxation Avoidance Agreements. This is to ensure that countries would bilaterally agree on various taxing concepts including the singular right or a joint right of taxation of a particular income. Countries would also agree on various aspects such as withholding tax rates, tax credits, sharing of information, etc. India is a party to 94 such bilateral treaties (Double Taxation Avoidance Agreements) with nations of the world and has adopted the Multilateral Instrument (OECD Model) with specific reservations. When such a DTAA does not exist it creates its own complications based on the scope and reach of the domestic law.

The digital economy offers great potential and paves a conducive environment for businesses that do not need any physical presence in a country to conduct business in the said country. The conventional method of a 'physical presence' is no longer relevant. Slightly digressing if one was to go back in time, physical verification of the product and visual satisfaction was paramount for a customer. As a consequence, any global player would set up either a subsidiary or a branch office or a liaison office or engage an agent in a country to ensure that all the product specifications are identified and the customer is in a position to physically examine the product and be satisfied that the said product meets his requirements.

With the advent of technology, the customer is now able to virtually examine the product. Business happens sans physical presence. From a customer's perspective nothing has changed except that the ease of doing the transaction has gone up multi-fold. From a country's perspective which was deriving a tax on income based on the fact that the foreign company had a physical presence, the revenue has dried down since no income could be taxed in the absence of a permanent establishment given the broad contours of existing international tax principles.

There is no change in the customers or the consumption of goods and services but there is a significant dip in the direct tax revenue.

## CONCEPT OF PERMANENT ESTABLISHMENT

One of the primary objectives of a tax treaty is to settle the claims of tax jurisdictions by participating countries where an company is resident in one country and carries out business activities in another. Most often, municipal statutes of countries setout the threshold for taxing business profits of a foreign company carrying out business operation within their taxable territory. For example in India, we have the concept of a 'business connection', which is discussed below with the help of caselaw, and is akin to the concept of a PE. The PE concept marks the dividing line for businesses between merely *trading with a country* and *trading in that country*; if an enterprise has a PE, its presence in a country is sufficiently significant than when it is trading in a country.

As the Indian judiciary puts it; the words **'permanent establishment' postulate the existence of a *substantial element of an enduring or permanent nature of a foreign enterprise in another country, which can be attributed to a fixed place of business in that country. It should be of such a nature that it would amount to a virtual projection of the foreign enterprise of one country into the soil of another country*[1].** The main usage of the PE concept is to establish the right of a country to tax the profits of an enterprise of another country.

In short, PE is a term defined in tax conventions to determine when a non-resident is taxable in a source country. It defines the required level of nexus in a country to endorse taxation of income at source. Under Article 7, a Contracting State cannot tax the profits of an enterprise of the other Contracting State unless it carries on its business through a PE situated therein. In the UK, the threshold is described as the point when a foreign enterprise trades within the UK, as opposed to merely trading with the UK. The PE concept is therefore a major contribution to international tax law and is a significant feature of bilateral tax treaties in force throughout the world. Where a tax treaty is in operation, the crucial question is whether a foreign enterprise is carrying on business through a PE in the country where the profits are earned. If the enterprise does not have a PE then it can be taxed only in the country where it is a resident. However, where the enterprise operates through a PE, the profits attributable to it, may be taxed by the country where the PE is located, leaving the country of residence to give relief from double

[1] *CIT v. Visakhapatnam Port Trust,* 1983 ITR 146 (AP)

taxation. Thus it may be possible for an enterprise with overseas trading operations to avoid foreign taxes by carefully structuring its operations to come below the PE threshold. Where a PE is in existence, the country where it is located may also tax its capital gains, dividends, interest and royalties that are effectively connected to such PE.

The profits of an business of a Contracting State shall be taxable only in that state unless the company carries on business in the other Contracting State through a permanent establishment situated therein. Thus the term `permanent establishment´ simple means a fixed place of business through which the business of the enterprise is wholly or partly carried on. The inability to define PE successfully under the e-commerce economy exposes country to BEPS and other harmful tax practices. Secondly, it makes the country-by-country reporting proposed by the OECD deficient, in that e-commerce MNEs may not report their activities in some jurisdictions due to the absence of a robust definition of PE under e-commerce . In so far as Indian law is concerned, Article 5 of the DTAAs entered into by India with other countries set out as to what constitutes a permanent establishment (PE). All income accruing or arising whether directly or indirectly through or from any business connection in India is deemed to accrue or arise in India.[2] Lets look into the various facet of 'Permanent Establishment" evolved through judicial interpretation, to get deeper understanding on the concept.

## FIXED PERMANENT ESTABLISHMENT

Permanent establishment has its origins in the 'base theory', which entails a quite fixed place of business in the other country. It should be connected to a specific geographical point in the Source country to claim taxable jurisdiction. followig cases would substantiate the concept of 'Fixed Permanent Esatblishment'.

In the case of ***Rolls Royce PLC v. Director of Income Tax (International Taxation)[3],*** RRPLC was a UK company which had offices in India. RRPLC was a non-resident under Indian Income Tax law and supplied parts and equipment to Indian customers. RRIL was another entity which had offices in India and rendered liaison services. The Delhi High Court held that RRIL's presence in India is a PE of RRPLC since it is a fixed place of business at the disposal of RRPLC and its group companies through which their business is carried on. RRIL acts almost as a sales office of RRPLC and its group companies. Further. RRIL and its employees work wholly and exclusively for RRPLC and the group. Employees of RR group are also present in various

[2] Section 9(1)(i) of the income tax act,1961
[3] (2011) 339 ITR 147(Del)

locations in India and they report to the Director of RRIL in India. The Appellant has a permanent establishment within the meaning of Article 5(1), 5(2) and 5(4) of the Indo-UK DTAA. Thus from the above case it is observed that the mere existence of a fixed place of business or the ownership of assets (say, office and equipment) by itself would not be sufficient to constitute a PE. The place of business should actually carry on business activities and the business activity must have a certain connection to the place of business.

The concept of PE stands significantly enlarged due to the decision of the Supreme Court in the case of ***Formula One World Championship ltd v. CIT***[4]. In this case it was held that as per Article 5 of the DTAA, the PE has to be a fixed place of business 'through' which business of an enterprise is wholly or partly carried on. In order to bring any other establishment which is not specifically mentioned, the requirements laid down in sub-article (1) are to be satisfied. Twin conditions which need to be satisfied are

- Existence of a fixed place of business and
- Through that place, business of an enterprise is wholly or panty carried out.

The Supreme Court was of the opinion that the Buddh International Circuit is a fixed place. From this circuit, different races including the Grand Prix is conducted, which is undoubtedly an economic/business activity. The core question was identified as to whether this was put at the disposal of FOWC. Taking into account the entire arrangement between FOWC and its associates on the one hand and jaypee on the other hand, the Court held that not only is the Buddh International Circuit a fixed place where the commercial/economic activity of conducting F-1 Championship was carried out, one could clearly discern that it was a virtual projection of the foreign enterprise, namely, Formula-I (i.e. FOWC) on the soil of this country.

Thus from this case three characteristics identified for a fixed place PE as per the Supreme Court was *stability, productivity and dependence***.** The Court held that the 'physically located premises have to be at the disposal of the enterprise.' The place will be treated 'at the disposal' of the enterprise when the enterprise has the right to use the said place and has control thereupon.

The Indian Authority for Advance Rulings (AAR) in the case of ***Saudi Arabian Oil Company.***[5] observed that the requirements for fixed place PE are as follows

- There should be a fixed place.
- That fixed place should have been placed at the disposal of the foreign enterprise.

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[4] (2017) 394 ITR 416 (SC)
[5] (2018) 405 ITR 83 (AAR)

- The main business of the foreign enterprise should be carried on from that place.
- Support services or outsourcing work would not be sufficient to make it a permanent establishment.

*Henceforth, to constitute a PE, the existence of physical presence is must.*

## ONLINE PLATFORM

eBay AG was a tax resident of Switzerland and operated India specific websites for providing an online platform for facilitating the purchase and sales of goods and services to users based in India. eBay India and eBay Motors India provided support services to eBay AG in connection with the websites. On the question as to whether there existed a permanent establishment in India, the Mumbai ITAT in the cast of ***eBay International AG v. Assistant Director of Income Tax***[6] held that eBay India is involved in creating awareness about the websites of the assessee; collection of payments on behalf of the assessee and its remittance and the website of the assessee was not directly or indirectly controlled by eBay India. The Tribunal in Para 25 of the decision observes that 'though eBay India makes advertisement in India so as to create awareness amongst the sellers to get attracted towards assessee's websites, it has no role in directly introducing any specific customer to the assessee. The agreements between the sellers of the products and the assessee which result into user fee being the source of assessee's income from Indian operations are entered online through the assessee's websites directly, without any interference or involvement of eBay India. The transactions between the buyers and sellers of the products are finalised through the assessee's websites operated from outside India. On the successful completion of sale, it is the assessee who raises invoices on the sellers directing them to deposit their due with eBay India so that forward transmission of the same could be made to it instead of sellers sending the amount to Switzerland. The Tribunal held that there is no dependent agency PE and hence the business profits cannot be taxed.

This decision relates with the broad contours of digital economy but the question was focused on whether the Indian entities could be considered as dependent agency PE or not. In the current context, the question that would now require examination is whether existence of customers in India through websites operated from outside India can by itself constitute a PE or should be considered as a new form of PE or there should be a new mechanism for ensuring that the portion of profits gets taxed in India.

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[6] (2013) 140 IDT 20 (Mum)

## PERMENANT ESTABLISHMENT VERSUS BUSINESS CONNECTION

The Supreme Court in the case of ***CIT v. R.D. Aggarwal***[7] has held that the expression 'business connection' means something more than a business. It presupposes an element of continuity between the business of the non-residents and the activity in the taxable territory. A stray or isolated transaction is normally not to be regarded as a business connection. Business connection may take several forms, it may include carrying on a part of a main business or activity incidental to the non-resident through an agent or it may merely be a relation between the business of the non-resident and the activity in the taxable territory which facilitates or assists the carrying on of that business. A relation to be a business connection must be real and intimate and through or from which income must accrue or arise whether directly or indirectly to the non-resident.

From a simplistic approach if this test is to be applied for a social media platform, can it be said that the foreign company which provides the platform has a business connection in India on account of its customers located in India?

If the location of customers creates a business connection, then the foreign company would he having business connection in many countries. The issue is further compounded by the fact that the social media company does not derive any income from the customer but is in a position to generate income indirectly through the customer. The data provided by the customer is capable of being marketed to companies or advertising agencies. If so, is it really a business connection that is explicit and clear?

***The term 'business connection' is the raw form whereas the term 'permanent establishment' is a refined form.*** Even if the location of the customer is identified to establish a business connection that may not be enough to create a tax liability in the absence of the definition of 'permanent establishment' mirroring the same.

The Supreme Court in the case of ***Carborandum Co. v. CIT***[8] held that in order to rope in the income of a non-resident under the deeming provision it must be shown by the Department that some of the operations were carried out in India in respect of which the income is sought to be assessed.

The distinction between business connection and permanent establishment was brought out by the Supreme Court in the case of ***Ishikawajima Harima Heavy Industries v. Director of***

[7] (1965) 56 ITR 20 (SC)
[8] (1977)108 ITR 335 (SC)

***Income Tax, Mumbai***[9]**.** In the said case it was held that the concepts of profits of business connection and permanent establishment should not be mixed up. Whereas business connection is relevant for the purpose of application of Section 9; the concept of permanent establishment is relevant for assessing the income of a non-resident under DTAA.

The Andhra Pradesh High Court in the case of ***G.V.K. Industries v. ITO***[10] had held that

i. Whether there is a business connection between an Indian and a non-resident company is a mixed question of facts and law.

ii. The expression business connection is too wide to admit any precise definition; however, it has some well-known attributes.

iii. The essence of business connection is the existence of close, real intimate relationship and commonness of interest between the non-resident company and the Indian person.

iv. There must be continuity of activity or operation by the non-resident company with the Indian company and a stray or isolated transaction is not enough to establish a business connection.

The AP high Court had however held on fact that the success fee paid by the Indian Company would be in the nature of managerial, technical or consultancy services and chargeable to tax. This was affirmed by the Supreme Court[11].

The fact that the activities should be continuous, real, and not casual have been laid down in a number of decisions[12].

Permanent Establishments are given a more inclusive interpretation in Indian Tax Laws and are also termed 'Business Connections' for the purpose of establishing a nexus. The same must also be of a continuous nature, in that isolated activities do not by default comprise a business connection. Profits that maybe attributed to this business connection must also be reasonable to the end that they can be so ascribed.

The transactions between associated enterprises and profits that have to be attributed are determined in accordance with International Transfer Pricing principles.

The tax treaties which are bi-laterally agreed upon by Nations define the scope of permanent establishment in order to mitigate double taxation. These treaties are based on the UN and

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[9] (2007) 288 ITR 408(SC)

[10] (1997)228 ITR 564 (AP)

[11] GVK Industries Ltd. v. ITO (2015)371 ITR 453 (SC)

[12] Barendra Prarad Ray v. ITO (1981) 129 ITR 295 (SC); ***Anglo French textile Co. Ltd. v. CIT*** (1953)23 ITR 101 (SC)

OECD Model Tax Conventions. So far. four different types of PEs have been recognised in India namely, Agency PE, Fixed Place / Subsidiary PE, Installation PE and Service PE.

In this context, the *Supreme Court in the case of* ***DIT(International Taxation) v. Morgan Stanley & Co. Inc.,***[13] pointed out the difference between the definition of the word PE in the inclusive sense under the Income Tax Act as against the definition of the word PE in the exhaustive sense under DTAA. The analysis was considered important as it indicated the intention of the Parliament in adopting an inclusive definition of PE so as to cover Service PE, Agency PE, Software PE, Construction PE etc.,

## VIRTUAL ESTABLISHMENT

The term 'virtual projection' was always referred to in the context of determination of PE. This term has taken a new trajectory in the digital world. Virtual Projection was basically a concept whereby if it could be established that a place identified in one country could be perceived as a virtual projection of the foreign enterprise in the said country, then PE could be inferred. This principle was first brought out by the AP High Court in the case of ***CIT v. Visakhapatnam Port Trust***[14], wherein the Court observed that the words "permanent establishment" postulate the existence of a substantial element of an enduring or permanent nature of a foreign enterprise in another country, which can be attributed to a fixed place of business in that country. It should be of such a nature that it would amount to a virtual projection of the foreign enterprise of one country into the soil of another country.

The view expressed by the AP High Court was applied by the Supreme Court in ***Formula One World Championship Ltd v. CT (International Taxation)***[15] and the Supreme Court observed that not only the Buddh International Circuitis a fixed place where the commercial/economic activity of conducting FORMULA I Championship was carried out, one could clearly discern that it was a virtual projection of the foreign enterprise, namely ; Formula-1 (i.e., FOWC) on the soil of this country. A permanent establishment must have three characteristics stability, productivity and dependence. All characteristics am present in this case. A fixed place of business in the form of physical location. i.e.. Buddh International Circuit, was at the disposal of FOWC through which it conducted business. The aesthetics of law and taxation jurisprudence leave no doubt in our minds that the taxable event has taken place in

[13] (2007) 292 ITR 416(SC)
[14] (1983) 144 ITR 146 (AP)
[15] (2017) 291 CTR 24 (Delhi)

India and the non-resident FOWC is liable to pay tax in India on the income it has earned on this soil.

New Questions Past Formula One

(i) How will profit be attributed to the PE that is determined?

(ii) If the foreign entity has a PE in India. whether the Indian company making payments can take a position that reverse charge mechanism for payment of service tax , IGST is not applicable and the PE will have to discharge service tax / GST?

(iii) Whether a PE can tantamount to a fixed establishment (FE) for the purpose of GST?

(iv) Even if PE is identified and attribution of profits is done, there is Still no revenue to the PE since all payments are made only to the foreign entity. If so. how will GST. which is a tax on value. i.e.. price paid or payable, work?

In the case of ***Production Resource Group***[16] the AAR observed that the Applicant neither has an office or a branch or establishment or other fixed places of business in India nor can it, as a matter of right or otherwise, enter and make use of the premises of the organising committee of the Commonwealth Games in relation to rendition of the contracted services, thus, there is no projection at all of the Applicant into the soil of India.

The US Supreme Court in the case of ***Scripto Inc. v. Carson***[17] has held that solicitation of customers for the retailers by instate sales representative counts as physical presence even where the sales representatives are independent contractors. Concept of minimum size in terms of necessary human and technical resources may not be equally viable in modern contest as due to technological advancements , physical presence is no longer an inevitable factor for supply of services. An entity may now have a profound impact upon other jurisdiction solely through its virtual projection.

## CONCLUSION

"Virtual PE" (VPE) theory is that the taxing nexus for electronic commerce should be "the continuous commercially significant conduit of business activity", rather than the fixed place of business. The virtual PE approach applies to the jurisdictional criterion for source-based taxation of profits.

Furthermore, the modern PE definition should be "reinvented" in order to apply to electronic commerce the original idea of taxation on basis of economic commitment and equivalence and

[16] (2018) 401 ITR 256 /301 CTR 62/ 163 DTR 266 (AAR)
[17] 362 US 207 (1960)

establish common thresholds for differentiating commercial mainstream from auxiliary business activity.

Additionally, in order to determine if the taxing nexus is met, it can be done by measuring the development of a qualitative and quantitative facts and circumstances test, taking into account issues like the turnover or number of transactions.

Under COVID-19, the world has, by need, gone into segregation. Social distancing is as of now the best method to slow the spread of the infection until an immunization can be found to secure the populace. Therefore, anything that depends on physical contact which is to state, our routine must be revised to save ourselves from the perils of the infection.

Digitization has paced in to connect the holes left by ordered shutdowns and social distancing measures. Without digital tools and technologies, we would have no way to work, shop, go to class, etc.

This digital economy is not fresh; it's simply been brought into sharp focus. Prior to the pandemic, a paradigm shift towards digitization and servitization of the economy was already in progress. Current events have speeded up the paradigm, as demonstrated by the conspicuous shift in splurging towards digital businesses. With this pace, it is the high time to address the issue of digital taxation. The definition of 'permanent establishment' shall be amended to cover even virtual economy.

When Virtual Projection of the foreign soil is considered a litmus test, in the context of the digital economy, the term itself is a oxymoron. When the entire business operates in the virtual world, a new test will have to be identified for creating a virtual PE.

Digital PE should be carefully structured to bring within the ambit of taxation only businesses, which are exclusively conducted using digital means. While there is a consensus to the effect that ring-fencing should not be done, practically, either by definition of scope or through exclusions and exceptions, some degree of ring-fencing would be inevitable.

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