HAS THE 'PERMANENT ESTABLISHMENT RULE' OUTLIVED ITS UTILITY IN A DIGITALIZED WORLD?

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This article is written at a critical time when countries across the world are meaning to design effective ways to tackle the international tax challenges posed by digital economy. Although the Organisation for Economic Co-operation and Development's final report on base erosion and profit shifting Action 1 discusses some of the key challenges, it does not provide concrete solutions or recommendations for world governments to act upon. We note that the traditional international tax rules governing source-based taxation of business profits of foreign enterprises need to be reconceptualised in view of the recent advancements in information and communication technology. This could be done by supplementing the current "physical nexus" rule stipulated in the permanent establishment article of tax treaties with a new nexus to tax based on "significant economic presence". We recommend two Options that countries can consider while drawing this new nexus.

I. INTRODUCTION

The rise of the digital economy has posed a unique threat to the working of the traditional rules governing allocation of taxing rights between source and resident countries. A foreign company can provide virtual professional services to customers located in a market country, receive consideration and yet pay no income tax on profits so generated. A reliance on physical or representative presence raises questions as to whether the traditional rules on tax allocation continue to be an adequate mechanism to preserve the tax rights of the market country in a digital era, which relies excessively on digital technologies to carry on key business activities. The reduced need for a physical presence in the source country due to digitalisation of business activities present

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several international tax-related policy challenges,[1] particularly, in establishing nexus with a jurisdiction to tax business profits. This is due to the nature of business models that are unique to digital companies.[2]

Currently, Article 5 of double taxation avoidance agreements ('tax treaties') does not permit source countries to tax a foreign company's profits unless they are attributable to business activities carried on in the source country through a permanent establishment ('PE'), that is, through a fixed place of business ('physical presence') or through agents ('representative presence').[3] In other words, Article 5 does not allow source-based taxation of profits earned from the provision of virtual services, leading to a significant loss of revenue to the market country. It is in this context, and for these reasons, that the need for creating a new PE nexus based on a "significant economic presence" to re-allocate taxing rights between the source and residence countries is currently under review.[4]

In July 2013, the Organisation for Economic Co-operation and Development (OECD) adopted a 15-point base erosion and profit shifting (BEPS) Action Plan[5] to close gaps in current international taxation rules that

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1 OECD, BEPS Final Report, 109 (2015) (The two other main policy challenges relate to characterization of payments and the use and generation of data. There are several administrative challenges too in taxing of digital economy).

2 *Id*.

3 *See* OECD Model Tax Conventions & UN Model Tax Conventions, Art. 5.

4 *See* OECD, *Addressing the Tax Challenges of the Digital Economy, Action 1 – 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project, (2015). *See also* Communication from the Commission to the European Parliament and the Council, *A Fair and Efficient Tax System in the European Union for the Digital Single Market* (2017), available at https://ec.europa.eu/taxation_customs/sites/taxation/files/communication_taxation_digital_single_market_en.pdf (Last visited on October 15, 2017). (The OECD released a document requesting stakeholders' comments on key questions relating to the introduction of a new PE nexus based on a "significant economic presence". In particular, the OECD invited comments on how should digital presence be measured and determined, what transactions should be included within its scope, and how could such a measure be efficiently and effectively implemented in practice. In the Indian context, a High Powered Committee on E-commerce was set up in 1999 to examine direct tax related issues in the world of digitalization. In its Report submitted in 2001, the Committee recommended abandoning the PE concept and moving towards a "base erosion" approach to address the tax challenges posed by digital economy. The Committee's report is of little use today given that the report was drafted at a time when cross-border e-commerce was at a nascent stage and the members of the Committee did not have sophisticated data to appreciate the rather mature international tax issues that countries face today).

5 OECD, *Action Plan on Base Erosion and Profit Shifting*, OECD Publishing (2013) (The BEPS project, launched by the OECD in 2013 at the instance of Group of Twenty nations, comprises 15 Action Items: Action 1 (addressing the tax challenges of the digital economy); Action 2 (neutralizing the effects of hybrid mismatch arrangements); Action 3 (strengthening controlled foreign corporation rules); Action 4 (limiting base erosion via interest deductions and other financial payments); Action 5 (countering harmful tax practices); Action 6 (preventing treaty abuse); Action 7 (preventing the artificial avoidance of PE status); Action 8-10 (assuring that transfer pricing outcomes are in line with value creation); Action 11 (establishing methods to collect and analyse BEPS data and the actions to address it); Action 12 (requiring

allow large businesses to artificially (but legally) shift profits to low or no-tax jurisdictions. Action 1 of the BEPS project mandated the OECD to "identify the main difficulties that digital economy poses for the application of existing international tax rules and develop detailed options to address these difficulties."[6] The OECD was particularly mandated to examine, among other issues,[7] the ability of a company to have a "significant economic presence" in the economy of the market country without being liable to taxation due to the lack of a nexus to tax under the current regime.[8] Although the OECD discussed the idea of creating a new PE nexus in its Final Report on BEPS Action 1, there was no political agreement on the issue and, therefore, the OECD did not recommend it at this stage.[9] A new nexus in the form of a "significant economic presence", the OECD concluded, "would require substantial changes to key international tax standards and would require further work".[10] The OECD further concluded that there is no clarity, at this stage, whether changes to basic international tax principles on which allocation of taxing rights is based, are warranted to deal with the changes brought about by advances in the information and communication technology.[11]

In this regard, several countries in the European Union, led by France, Germany, and Italy, are currently in talks to modify the traditional PE concept such that a business with a "significant economic presence" would be deemed to have a PE in the market country.[12] While there is no unanimity for

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taxpayers to disclose aggressive tax planning arrangements); Action 13 (re-examining transfer pricing documentation); Action 14 (making dispute resolution mechanisms more effective) and Action 15 (developing a Multilateral Instrument to implement BEPS proposals)); (The Indian Government has largely welcomed these Action Items, except Action 14 on which the Government has expressed a reservation noting sovereignty issues); *See generally* Ashish Goel, *Modi Government Shifts India's Corporate Tax Landscape Amidst Grim Dispute Resolution Climate*, The Wire, available at https://thewire.in/125299/modi-government-shifts-indias-corporate-tax-landscape/ (Last visited on October 15, 2017).

6 OECD 2015 Final Report, *supra* note 4.

7 OECD 2015 Final Report, *supra* note 4 (It also discusses issues relating to the attribution of value created from the generation of marketable location-relevant data through the use of digital products and services, the characterization of income derived from new business models and the application of related source rules).

8 OECD 2015 Final Report *supra* note 4.

9 OECD 2015 Final Report *supra* note 4

10 OECD 2015 Final Report, *supra* note 4.

11 OECD 2015 Final Report, *supra* note 4.

12 "Suitable alterations for tackling the challenges of the digitalised economy within the current framework of international tax rules would entail modifying the concept of PE and enhancing the rules for attribution of profits to the newly modified PE reflecting the value created by it. Under this approach, even without a physical presence, a business with a significant digital presence would be deemed to have a (virtual) PE in a jurisdiction of operation and, therefore, be liable to its corporate tax regulations, including adapted attribution of profit rules". *See* Estonian Presidency Note released ahead of the meeting of the European Council Financial Affairs, (September 2017); (Importantly, India's 2018 Budget, presented on February 1, 2018, seeks to amend the definition of "business connection" set out in section 9(1)(i) of the IT Act, by introducing a new nexus to tax based on "significant economic presence"). *See* TP News*, Indian 2018 Budget Introduces Virtual PE Concept to Tax Business Profits*, available

now, on what standards and principles will the new PE nexus be based on and applied,[13] the challenges that governments face today are common: digital businesses rely heavily on hard-to-value intangibles, data, and automation, which obviate the need for them to be physically present in the market country to carry on business activities, and in the circumstances that they do, such presence is strategically avoided.[14]

Digital economy by itself, does not generate BEPS issues; however, features that are unique to some digital business models do exacerbate BEPS risks.[15] For instance, foreign companies operating in the digital economy employ models that allow them to exploit gaps in the current regime, particularly the warehouse and the preparatory and auxiliary activity exemptions[16] and the current rules on dependent agency PE,[17] to artificially avoid PE status in the market country. In its final report on BEPS Action 7, the OECD proposed key revisions to Article 5 of the OECD Model Tax Convention, with a view to ensuring that core activities in the digital economy do not, inappropriately, benefit from the exception from PE status, and that artificial arrangements relating to the sales of goods and services are not used to avoid PE status.[18] That said, the purpose of OECD's work on BEPS Action 7 is to prevent or at least minimize specific types of tax avoidance strategies, and not to reconceptualise the PE concept as it has traditionally been used and applied. After all, developing a new PE nexus is a policy concern and not a tax avoidance issue.

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at https://transferpricingnews.com/indian-2018-budget-introduces-virtual-pe-concept-to-tax-business-profits/ (Last visited on February 6, 2018). (We do not wish to discuss the proposal in the present article for two reasons: first, the Budget was presented on February 1, 2018, i.e., much after the current article was finalized; and second, the proposal does not have any immediate practical impact on taxation of business profits of foreign enterprises pending bilateral re-negotiation of tax treaties between India and foreign tax jurisdictions. For a discussion on the proposal); *See* Shilpa Goel, *Indian 2018 Budget: New Nexus to Tax Based on Virtual Presence*, Kluwer International Tax Blog, (February 1, 2018), available at http://kluwertaxblog.com/2018/02/05/indian-2018-budget-new-nexus-tax-based-virtual-presence/ (Last visited on February 6, 2018).

13 "The OECD is already carrying out important research into the digital economy, with the publication of its interim report expected in Spring 2018. This will provide important input into the ongoing consideration of where value is created in digital business. I said last weekend and I say now that it would be best to take action having considered that OECD analysis as a consistent global approach is needed. Any solution must build on a shared understanding of where value is actually created by digital business. Because we can no longer speak of 'the digital economy'. Instead, we can speak of an entire economy that is 'digitised'. Applying different rules within the EU to what is being applied globally is likely to result in double taxation and greater uncertainty". *See* Paschal Donohoe, Ireland's Minister for Finance and Public Expenditure and Reform, Speech delivered at Dublin Economics Workshop, (September 23, 2017).

14 OECD 2015 Final Report, *supra* note 4.

15 OECD 2015 Final Report, *supra* note 4.

16 The OECD Final Report on Action 7 proposes key revisions in this regard, which are discussed in Part II.

17 *Id*.

18 These changes are discussed in Part II.

The PE rule, as embodied in Article 5, has a robust normative foundation in international tax law. Countries have long used[19] the rule as a minimum threshold for source countries to tax business profits of foreign companies, based upon established theories, including the sourcing and benefit theories.[20] Naturally, some countries find the idea of reconceptualising the traditional PE concept to accommodate a new nexus, a deviation from the "long-standing" international tax principles.[21] While it is true that the PE rule has hitherto played a significant, well-meaning role in the allocation of taxing rights between the residence and source countries, noted international tax scholars have in the past pointed out that the rule is not so sacred[22] that it cannot be adequately reconceptualised to adapt to changing times. In fact, the PE concept has been diluted several times in the past to achieve certain desired purposes,[23] from the introduction of a construction clause, to a server or a service PE concept, to the recent modification in the dependent agent PE rule as part of the OECD's work on the BEPS project. The rise of the digital economy is viewed as a threat to the working of the traditional PE rule and questions are raised as to whether a reconceptualization of the current PE threshold to best tackle international tax challenges at hand is warranted, especially when there exists a theoretical basis to do so.[24]

This article stresses that a new PE nexus to tax to tackle changing business models in the era of digital economy may be justifiable and examines how such a new nexus could be drawn. Part II shows that a wholesome reliance on physical or representative presence under Article 5 has ceased to be an adequate mechanism to preserve the taxing rights of the market country in a digital era, in which companies rely excessively on digital technologies to carry on key business activities. Part III highlights that the current PE rule is inadequate to target foreign companies who do not have a physical or representative presence in the market country, but are otherwise integrated into the economic life of the market country due to their virtual presence. A recent ruling delivered by the Income Tax Appellate Tribunal, Bangalore is used to stress upon this proposition. Part IV provides a theoretical basis for the introduction of a new

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[19] The first time the PE concept was used in a bilateral treaty was back in 1899 in a treaty concluded between Austrio-Hungary and Prussia.

[20] *See* D. Pinto, *E-Commerce and Source-Based Income Taxation* (2003) (For a discussion of the theories).

[21] OECD, Banking and Finance Company Working Group, *Public Discussion Draft, BEPS Action 1: Address the Tax Challenges of the Digital Economy*, 5 (April 16, 2014), available at https://www.oecd.org/ctp/comments-action-1-tax-challenges-digital-economy.pdf (Last visited on October 15, 2017).

[22] *See generally* Arvid Skaar, Permanent Establishment: Erosion Of A Tax Treaty Principle (1992).

[23] Arthur Cockfield, *Reforming the Permanent Establishment Principle Through a Quantitative Economic Presence Test*, 38 CAN. BUS. L. J. (2003).

[24] Pinto, *supra* note 20 (This article does not discuss the theoretical foundations of the PE principle as they have already been a subject matter of extensive discussion and various scholars have written extensively on the issue).

PE nexus in tax treaties and suggests two Options that countries can consider in drawing the nexus in Article 5 based on a "significant economic presence". This part also suggests a suitable corresponding amendment to the definition of "business connection" under section 9(1)(i) of the Income Tax (IT) Act to introduce the concept of a "significant economic presence". Part V concludes with an observation that the introduction of a new PE nexus will require broad political agreement and countries must wait for the OECD to publish a detailed proposal setting forth how the new nexus would practically work out. In our view, countries, including India, must refrain from taking unilateral measures and join global efforts in establishing a disciplined and consistent international tax landscape[25].

II. THE TRADITIONAL REQUIREMENT OF PHYSICAL AND REPRESENTATIVE PRESENCE

India's right to tax profits of foreign companies is governed in accordance with the treatment assigned to it in a tax treaty. The PE concept in tax treaties runs parallel to the concept of "business connection" embodied in Explanation 2 of section 9(1)(i) of the Income Tax Act, 1961 ('IT Act')[26], although in some cases, it may be more appropriate for courts to mainly examine the existence of a PE, thereby eliminating the need to examine the "business connection" test under section 9 of the IT Act.[27] According to Article 7 of tax

[25] The scope of this article excludes the examination of whether and how unilateral tax measures contribute in the allocation of taxing rights between the source and residence countries in a digital era. In our view, these measures undermine the importance of bilateral tax treaty negotiations, they lead to denial of tax treaty benefits and double taxation as credit may not be available in the resident country, and finally, they increase taxpayer uncertainty and international tax disputes. In contrast, re-allocation of taxing rights to factor in the rise of the digital economy is arguably a long-term solution, although concerns remain if countries would at all reach an agreement on introducing a new PE nexus to tax in the near future.

[26] According to Explanation 2, "business connection" includes business activities carried out through a person who, acting on behalf of the non-resident, habitually exercises an authority to conclude contracts on behalf of the non-resident in India, or habitually maintains in India a stock of goods or merchandise, or habitually secures orders in India for the non-resident. Importantly, Budget 2018 widens this definition of "business connection" by inserting a new Explanation 2A to §9(1)(i) of the IT Act, according to which a non-resident shall be said to have a "business connection" in India if the non-resident has a "significant economic presence" in India. The details of what would constitute a "significant economic presence" is proposed to be inserted in the definition after a consultation with stakeholders; *See* The Finance Bill, 2018, available at http://www.indiabudget.gov.in/ub2018-19/fb/bill.pdf (Last visited on February 6, 2018).

[27] "…it is always desirable that courts must start with Article 5 of tax treaty to examine if profits of a foreign enterprise can or cannot be taxed in India and not with section 9 of IT Act. I say this for the following three reasons: (i) the definition of permanent establishment in a tax treaty is more illustrative and plain compared to the inclusive definition of business connection under section 9 of IT Act; (ii) if the court concludes in favour of a permanent establishment then there is no need to examine the meaning of business connection under section 9 of IT Act as the existence of permanent establishment will necessarily imply the existence of a business connection; and (iii) if the court concludes that there is no permanent establishment,

treaties that India has signed with foreign tax jurisdictions, business profits of a foreign company cannot be taxed in the source country unless the foreign company carries on business activities in the source country through a PE.[28] Therefore, the Indian tax authority is empowered under treaty law to tax the business profits of a foreign enterprise only if it has a PE in India. Although most of India's tax treaties allow for a low withholding tax (generally ten percent) on "fees for technical services" in the absence of a PE in India, such a tax is not imposed on business profits and is dependent on whether the services rendered fall within the definition of "fees for technical services".[29] Besides, some of India's tax treaties do not contain a provision for withholding tax on "fees for technical services".

The term PE means a fixed place of business[30] through which the business of an enterprise is wholly or partly carried on, and includes a place of

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then section 9 of IT Act anyway becomes redundant as Article 5 of a tax treaty will restrict taxation of business profits in the absence of a permanent establishment. It will of course be a different story where India does not have a tax treaty with a foreign country in which case section 9 of IT Act will play a significant role". See, Shilpa Goel, *Taxation of Profits of Foreign Enterprises in India: three and a Half Myths*, Kluwer International Tax Blog, available at http://kluwertaxblog.com/2017/04/25/taxation-of-profits-of-foreign-enterprises-in-india-three-and-a-half-myths/ (Last visited on October 15, 2017). Importantly, once the new Article on dependent agent PE as proposed under BEPS Action 7 becomes effective, the definition of "business connection" will need to be suitably amended to bring it into line with international best standards (to prevent companies from benefiting from the favourable provision of the IT Act). Importantly, the Finance Bill, 2018 proposes revisions to section 9(1)(i) along these lines.

28 OECD Model Tax Conventions & UN Model Tax Conventions, Art. 7(1): "Profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits that are attributable to the permanent establishment…may be taxed in that other State". "The quantum of taxable income is to be determined in accordance with the provisions of IT Act, including provisions relating to depreciation, investment loses, deductible expenses, carry forward and set off loses (DIT (International Taxation) v. Morgan Stanley & Co. Inc., (2007) 7 SCC 1 : (2007) 292 ITR 416); McCulloch v. State of Maryland, 4 L Ed 579 : 17 US 316 (1819) per Marshall, C.J.: "All subjects over which the sovereign power of a state extends, are, objects of taxation; but those over which it does not extend, are upon the soundest principles, exempt from taxation. This proposition may almost be pronounced self-evident".

29 *See also* The Income Tax Act, 1961, Explanation to §9(2) (For the removal of doubts, it is hereby declared that for the purposes of this section, income of a non-resident shall be deemed to accrue or arise in India under clause (v) or clause (vi) or clause (vii) of sub-section (1) and shall be included in the total income of the non-resident, whether or not…the non-resident has rendered services in India").

30 *See* OECD, Model Tax Convention on Income and on Capital: Condensed Version (2005) (Article 5(1) gives a general definition of the term permanent establishment which brings out its essential characteristics of a permanent establishment in the sense of the Convention, that is, a distinct situs, a fixed place of business. This definition contains the following conditions: the existence of a place of business, that is, a facility such as premises or in certain instances, machinery or equipment: the place of business must be fixed, that is, it must be established at a distinct place with a certain degree of permanence; the carrying on of the business through this fixed place of business, which means usually that persons who, in one way or another, are dependent on the enterprise conduct the business of the enterprise in the State in which the fixed place is situated". Also, Airline Rotables Ltd. v. DIT, (2010) 40 DTR 226: "There are

management, a branch, an office, a factory, a workshop, a place of extraction of natural resources and a farm or plantation. The definition also includes a building site, or construction or assembly project or supervisory activities provided such activities continue for a stipulated period of time.[31] The definition of PE, like the definition of "business connection", includes situations where an agent (other than independent contractors, brokers or general commission agents acting in the ordinary course of business) habitually concludes contracts on behalf of the foreign company in the source country,[32] unless the activities are limited to the purchase of goods or merchandise for the foreign company.[33] A PE is deemed not to exist in certain situations,[34] notably where the fixed place of business is maintained on behalf of the foreign company solely for the purpose of carrying on activities of a "preparatory" or "auxiliary" character.[35]

Additionally, the inclusion of a service PE[36] in some of India's tax treaties covers situations where a foreign company sends its personnel to render services in India, albeit for a specified duration but not necessarily from a fixed place of business. The concept of service PE[37] is distinct from physical PE and is considered as a standalone concept that does not require satisfying the "fixed place of business requirement".[38] A typical service PE clause would include the furnishing of services, including consultancy services, through

three criterions embedded in this definition – physical criterion, that is, existence of physical location, subjective criterion, that is, right to use that place, functionality criterion, that is, carrying out of business through that place. It is only when these three conditions are satisfied, a PE under the basic rule can be said to have come into existence").

31 For instance, the India-UAE tax treaty stipulates a period of nine months.

32 BEPS Action 7 proposes revisions in this regard, which are discussed below.

33 *See* UK-India Protocol to Double Taxation Agreement (2013), Art. 5.

34 Other exceptions include: the use of facilities solely for the purpose of storage, display and delivery of goods or merchandise belonging to the foreign enterprise; the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery; the maintenance of a stock of goods or merchandise belonging to the foreign enterprise solely for the purpose of processing by another enterprise and the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or collecting information for the foreign enterprise.

35 DIT (International Taxation) v. Morgan Stanley & Co. Inc., (2007) 7 SCC 1 : (2007) 292 ITR 416. *See also* OECD Commentary, *supra* note 30, on Art. 5(4) (As a general rule, an activity that has a preparatory character is one that is carried on in contemplation of the carrying on of what constitutes the essential and significant part of the activity of the enterprise as a whole. Since a preparatory activity precedes another activity, it will often be carried on during a relatively short period, the duration of that period being determined by the nature of the core activities of the enterprise. An activity that has an auxiliary character, on the other hand, generally corresponds to an activity that is carried on to support, without being part of, the essential and significant part of the activity of the enterprise as a whole. It is unlikely that an activity that requires a significant proportion of the assets or employees of the enterprise could be considered as having an auxiliary character").

36 *See generally* DIT (International Taxation) v. Morgan Stanley & Co. Inc., (2007) 7 SCC 1 : (2007) 292 ITR 416.

37 *Id*.

38 Electrical Materials Center Co. Ltd. v. DIT, (2017) 167 ITD 248, Income Tax Appellate Tribunal (Bangalore Bench) (International Taxation), (September 28, 2017).

employees or other personnel in the source country, provided such services continue for the same or connected project for a period or periods aggregating more than nine months within any twelve-month period ('day-counting test').[39] In its Commentary, the UN notes the following two reasons why few developing countries oppose the day-counting test.[40] First, some countries argue that, due to advancement in modern technology, construction, assembly and similar activities could be of a short duration and yet give rise to substantial profits in the hands of the foreign enterprise. Second, the period for which the personnel of the foreign company remain in the source country, some countries argue, is irrelevant to a source country's right to tax the income. Finally, few developing countries are of the opinion that a day-counting test could be used by foreign companies to set up artificial structures to avoid taxation in their territory.

A. CHALLENGES POSED BY DIGITAL ECONOMY TO THE TRADITIONAL PE RULE

It emerges from the above that the current PE concept requires a physical or representative presence as the nexus for source countries to tax profits of a foreign company. Whether or not a foreign company has a fixed place of business in the source country is dependent on several factors such as the character of income, the duration of the activities, and the right to use a particular location.[41] The underling idea, however, is that the source country is empowered to tax the business profits of a foreign company that is integrated into the economic life of the source country. In other words, the purpose of the current PE threshold is to define when a foreign company can be said to have a sufficient nexus with the source country to justify source-based taxation. Such a nexus to tax is determined by whether a foreign company conducts income-producing business activities through some degree of physical presence, either in the form of labour or property, in the source country.[42]

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[39] (Under the India-UAE treaty).

[40] 2011 UN Commentary to Art. 5(1).

[41] Formula One World Championship Ltd. v. CIT, (2017) 15 SCC 602 : (2017) 394 ITR 80 ("The principal test, in order to ascertain as to whether an establishment has a fixed place of business or not, is that such physically located premises have to be 'at the disposal' of the enterprise. For this purpose, it is not necessary that the premises are owned or even rented by the enterprise. It will be sufficient if the premises are put at the disposal of the enterprise. However, merely giving access to such a place to the enterprise for the purposes of the project would not suffice. The place would be treated as 'at the disposal' of the enterprise when the enterprise has right to use the said place and has control thereupon"). *See* Ashish Goel, *India's Supreme Court Rules in Formula One that Racing Event Creates PE*, MNE Tax, available at https://mnetax.com/indias-supreme-court-rules-formula-one-racing-event-creates-pe-20750 (Last visited on October 15, 2017).

[42] Report of the Technical Advisory Group on Monitoring the Application of Existing Treaty Norms for Taxing Business Profits*, Are the Current Treaty Rules for Taxing Business Profits Appropriate for E-Commerce*, available at http://www.oecd.org/tax/treaties/35869032.pdf (Last visited on October 15, 2017).

Although a server on which a company's website is stored and through which it is accessible, constitutes, for the purpose of Article 5, a "fixed place of business" of the foreign company that operates that server;[43] a website, which is a combination of software and electronic data, does not have a location that can constitute a "place of business" because there is no "facility such as premises or, in certain instances, machinery or equipment" as far as the software and data constituting that web site is concerned.[44] Noted international tax expert Dale Pinto has written extensively on why a server PE is inadequate to deal with the threats posed by the digital economy. Pinto convincingly argues that the location of the infrastructure such as the server is an unsatisfactory and unstable basis for attributing nexus to tax.[45] According to him, the location of server is inadequately related to the location of essential economic activities comprising production and consumption of information. He further argues that a server could be easily and frequently moved between different servers in different countries, and mirror sites could be set up to direct customers to different servers. Likewise, no PE exists where the e-commerce commerce operations carried on through representatives in the market country are restricted to preparatory or auxiliary activities. Examples of such activities include advertisement of goods or services.[46]

B. GOOGLE IRELAND'S PE DISPUTE WITH THE FRENCH TAX AUTHORITY

Google Ireland's USD 1.3 billion dispute with the French tax authority is a case in point.[47] Google France provided administrative and marketing support to Google Ireland for a fee. Google France did not accept orders for advertisement or did not conclude contracts with French customers on behalf of Google Ireland. Following an audit conducted at Google France's office,

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43 OECD Commentary, *supra* note 30, to Art. 5.

44 OECD Commentary, *supra* note 30, to Art. 5. *See also* Ashish Goel, *India's Position on Permanent Establishment Will Make Foreign Businesses Nervous*, Taxsutra, available at http://www.taxsutra.com/experts/column?sid=869 (Last visited on February 6, 2018).

45 *See* Dale Pinto, *The Need to Reconceptualize the Permanent Establishment Threshold*, 60 BULL. INTL. TAXN 7 (2006). *See also* Arthur Cockfield, *Transforming the Internet into a Taxable Forum: A Case Study in E-commerce Taxation*, (2001), 85 MINN L. REV. 1171 (Noting that the location of a server does not necessarily have any connection to the value creating activities).

46 If, however, the typical functions related to a sale are performed at that location, for instance, the conclusion of the contract with the customer, the processing of the payment and the delivery of the products are performed automatically through the equipment located in the source country cannot be considered to be merely a preparatory or auxiliary activity.

47 Press Release, Paris Administrative Tribunal, July 12, 2017, available at http://paris.tribunal-administratif.fr/Actualites-du-Tribunal/Communiques-de-presse/La-societe-irlandaise-Google-Ireland-Limited-GIL-n-est-pas-imposable-en-France-sur-la-periode-de-2005-a-2010 (Last visited on February 6, 2018); *See* Jonathan Schwarz, *Permanent Establishment: La Lutte Continue*, Kluwer International Tax Blog, available at http://kluwertaxblog.com/2017/07/24/permanent-establishment-la-lutte-continue/ (Last visited on October 15, 2017).

the French tax authority issued re-assessment notices to Google Ireland on the ground that Google Ireland had a PE in France.

The French Administrative Court in Paris ruled,[48] on a strict interpretation of Article 2 of the France-Ireland tax treaty, that Google Ireland did not have a PE in France because Google Ireland did not have any "fixed place of business" in France, nor did it have a dependent agent in France who was habitually concluding contracts on its behalf with its French customers. The Court ruled that the kind of marketing services that Google France provided to Google Ireland fell under the category of preparatory or auxiliary activities, which is outside the purview of Article 2. The Court rather bluntly pointed out that to achieve the tax authority's desired purpose of taxing Google Ireland, the French Government must modify the PE definition to target such an arrangement[49].

C. OECD'S RESPONSE UNDER BEPS ACTION 7

As part of its work on BEPS Action 7, on preventing the artificial avoidance of PE status, the OECD has proposed key revisions to definition of permanent establishment stipulated in Article 5 of the OECD Model Tax Convention to target such kinds of arrangements. In particular, the OECD has revised the preparatory and auxiliary activity exceptions and has removed the requirement for dependent agents to habitually conclude contracts in the market country.[50] The OECD concluded that activities previously considered to be merely preparatory or auxiliary may nowadays correspond to core business activities of an enterprise, particularly in the digital economy.[51] The list of exceptions contained in Article 5(4) have, accordingly, been modified to ensure that each of the exceptions included therein is restricted to activities that are otherwise of a "preparatory or auxiliary" character, and a new anti-fragmentation rule is proposed to ensure that it is not possible to benefit from these exceptions through the fragmentation of business activities among closely-related enterprises.[52] For example, the maintenance of a large local warehouse in which a significant number of employees work for purposes of storing and delivering goods sold online to customers by an online seller of physical products (whose business model relies on the proximity to customers and the need for quick delivery to clients) would constitute a PE for that seller.[53]

Likewise, the PE definition contained in Article 5(5) and 5(6) has been modified to address circumstances in which artificial arrangements

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48 *Id.*
49 *Id.*
50 OECD, *supra* note 1.
51 *Id.*
52 *Id.*
53 *Id.*

relating to the sales of goods or services of one company in a multinational group effectively result in the conclusion of contracts, such that the sales should be treated as if they had been made by that company.[54] For example, where the sales force of a local subsidiary of an online seller of tangible products or an online provider of advertising services habitually plays the principal role in the conclusion of contracts with prospective large clients for those products or services, and these contracts are routinely concluded without material modification by the parent company, this activity would result in a PE for the parent company.[55] However, as noted above, these changes are aimed at preventing PE status avoidance and not at creating a new PE nexus to tax profits in the absence of a physical or representative presence.

As a result, the BEPS changes to the traditional PE rule do not include in the source tax net some kinds of digital companies, who may participate or otherwise get integrated in the economy of the market country with the use of technology and tools, without having any physical presence therein. The removal of preparatory or auxiliary activity as well as the warehouse exemptions, or the tightening of the dependent agent PE rule only addresses a part of the problem, because foreign digital businesses with a virtual presence in the market country will continue to escape source-based taxation. Undoubtedly, the revisions to Article 5 will close numerous loopholes that foreign digital companies so far used, to artificially avoid PE status. However, there are two limitations of the OECD's BEPS Action 7 proposals: first, the changes are targeted at exceptions to physical PE and agency PE and do not address situations where foreign companies do not have a physical or representative presence in the market country; and second, which flows from the first, is that, due to digitalisation, some foreign companies can become integrated with the economic life of the market country and generate profits without actually being physically present therein. In such situations, the question of artificially avoiding PE status does not arise; after all, a foreign company must be physically present in the market country to avoid the PE status.

For instance, in the Google Ireland case as explained above, there would be no agency PE for Google Ireland if Google did not have a presence in France, and as a result, Google Ireland would not have had a representative presence in Ireland in the first place to strategically avoid that presence. In other words, Google Ireland would have paid French income tax if it had a representative presence in France (through a sister concern), but not otherwise. One thing that would remain common in both situations, however, is that Google Ireland would continue to benefit from France's infrastructure and legal system to generate profits. This scenario – similar to the one discussed in Part III – highlights that, in the era of digitalisation, foreign companies that employ digital business models substantially participate in the economic life of the

[54] *Id.*
[55] *Id.*

market country without the need for establishing a physical or representative presence. As a result, these companies do not pay any income tax on profits in the market country. As stated above, the OECD has, as part of its work on BEPS Action 7, widened the current PE definition as it relates to dependent agents to tackle artificial avoidance of PE status by digital businesses. However, the BEPS Action 7 revisions do not attempt to re-conceptualise the traditional principle of source-based allocation of taxing rights set out in Article 5 of tax treaties. As a result, there continues to remain several limitations in the current PE definition in tackling the direct tax challenges posed by the digital economy.

III. LIMITATIONS OF THE TRADITIONAL PE RULE

On June 21, 2017, the Income Tax Appellate Tribunal ('Tribunal') delivered an important ruling on service PE in *ABB FZ LLC* v. *CIT*.[56] The ruling is important because it goes beyond the mandate of the tax treaty and the IT Act, to allow source-based taxation of virtual services rendered by a foreign company from outside India but utilised in India. It is worthwhile to mention here that the ruling deals with several other areas such as taxation of royalty income and determination of tax residence for the purpose of availing tax treaty benefits. Nonetheless, this article will restrict itself to the services aspect of the case.

The taxpayer, a non-resident company incorporated in UAE, was engaged in the business of providing regional services to its Indian related party, ABB Limited. The parties entered into a Service Agreement pursuant to which the taxpayer rendered certain kinds of services to ABB Limited. The Service Agreement envisaged a consideration amount of INR 1.78 billion for the said services. The main issue before the Tribunal was whether a foreign company can be said to have a PE in India in situations where it does not have a fixed tax residence for the purpose of availing tax treaty benefits. Nonetheless, this article will restrict itself to the services aspect of the case.

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[56] ABB FZ LLC v. DCIT, ITA (TP) No.1103/Bang/2013 & 304/Bang/2015.

The Assessing Officer ('AO') examined the nature of services rendered by the taxpayer under the Service Agreement. The AO stated in its order that the taxpayer did not satisfactorily prove that the consideration received as part of the Service Agreement was not taxable in India because the taxpayer did not have a service PE in India. Moreover, the Assessing Officer noted that the taxpayer failed to furnish specific details relating to the transaction except for a letter noting that some of the services provided by the taxpayer were provided online, *i.e.*, through electronic emails, phone calls and video conferences.

The AO treated the consideration received by the taxpayer as fees for technical services ('FTS') covered under section 9(1)(vii) of the IT Act, in the absence of a specific clause on FTS in the India-UAE tax treaty. The taxpayer of course contested noting that in the absence of a specific clause on FTS in the India-UAE tax treaty and in the absence of a PE in India, its business profits cannot be taxed in India. Conceding that the taxpayer's stand on this issue is the correct legal position, this article does not go into the FTS-PE debate as the same is settled by various previous judicial precedents.[57] The position of law today is that in the absence of a FTS clause in a tax treaty, the default Article to tax income of non-residents is Article 7, on business profits, which again rests on the existence or non-existence of a PE in India.

The issue for consideration before the Tribunal was whether the consideration of INR 1.78 billion received by the taxpayer during the disputed financial year is subject to tax in India as FTS under section 9(1)(vii) of the IT Act, in the absence of a FTS article under the provisions of the India-UAE tax treaty. Quite obviously, the Tribunal would have had to examine the provisions of the India-UAE tax treaty to reach the correct position and that is exactly what it did. However, according to us, it arrived at a wrong conclusion.

According to Article 7 of the tax treaty, the profits of an enterprise of the contracting state shall only be taxable in the state of residence unless the enterprise has a PE in the other Contracting State. The profits arising to the enterprise in the other Contracting State will be taxed to the extent it is attributable to the PE. Article 22 of the treaty provides that the income of a resident of a Contracting State shall not be taxable in the other Contracting State if the income is not expressly dealt with any of the Articles in the tax treaty unless the enterprise carries on business in the other Contracting State through a PE.

It follows from a conjoint reading of Article 5, 7 and 22 of the tax treaty that the business profits of a foreign company cannot be taxed in the

[57] *See generally* Income Tax Appellate Tribunal (Mumbai Bench), Booz & Co. (ME) FZ-LLC v. DDIT, (January 19, 2018) (The Tribunal held: "There is no dispute between the parties that the fees received by the assesse from M/z Booz India for provision of technical/professional personnel are in the nature of business receipts. As per Article 7 of the India-UAE DTAA, the business receipts are taxable in India only if the assesse has PE in India.").

source country unless the foreign company carries on business in the source country through a PE. As noted above, PE gecan only exist if a foreign company has a fixed place of business and an agent, who habitually concludes contracts on its behalf in the source country; or as in the case of the India-UAE treaty[58], has its employees in the source country to carry on business on its behalf for a minimum period. The India-UAE tax treaty does not empower the Indian government to tax profits earned by a foreign company from the provision of virtual services for utilization in the Indian market. In the absence of a FTS Article in the India-UAE tax treaty, the income generated through services rendered for utilization in India cannot be taxed.

The Tribunal asked itself the following question: can a foreign company generate profits through carrying on virtual business activities in the market country and yet not pay income tax there? In this case, the employees of the foreign company were sent to India for twenty-five days, but most of the services were provided mainly from outside India over the telephone and internet. The India-UAE tax treaty provides that a foreign company will have a service PE in India if it is involved in the furnishing of services, including consultancy services, through the presence of employees in India. Additionally, such activities must continue for the same and connected project for a period exceeding nine months within any twelve-month period. The Tribunal noted that three conditions must be satisfied before a foreign company can be said to have a service PE in India: first, the furnishing of services including consultancy services on behalf of the foreign company; second, such services must be furnished through the employees or other personnel of the foreign company; and lastly, such services must continue for a period of nine months or more in any twelve-month period.[59]

Upon a perusal of the service PE rule, the Tribunal noted that the taxpayer provided consultancy services in India through its employees. Surprisingly, the Tribunal noted that it is the fact of rendering of services for a period of nine months that is required under the law, and not the stay of employees in India for more than nine months. The Tribunal further noted that the clause on service PE is an independent clause and distinct from the clause on physical PE. The Tribunal's views cannot be disputed. In fact, the South African Constitutional Court in a recent decision, held along similar lines.[60]

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[58] Article 5(2)(i), India-UAE tax treaty.

[59] ABB FZ LLC v. DCIT, ITA (TP) No.1103/Bang/2013 & 304/Bang/2015, ¶ 48.

[60] AB LLC and BD Holdings LLC v. Commissioner of the South African Revenue Services, (2015) South Africa Tax Court ZATC 2 No. 13276 (Per Vally J. while interpreting the South Africa-US tax treaty: "when considering the furnishing of services by an enterprise (Article 5(2)(k)), the analysis or interpretation accorded to the place of work (Articles 5(2)(a)-5(2)(f) is not applicable. It goes on to say that in the case of furnishing of services this does not have to occur within a "fixed place of business". Thus, once the provisions of Article 5(2)(k) are met, there is no need to further examine whether provisions of Article 5(1) have also been met to

However, it is wrong to suggest that since service PE is a standalone provision, there is no requirement under Article 5(2)(i) to have a physical presence of employees in the market country. This is because the text of the Article specifically requires the presence of the foreign company's employees in the source country for a stipulated time for such activities to constitute service PE in India.[61] Moreover, the Indian Tribunal is not alone in its expansive reading of the PE rule. Few years ago, even a court in Spain was faced with a similar set of facts and reached a similar conclusion, while reading the Spain-Ireland tax treaty.[62]

That said, the Tribunal's observations highlight some of the tax challenges faced by source countries that are unable to exercise their jurisdiction to tax business profits of foreign companies who operate in the digital age due to a lack of nexus to tax. The Tribunal reasoned, and we quote:

> *"In the present age of technology where the services information, consultancy, management etc can be provided with various virtual modes like email, internet, video-conference, remote monitoring, remote access to desktop, through various software, the argument that the foreign company renders services through its employees only for 25 days cannot be sustained as the services can be rendered without the physical presence of employees of the foreign company."*

Both these decisions have been widely criticized by experts and rightly so.[63] None in their right minds would endorse such an interpretation of Article 5, which effectively amounts to rewriting of the PE rule. However, it is also true that courts often find themselves in situations where they are tempted to bridge a gap in the law left by the legislature. One such situation

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determine whether the existence of a permanent establishment has been proved".) See Also Income Tax Appellate Tribunal (Mumbai Bench), Linklaters LLP v. ITO, (2011) 9 ITR 217.

61 Electrical Materials Center Co. Ltd. v. DIT, (2017) 167 ITD 248 Income Tax Appellate Tribunal (Bangalore Bench) (International Taxation), (September 28, 2017) ("…in the present case, the stay in India of the assesse was only 90 days and since it is less then 182 days as required under Art. 5(3)(b) of the India-Saudi Arabia tax treaty, there is no [service] PE".).

62 *See generally* Gary Sprague, *Spanish Court Imposes Tax Nexus by Finding a Virtual PE*, Bloomberg BNA, available at https://www.bna.com/spanish-court-imposes-n17179871765 (Last visited on October 15, 2017) (In that case, Dell Ireland was selling goods in Spain through a website targeted at the Spanish market and its Spanish affiliate was administering that website. The Court invoked the virtual PE theory to hold that Dell Ireland had a PE in France (even though it did not have a physical presence in Spain and the server on which the website was hosted was located outside Spain).

63 *See* Shilpa Goel, *Addressing Tax Challenges of the Digital Economy: Fair Play or Foul Play*, Kluwer International Tax Blog, available at http://kluwertaxblog.com/2017/08/18/addressing-tax-challenges-digital-economy-fair-play-foul-play/ (Last visited on October 15, 2017). See Gary Sprague, *Spanish Court Imposes Tax Nexus by Finding a Virtual PE*, Bloomberg BNA, available at https://www.bna.com/spanish-court-imposes-n17179871765 (Last visited on October 15, 2017) (criticism of the Spanish court's ruling).

is the non-taxation of profits earned by foreign companies in source countries through a virtual presence. The best way, of course, is to leave these policy choices with the Parliament as was done by the Indian Supreme Court many years ago in the context of treaty shopping.[64]

IV. LOWERING THE PE THRESHOLD: THE NEED FOR AN ALTERNATIVE NEXUS TO TAX

Inter-jurisdictional e-commerce has created challenges that were unknown to governments at the time when international tax rules were being developed a century ago. As a result, and as discussed in Parts II and III, some digital companies escape source-based taxation in countries where economic activities take place and where value is created. In such a situation, the proposal to introduce a new PE nexus based on "significant economic presence" to tax digital companies cannot be completely unjustified.

Several countries in the European Union, including France, Germany, and Italy, are seeking to reconceptualise the concept of PE to prevent large digital businesses from artificially avoiding PE status and shifting profits to low-tax jurisdictions.[65] Austria has in fact declared its intention to negotiate its bilateral treaty with Ireland to target sales of online services by digital businesses that do not have a physical presence in Austria.[66] Critics have rejected the idea of a new PE nexus noting several practical challenges such as the difficulty in attributing profits and the difficulty in enforcing or collecting taxes.[67]

Significant and relevant literature exists that highlight and address these practical difficulties and we do not find any pressing need to go into

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[64] Union of India v. Azadi Bachao Andolan, (2004) 10 SCC 1 ("There are many principles in fiscal economic which, though at first blush might appear to be evil, are tolerated in developing economy, in the interest of long term development. Deficit financing, for example, is one; treaty shopping, in our view, is another. Despite the sound and fury of the respondents over the so-called 'abuse' of 'treaty shopping', perhaps, it may have been intended at the time when Indo-Mauritius tax treaty was entered into. Whether it should continue, and, if so, for how long, is a matter which is best left to the discretion of the executive as it is dependent upon several economic and political considerations. This Court cannot judge the legality of treaty shopping merely because one section of though considers it improper. A holistic view has to be taken to adjudge what is perhaps regarded in contemporary thinking as a necessary evil in a developing economy".).

[65] See Press Release, European Union, *Political Statement on Joint Initiative on the Taxation of Companies Operating in the Digital Economy* (September 2017).

[66] Ministry of Finance, Government of Austria, *Schelling: Commit Myself to fair Taxation of the Digital Economy at all Levels*, (September 2017), https://www.bmf.gv.at/presse/schelling-gerechte-besteuerung-digitale-wirtschaft.html (Last visited on February 6, 2018).

[67] *See generally* OECD, *Comments Received on the Request for Input – Part I*, October 25, 2017, available at https://www.oecd.org/tax/beps/tax-challenges-digitalisation-part-1-comments-on-request-for-input-2017.pdf (Last visited on February 6, 2018).

that debate.[68] Our main aim here is to highlight that the idea of a new PE nexus has a theoretical basis and to examine how such a nexus can be practically drawn. Noted international tax scholars have written extensively in support of a new nexus. As Dale Pinto writes:[69]

> *"...the fundamental tax policy principles that underlie source-based taxation...include the benefit theory, neutrality considerations, principles of equity, the concept of entitlement and pragmatic considerations, such as the prospect of double taxation and the likely impediments to international trade. After analysing the basis for each of these principles and how they justify source-based taxation in a traditional context, it was argued that they remain applicable in an electronic commerce environment, thereby establishing the first argument of this article that source-based taxation of electronic commerce transactions is theoretically justifiable."*

Along similar lines, Klaus Vogel, noted that providing a market contributes to the overall income of a company at least to some extent and, therefore, a claim of the market country to tax part of that income is not unjustified.[70] Likewise, Professor Doernberg observed that the traditional PE concept must be adjusted to factor in changes in the nature of business and in the way digital business is carried on.[71] Skaar too suggested that source countries have every right to include PE fictions in their tax treaties for industries where high mobility, impermanence and the lack of physical location are predominant.[72] In fact, in a recent paper, Hongler and Pistone set out a valid theoretical background in international taxation for developing a new PE nexus for the digital economy.[73]

In its final report on BEPS Action 1, the OECD noted that the digital economy is becoming a part of the economy and it is difficult, if not impossible, to ring fence digital economy; and that a new nexus would mean deviation from long-standing principles of international tax law governing allocation of taxing rights between source and residence countries. It is difficult to agree with this view. The traditional PE rule is based upon the neutrality, equity, and benefit theories, and these theories in no way create an impediment for revisions to the PE principle as they would apply to the concept of a virtual

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68 *See generally* OECD, *Comments Received on the Request for Input – Part I*, available at https://www.oecd.org/tax/beps/tax-challenges-digitalisation-part-1-comments-on-request-for-input-2017.pdf (Last visited on February 6, 2018).

69 Pinto, *supra* note 45.

70 Klaus Vogel, *Worldwide vs. Source Taxation of Income – A Review and Re-evaluation of Arguments*, 1998, 11 INTERTAX, 393 at 400.

71 Richard Doernberg et al., Electronic Commerce and Multijurisdictional Taxation, 79 (2001).

72 Skaar, *supra* note 22.

73 Hongler & Pistone, *infra* note 74.

PE in the same vein as they do to traditional PE. For instance, the market country's jurisdiction to tax profits from provision of services in that country can be justified because it provides an opportunity for foreign companies to exploit their benefits. Moreover, the market country allows foreign companies to use its infrastructure, including its stable legal and economic system, and most importantly, offers protection of intellectual property rights. Hence, the introduction of a new nexus does not violate the neutrality principle either, given that there will be a level-playing field for both kinds of businesses (traditional and digital).[74]

The question that arises is how such a nexus can be drawn. The phrase "significant economic presence" is a broad one and difficult to define. The OECD's Final Report on BEPS Action 1 briefly discusses various factors that countries may examine to determine if a foreign company has a "significant economic presence" in the market country. These are: gross revenue derived from remote transactions with customers based in market country; online presence based on several digital factors such as obtaining a local web address or a local domain name; use of local payment options with prices reflected in local currency after calculation of local taxes, levies and duties; the number of active monthly users on the digital platform; and the routine conclusion of contracts. The revenue factor is proposed to be combined with all the other factors to determine "significant economic presence".

The above factors are not full-proof and concerns are raised as to whether they can accurately determine the economic presence of a foreign company as some of these can be manipulated. For instance, the OECD's Final Report on BEPS Action 1 notes that the number of active users does not present the right picture of economic presence as most of these users may be robots or fake.[75] The idea, however, is to use a combination of these objective factors to see whether or not the foreign company has a "purposeful and sustained interaction with the economy of the country concerned."[76]

Of course, not all of the above factors can or should be incorporated in the text of Article 5. The overall importance of factors such as the requirement of active users, use of local payment options or the use of a local

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[74] *See* Peter Hongler and Pasquale Pistone, *Blueprints for a New PE Nexus to Tax Business Income in the Era of the Digital Economy*, IBFD, available at https://www.ibfd.org/sites/ibfd.org/files/content/pdf/Redefining_the_PE_concept-whitepaper.pdf (Last visited on October 15, 2017) ("Furthermore, if the mere introduction of a new nexus were to be regarded as an infringement of the neutrality principle, the current PE definition would also be an infringement of the neutrality principle, as it only affects enterprises operating abroad through a fixed place of business".).

[75] OECD, *Addressing the Tax Challenges of the Digital Economy Action -1- 2015 Final Report*, available at http://www.oecd.org/ctp/addressing-the-tax-challenges-of-the-digital-economy-action-1-2015-final-report-9789264241046-en.htm (Last visited on October 15, 2017).

[76] *Id*.

domain name can be further explained by the OECD in its Commentary to Article 5. Drawing a new nexus is not an easy task, as it needs to balance the rights of source countries with that of the resident countries, while upholding basic international tax principles.[77] In our view, Article 5 must specifically include the following two factors that will be condition precedent to establishing a "significant economic presence": a *de minimis* revenue threshold and the requirement for digital businesses to habitually conclude contracts with residents of the market country. A minimum revenue threshold will ensure that small companies and one-off, low-value transactions are taken out of the PE threshold; while the habitual conclusion of contracts will imply a certain degree of business connection with the market country. At the same time, the removal of the "active users" test from the text of Article 5 would ensure that the new PE nexus remains certain and simple in its application, given that there is no unanimity at present on how best to tackle potential manipulation of the number of users that a digital business might have in the market country.

There are two Options that countries can use to incorporate these factors while drawing a new PE nexus in Article 5. The first option (Option A) is to insert a new Clause after Article 5(8) as follows:

> *"Notwithstanding anything contained in the foregoing provisions, an enterprise of a Contracting State shall be deemed to have a permanent establishment in the other Contracting State if the enterprise carries on business activities in the other Contracting State through digital or electronic means, if the total revenue of the enterprise from such business activities exceeds [******] in a financial year, or if the enterprise habitually enters into contracts with residents of the other Contracting State."*

The second option (Option B) is to insert a new Sub-clause in Article 5(2) to provide that a PE shall also include a "digital establishment". This needs to be supplemented with a new Clause 2A in Article 5 to explain situations in which a "digital establishment" shall constitute a PE for the purposes of Article 5. The proposed changes in Article 5 would be as follows:

V. OECD MODEL TAX CONVENTION[78]

"Article 5. Permanent Establishment

[77] OECD, *Taxation and Electronic Commerce: Implementing the Ottawa taxation Framework Conditions,* available at https://www.oecd.org/tax/consumption/Taxation%20and%20eCommerce%202001.pdf (Last visited on October 15, 2017) (Mainly the Ottawa principles of neutrality, efficiency, certainty, and simplicity).

[78] Art. 5, post BEPS revisions.

1. For the purposes of this Convention, the term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on.

2. The term "permanent establishment" includes especially:

   a) A place of management;

   b) A branch;

   c) An office;

   d) A factory;

   e) A workshop;

   f) A mine, an oil or gas well, a quarry or any other place of extraction of natural resources; and

   g) A digital establishment.

2A. Notwithstanding anything contained in Article 5(1) above, an enterprise of a Contracting State shall be deemed to have a digital establishment in the other Contracting State for the purpose of Clause 2(g), if the enterprise carries on business activities in the other Contracting State through digital or electronic means, and the total revenue of the enterprise from such business activities exceeds [******] in a financial year, or if the enterprise habitually enters into contracts with residents of the other Contracting State..."

Both Option A and Option B will ensure that digital businesses with a "significant economic presence" (ascertained through a revenue threshold and the habitual conclusion of contracts) in the market country will have a PE in the market country and will be taxed on income attributable to the PE. In our view, the two Options have regard to the principle of neutrality in that they subject both physical and digital businesses to source-based taxation if they have a significant economic presence in the market country – be it in the physical or digital form. How much profits are attributable to that presence (digital or physical) is a different issue. The current OECD Model does not provide for a service PE article, and countries may deliberate on whether or not to insert a new UN-styled service PE article to address situations in which a foreign company's personnel are physically present in the market country, except that there will be a lower stay requirement.[79] Finally, revisions to Article 5

[79] To cover situations where the nature of business activities does not require stay for longer than few weeks.

based on the above options must be followed by detailed guidance in the OECD Commentary (using illustrations) to increase certainty and avoid disputes.

Some would argue that the traditional PE concept must be completely abandoned to give way to a new PE nexus based on "significant economic presence". However, this seems to be a radical proposal and, while it may hold good in distant future, it certainly cannot be implemented today because a new PE nexus based on "significant economic presence" as proposed by the OECD, and as discussed herein, cannot be uniformly applied to traditional brick and mortar companies. In any event, the current concept of PE does not in any manner conflict with the new PE nexus and there is no reason why the same must be completely abandoned when it can harmoniously co-exist with the new PE nexus. We would like to conclude with a caution that the Options discussed here are only a trigger point for future deliberation and countries are free to apply the most appropriate model that suits the current needs and that best complies with current international tax rules. Of course, in the process, new options may be proposed and deliberated upon.

Finally, the definition of "business connection" under Explanation 2 of section 9(1)(i) of the IT Act must be suitably amended to incorporate the concept of a "significant economic presence" as outlined above.[80] Additionally, the revised definition must also take into account changes made to the dependent agent PE Article as part of the OECD's work on BEPS Action 7 so as to provide that a foreign company shall have a dependent agent PE in India if it carries on its business through an Indian agent, who habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts (including for the provision of services) that are routinely concluded without material modification by the foreign company.

VI. CONCLUSION

The right to tax business profits of a foreign company with a physical or representative presence is seen as an incentive for the source country to co-operate with the resident country and participate in mutual trade and investment, while safeguarding foreign investors and their investments. The PE principle has played a significant role so far in the allocation of taxing rights over profits; however, the rise of digital economy requires countries to revisit the basic principles governing allocation of taxing rights. One way to do this is to introduce a new PE nexus to tax in Article 5 based on a "significant economic presence". In this article, we have stressed upon the need to introduce a new PE

[80] The Income Tax Act, 1961, § 9(1)(i), Explanation 2 (It is important to note that the Finance Bill, 2018 amends the definition of "business connection" along these lines. However, the Bill does not contain details on how the new definition shall apply practically, i.e. it does not state what will be the revenue threshold or the minimum number of users to give to a "significant economic presence" in India.).

nexus and have examined how such a new nexus may be drawn. We have suggested two Options for countries to deliberate upon. Both Options will ensure that digital businesses with a "significant economic presence" in the market country will have a PE in the market country and will be taxed on income attributable to the PE. Both Options have regard to the principle of neutrality in that they subject both physical and digital businesses to source-based taxation if they have a "significant economic presence" in the market country – be it in the physical or digital form.

Ever since the OECD published its Final Report on BEPS Action 1, several countries,[81] including India, have taken a range of unilateral measures in their domestic tax laws to invoke a tax jurisdiction in relation to foreign digital businesses where none existed. In India, for instance, the Government introduced a new six percent "equalization levy" on advertisement payments made to foreign digital businesses. The Indian "equalization levy" has been widely criticised,[82] and rightly so, on grounds, among others, that it seeks to bypass important international tax principles. It is important to note that the OECD is due to publish its Final Report on digital economy taxation by the end of 2020 (and an interim Report in 2018) and countries must refrain from taking unilateral measures in their domestic tax laws to avoid potential breach of their treaty obligations and wait for a broad political agreement on this issue. Until then, countries must continue to conform to and apply the traditional PE rule governing source-based taxation of business profits of foreign enterprises.

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[81] OECD, *Addressing the Tax Challenges of the Digital Economy Action -1- 2015 Final Report*, available at http://www.oecd.org/ctp/addressing-the-tax-challenges-of-the-digital-economy-action-1-2015-final-report-9789264241046-en.htm (Last visited on October 15, 2017). (Some of these countries are: Australia, China, France, Israel, Italy, Saudi Arabia, and United Kingdom.).

[82] *See generally* Guillermo Teijeiro, *A Call for a Sustainable Response to the Taxation of Digital Economy within the International Income Tax System*, available at http://kluwertaxblog.com/2017/10/05/call-sustainable-response-taxation-digital-economy-within-international-income-tax-system/ (Last visited on October 15, 2017).