

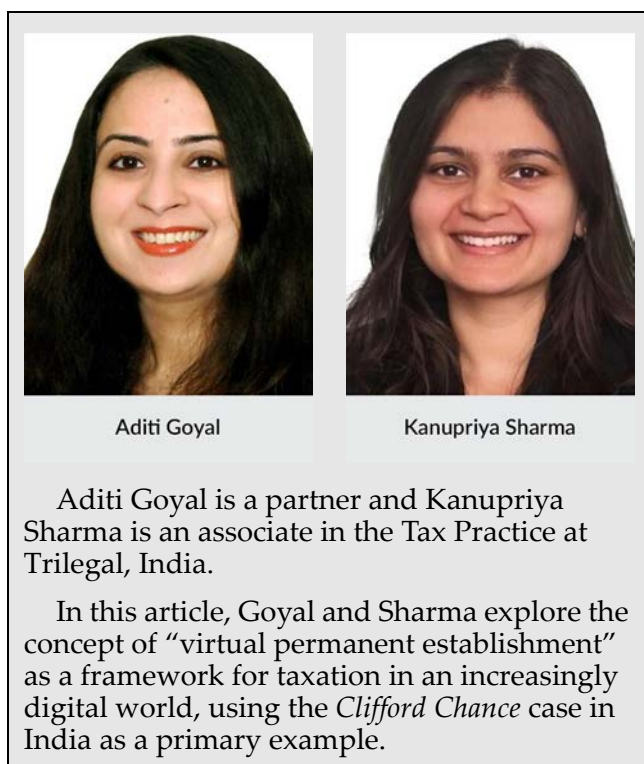
Virtual Permanent Establishment – A New Nexus to Tax?

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Background

With the digitalization of businesses and the increased use of technology, entities across the globe have adopted digital tools to provide services in jurisdictions despite not having a physical presence there. Countries are increasingly focusing on taxation of services provided by businesses having only a virtual presence. In the recent *Clifford Chance* ruling,¹ Indian income tax authorities sought to tax the gross receipts of a law firm based in Singapore from clients in India on the basis that the firm had created a permanent establishment in the form of a “virtual service PE” in India. According to tax authorities, a virtual service PE exists when a

¹ *Clifford Chance Pte. Ltd. v. ACIT*, ITA Nos. 2681 and 3377/Del/2023.

nonresident entity provides services in another contracting state, without its personnel being physically present in the jurisdiction.

The issue has been discussed at the international level as well. Recognizing that the growth of a country’s customer base does not necessarily require the level of local infrastructure and personnel that would have been needed in the pre-digital age, the OECD in its October 2015 report² discussed the possible introduction of a new nexus or form of taxable presence in a country in which a nonresident entity has a significant economic presence through technology. The term “virtual service PE” was recognized by the OECD in its March 2018 report,³ noting that the concept has been officially endorsed in some jurisdictions, as well as recognized in rulings in India and other jurisdictions. The report noted that the effect of this measure could extend far beyond online activities and include any remote services supplied to a market (for example, consultancy services, call center services, etc.). Further, the IMF in its policy paper on corporate taxation⁴ also noted the concept of a virtual PE.

Analysis

Model Tax Conventions

The OECD model convention⁵ does not contain provisions dealing with service PEs. However, the OECD has noted that some countries agree that a jurisdiction in which

² OECD, “Addressing the Tax Challenges of the Digital Economy, Action 1 – 2015 Final Report” (2015).

³ OECD, “Tax Challenges Arising From Digitalisation – Interim Report 2018: Inclusive Framework on BEPS” (2018).

⁴ IMF, “IMF Policy Paper: Corporate Taxation in the Global Economy,” Policy Paper No. 2019/007 (Mar. 2019).

⁵ OECD Model Tax Convention (Condensed Version) (2017).

services are performed should have a right to tax, even if the services are not attributable to a local PE as discussed in article 5 of the model convention. The commentary noted that these countries are free to include a provision in their tax treaties on taxing services provided by nonresident entities. However, the taxation should not extend to services performed outside the country's territory. Also, there should be a minimum level of presence in the country before taxation is allowed. Importantly, the provision should only apply to services that are performed in a country by a foreign entity. Whether the relevant services are furnished to a resident of the country would not matter; what would matter is the performance of services in the country through an individual present there.

The commentary also made note of the fact that India does not agree that a service PE will be created only if services are performed within the country. India is of the view that the furnishing of services is sufficient for the creation of a service PE.

On the other hand, the U.N. model tax convention⁶ contains specific provisions pertaining to a service PE. It includes services that are provided within another contracting state by an enterprise through its employees/other personnel, subject to the services being provided for more than 183 days in any 12-month period. The commentary notes that some developing countries oppose the 183-day time limit because they believe that some activities could, because of modern technology, be of very short duration and still result in substantial profits for the entity. These countries believe that the period during which foreign personnel remain in the country is irrelevant to the right to tax the income. Treaties that have incorporated the provision for service PEs have followed the principles contained in the U.N. model convention (such as most of India's tax treaties). However, the duration stipulated for this provision varies. Further, to date these treaties have largely focused on the physical performance of services within the contracting state.

⁶U.N. Model Double Tax Convention Between Developed and Developing Countries (2017).

Indian Domestic Law and Courts on Virtual Service PEs

“Significant economic presence” (SEP) was introduced into Indian domestic law through the Finance Act, 2020, allowing taxation of businesses that operate digitally in India but do not have a physical presence there. Income of entities having a business connection in India through an SEP is taxable under domestic law. The term “business connection” is nebulous and wider in scope than the concept of PE as defined in the tax treaties. The SEP of a nonresident is deemed to constitute a business connection in India and has been defined as:

- a transaction of goods, services, or property carried out by a nonresident with a person in India (including the downloading of data or software in India), if the aggregate of payments arising from those transactions during the year exceeds INR 20 million (about \$240,000); and
- systematic and continuous soliciting of business activities or interactions with 300,000 or more users in India.

Given the low thresholds prescribed for these provisions, most nonresident entities providing services digitally in India are likely to constitute an SEP. However, if these entities are based in jurisdictions with which India has entered into tax treaties, they should be able to use treaty provisions, to the extent they are more beneficial.

Most of India's tax treaties incorporate a service PE. However, the treaties require that for a service PE to be created, services must be performed in India. That is, employees/personnel of the foreign entity must be physically present in India for the specified period. Therefore, the scope of the PE provisions is narrower than Indian domestic law. Accordingly, income from the remote provision of services should not be taxable in India under a service PE.⁷

Despite this, there have been instances in which Indian tax authorities have argued that physical presence in India is not mandatory for a service PE. Authorities have also tried to argue that if services are rendered partly within and

⁷The remote provision of services may, however, be subject to an equalization levy in India, which is in the nature of a digital services tax.

partly outside India, the threshold will have been satisfied. In the case of *ABB-FZ LLC*,⁸ the Bangalore Tribunal held that a service PE had been constituted without the physical presence in India of employees of the foreign entity.

ABB-FZ LLC (a United Arab Emirates-based entity) provided services to its Indian group entity through employees who stayed in India for a cumulative period of 25 days in the year. The Bangalore Tribunal observed that for a service PE to be constituted under the India-UAE tax treaty, an enterprise of a contracting state is required to provide services in the other contracting state through employees or other personnel, and the activities are required to continue (for the same project or a connected project) for a period or periods aggregating to more than nine months in any 12-month period.

The court concluded that the necessary condition isn't physical presence for more than nine months, but rather the rendering of services for the same or a connected project for more than nine months. Further, in the present age of technology, in which services can be provided through various virtual modes, physical presence in India is not necessary for the constitution of a service PE. Therefore, even though the employees of the UAE entity stayed in India for only 25 days, the court held that a service PE was constituted in India because services were rendered for more than nine months within a 12-month period.

On the other hand, in *E-Funds IT Solutions*,⁹ the supreme court held that for the constitution of a service PE, services must be performed in India. In this case, the taxpayer (a U.S. entity) had an Indian subsidiary that performed back-office operations for services provided by the U.S. entity to its customers abroad. The taxpayer had seconded two employees to the Indian subsidiary. The argument of the tax department was that the secondment would constitute a service PE of the U.S. entity in India. This was rejected by the supreme court, which held that a service PE is constituted if services are performed by a nonresident in India. In the facts of the case, the

U.S. entity was providing services to its customers entirely outside India, and the seconded employees were providing services only to the Indian entity. Because no services were rendered by the U.S. entity in India, there was no service PE.

The principle underlying the supreme court ruling appears to be that for a service PE to be created, services must be physically performed in India. This ruling was also relied upon in *Clifford Chance*.

The ruling pertained to two financial years. In one of the years, while the firm had provided advisory services to clients in India largely remotely, there were situations in which firm personnel visited India. In the following year, the services were provided entirely remotely. The tax department held that the firm had constituted a virtual service PE. In its view, physical presence of personnel was not required. However, the Delhi bench of the tribunal rejected the contention that a service PE may get constituted without the physical presence of personnel in India. Relying on the *E-Funds* ruling, the tribunal held that actual performance of services in India is essential to constitute a service PE. Accordingly, for computing the threshold limit for the creation of a service PE in India, only those services that are performed by employees physically present in India can be taken into account. While the tribunal did not expressly comment on the correctness of the ruling of the Bangalore Tribunal in *ABB-FZ*, it distinguished the decision by stating that it dealt with different facts.

International Perspective

Some countries — for example, Saudi Arabia¹⁰ and Pakistan — have modified their domestic laws and adopted the interpretation that physical presence of personnel is not required for the constitution of a PE. However, Saudi Arabia subsequently released a clarification stating that the requirement of physical presence will apply if it is required under the treaty.¹¹ Pakistan has also inserted provisions pertaining to virtual PEs into its domestic law with effect from July 1, 2023. The

⁸ *ABB FZ-LLC v. Deputy Commissioner of Income Tax (International Taxation), Circle-1 (1)*, Bengaluru [2017] 83 taxmann.com 86 (Bengaluru – Trib).

⁹ *ADIT v. E-Funds IT Solution Inc.*, 86 taxmann.com 240 (SC).

¹⁰ Saudi Arabian Zakat, Tax and Customs Authority, Circular No. 1/80/1436 (Dec. 2, 2014).

¹¹ Saudi Arabian Zakat, Tax and Customs Authority, Circular Publication No. 2303001 (May 17, 2023).

term “fixed” was removed from the definition of PE, and a new clause was inserted to include “virtual business presence” within the definition of PE.¹² However, because the provision was not incorporated in the treaties entered into by Pakistan with other countries, physical presence has been held to be essential for the constitution of a service PE¹³.

In *Snamprogetti Engineering B.V.*,¹⁴ the employees of a Dutch company were present in Pakistan for 97 days each year to provide engineering services to a company incorporated in Pakistan. The issue before the Pakistan supreme court was if the Dutch company triggered a service PE. In its ruling, the court noted that the condition for the constitution of a service PE in the Netherlands-Pakistan tax treaty was not satisfied because the employees of the Dutch company were not physically present in the country for the stipulated period (four months

within a period of 12 months). Accordingly, a service PE was not constituted. There are similar rulings in other jurisdictions.

Conclusion

Physical presence in a country is no longer a prerequisite for enterprises to conduct business given the pivotal role that digitalization plays in our lives. It is therefore expected that countries, including India, will increasingly look to expand the scope of service PEs to include virtual PEs.

The recent decision in *Clifford Chance* appears to suggest that based on current law, physical presence is a prerequisite for the constitution of a service PE in India. The decision reinforces that unless appropriate provisions are incorporated in tax treaties, the requirement of physical presence in India for the constitution of a service PE cannot be dispensed with.

Despite the absence of explicit recognition of virtual PEs in tax treaties, the expansion of business activities in the digital realm demands a reevaluation of traditional tax frameworks. A holistic solution at the global level may be the need of the hour. ■

¹² Orbitax, “Pakistan Enacts Finance Act 2023 Including New Provisions for a Virtual PE and Windfall Taxes and Several Tax Rate Changes” (June 2023).

¹³ Taxsutra, “FC: Pakistan’s Apex Court Prefers Physical Over Virtual Presence for Existence of ‘Service PE’” (June 2023).

¹⁴ *Snamprogetti Engineering B.V.*, TS-1051-FC-2022.