Digital Permanent Establishment (Digital PE): A Road Ahead for E-commerce Taxation

By Sagar Wagh[1]

1. Introduction

With nations all over the world raising concerns over tax avoidance due widespread e-commerce transactions, it is essential to analyze the shortcomings in the existing law and find practical solutions to plug the issue of revenue leakage.

Any domestic tax statute gets the teeth to impose tax on the people (taxpayers) by the virtue of charging section in the tax statute. The primary requirement to be fulfilled by a contracting state for putting a particular transaction to tax whether domestic or cross-border is to define the incidence & scope of charging section in its domestic tax law. This means that, the contracting state should provide for express provisions in its domestic tax statue in respect taxation system it has adopted (i.e. Incidence of tax / jurisdiction to tax – territorial or worldwide residence taxation).

In case of cross–border transactions, especially the ones in which the income arises in contracting state to resident of other contracting state, the domestic tax laws of the contracting state define the degree up to which the contracting state seeks to levy charge of tax on resident of other contracting state. The provisions of this nature can be termed 'scope provisions'.

The 'scope provisions' in domestic tax law generally correspond with the income heads of the distributive articles of Double Taxation Avoidance Agreements (DTAAs). The true role of DTAAs is to impose limitations on the application of 'source provisions' in domestic laws of contracting state. Hence, it can be said that, the application of DTAA will kick in only when the 'scope provision' is wider than DTAA and brings within its ambit the transactions/situation which are not provided in DTAA.

For example, in Indian Income Tax Act, the 'scope provisions' (provided in Section 9 of Income Tax Act, 1961) define the degree up to which Indian government can impose the tax on income earned by non-residents in India with respect to business income, salary, independent services, interest, royalty and Fees for technical services. The scope provisions in Indian tax law being wide are often limited by application of DTAAs.

[1] **By Sagar Wagh. Sagar Wagh is an International Tax Specialist based in Mumbai, India and can be reached at sagarwagh@gmail.com**

The DTAA generally grants primary right to tax a particular source of income to state of residence (resident state) and credit is granted by resident state for tax paid in source state. In certain cases, the tax paid in source state is exempted from tax in resident state.

This research paper will first analyze the existing legal provisions in relation to e-commerce taxation and need of Digital Permanent Establishment (Digital PE), and then suggest proposed legal framework both in municipal (domestic) laws of countries and treaties to subject e-commerce transaction to taxation in source jurisdictions through constitution of Digital PE.

Part One: Need of Digital Permanent Establishment

2. Understanding existing legal framework :

As discussed earlier, the provisions of DTAAs can only limit the application of domestic scope provisions of the contracting state. Hence, the starting point for determining whether the digital transactions can be put to tax by a contracting state, it is extremely important to analyze the domestic laws of the contracting state.

Digital transactions are of following types – 1) Sale through websites i.e. e-commerce transaction 2) Licensing information/knowhow by its dissemination through web

Generally domestic laws of all contracting state contain provision for taxing non-resident (resident of other contracting state) in respect of transaction granting right to use (licensing) of information/knowhow to the resident of contracting state under the head ‘Income from Royalty. Further, even Article 12 Royalties of DTAAs limits the right to tax royalty income by allocating such right to tax to state of source (where royalty income arises) i.e. state where such right to use is granted.

When companies sell/financial lease their products or provide services through websites or app markets, the income from such transactions is income from business.

The domestic laws of contracting state imposes tax the business income of the non-residents arising in their states only if the non-resident has the economic presence in the contracting state. The economic presence in a contracting state is generally defined in domestic laws of the contracting state as existence of either ‘business connection’ or ‘permanent establishment’ (PE). For example: Indian Income Tax Act taxes the business income arising to non-resident in India through or from a business connection.

The term ‘business connection’ is wider than ‘permanent establishment’ (PE). This is because, though ‘business connection’ seeks to tax only the income to the extent it arises (so much income as is directly attributable to activities of business connection) in the contracting state, it does not test other criteria which are relevant for testing the existence of PE like: degree of permanence (duration of economic existence) or whether the place of business is at the disposal of the non-resident enterprise. The legal provisions concerning 'business connection' also provide for 'Agency Business Connection' clauses which are similar to Para 5 and Para 6 of Article 5 of OECD Model Tax Convention i.e. Agency PE.

Those contracting states which define in their domestic laws, the economic existence of the non-resident enterprise in its own territory in terms of 'permanent establishment', have legal provisions similar to the provisions of Article 5 of OECD Model Tax Convention on Income and Capital (OECD Commentary).

However, as each nation strives to widen or protect its tax base and thus introduce provisions concerning 'business connection' or 'permanent establishment' in their domestic tax laws with aim to cover wide gamut of business transactions, it becomes essential for DTAA by the means of Article 5 r.w. Article 7 to limit the application/extent of domestic tax laws and tax the non-residents in source state as per bilateral consensus.

2.1 E-commerce Taxation under Current Legal Framework:

In order to understand the current e-commerce tax framework, it will be pertinent to understand the technological arrangement surrounding the transaction.

Technological Framework:

An e-commerce transaction involves a server, place where website is controlled and updated and jurisdiction where end customer enters into e-commerce transaction through aforesaid website. Server is nothing but storage and hosting medium for a particular website. Hence, it is server which stores the websites and hosts it over an internet.'

Para 42.3 of OECD Model Tax Convention on Income and Capital (OECD Commentary) on Page no. 110 makes an important distinction between host server (which is hosting computer equipment) and website. Further, the OECD Commentary points out that the enterprise which owns and operates a server might be different from the enterprise which carries on a business through a website.

Hence, there might be situations wherein, either the enterprise owning website might own server or the aforesaid enterprise might pay fees to Internet Service Provider (ISP) to obtain disk space used to store software and data required by the website and hosting the website on the internet. In certain cases enterprise owning a website may take the server on lease.[2]

[2] OECD Commentary, Para 42.3, Page no. 111

We will be analyzing 'technological framework of website' by studying below situations:

Generally speaking the e-commerce transaction has involvement of at least two jurisdictions. Many times even three jurisdictions are involved.

Situation 1: Three jurisdictions

Three jurisdictions are involved wherein country A is the jurisdiction where enterprise owning the website is situated (place of website ownership).This enterprise either takes server on lease or pays for server space from another enterprise located in country B which is second jurisdiction. Thus, the website is hosted on the server located in country B. The third jurisdiction is the Country C wherein actual sale of goods takes place through such website.

Situation 2: Two Jurisdictions

Two Jurisdictions are involved where server and place of ownership of website are in country L and the country wherein actual sale of goods takes place through such website is country M.

The moot question which arises after viewing above two situations is that, if the sale transaction takes place through the website, then which is the jurisdiction to which this website can be primarily attributed to?

Here our focus is to answer the primary location of the website. For example in situation 1, whether primary location of the website is Country A (place of ownership of website) or Country B (place where server is located)?

It is important to technically understand the role of server in entire arrangement. Technically speaking, real control of website is with the server. It is the server which gives the facility to website owners to update website from remote location. Further, the server can modify the website, disable it, can override remote updates.

Lets view some examples to determine the primary jurisdiction of the website:

Illustration 1:

Enterprise owning website in Country X has paid fees for obtaining disk space to server owning enterprise in Country Y. The website will be hosted from aforesaid server in country X. Server owning enterprise grants the facility of remote update to website enterprise so as to enable the website owning enterprise to update the website from Country A. However, the agreement between server owner and website owner states that, server owner will have overriding power over any update to website which he considers illegal or offensive in Country Y.

The right to host, store data, update and modify website is a conditional facility given by server owner to

Thus, we conclude that place of control of website is not Country X where enterprise owning website is situation, but it is jurisdiction where server is located i.e. Country Y in our example.

Thus, the primary location of website is Country Y.

Illustration 2:

We modify example given in Illustration 1. Here, enterprise owning website in Country X owns a server in Country Y or takes a server on lease from a server owning enterprise in Country Y. In both the situations, the server is fully under unconditional control of website owning enterprise in Country X.

The website is stored and hosted from the server located in Country Y. However, the complete control over the server and website lies with the website owning enterprise in country Y. It is the website owning enterprise which will fully control the functioning of server and the website, would have authority to update and modify the contents of the website.

Thus, we can conclude that place of control of website is Country X in this case. Therefore, primary location of website is Country X.

The primary location of website will be irrelevant factor for tax purposes. The only reason for above analysis was to understand the technical arrangement clearly.

The above technical illustrations will help us to understand how and where the sales transaction through a website is/should be ideally taxed under present legal framework.

The Current Legal Framework:

As per the ‘scope provisions’ of domestic laws of the contracting state, the source jurisdiction i.e. jurisdiction where the sale of end product takes place through a website acquires a right to tax non-resident website owning enterprise only if the aforesaid enterprise carries on business in source state through a ‘business connection’ or permanent establishment’.

As far as term ‘business connection’ is concerned, following points are worth noting:

a) The business connection contemplates an business/trading activity by a non resident in a source jurisdiction which contribute directly or indirectly in earning profits and gain[3]

b) The source rules generally stipulates that only part of/portion of profits which are reasonably attributable to the operations/activities performed by non-resident tax payer in

[3] CIT v Aggarwal & Co. 56 ITR 20 Supreme Court of India

source jurisdiction will be deemed to accrue or arise in and subjected to tax in source jurisdiction[4].

When website owning enterprise earns income on sale of goods through a website in a source jurisdiction, it cannot be said to be earning income in source jurisdiction through a 'business connection'. This is because; the website owning enterprise does not carry out any activity/operations in source jurisdiction. The only presence of website in source jurisdiction is because of the buyer who purchases the goods by accessing such website through the internet. Further, as the source rules stipulate that, the income attributable to business connection would be so much as is reasonably attributable to the operations/activities performed by the non-resident taxpayer in the source state, as no activity is performed by website owning enterprise in the source state, no income out of website sale can be attributed to it and subjected to tax in source jurisdiction.

The term 'permanent establishment has its roots in Article 5 of OECD Model Tax Convention of Income and Capital, and thus we will analyze whether website owning enterprise has in any way PE in the source jurisdiction.

As per Article 5, the general definition of PE is that:

"Permanent Establishment means a fixed place of business through which the business of the enterprise is wholly of partly carried on"[5]

As per OECD Commentary (page 92) on Article 5(1), the following conditions are to be satisfied cumulatively for an enterprise to constitute PE in a source state.

(i) Existence of *"place of Business"* i.e. facility such as premises or, in certain instances, machinery or equipment

(ii) Place of business must be *"fixed"* i.e. it must be established with a distinct place with a certain degree of permanence

(iii) The carrying on of the business of the enterprise through this fixed place of business. This means usually that persons who, in one way or another, are dependent on the enterprise (personnel) conduct the business of the enterprise in the state in which fixed place is situated.

    It is extremely important that, the fixed place of business is continuously made available to the enterprise i.e. it is at the disposal of the enterprise.

[4] Anglo-French Textile Company Ltd 23 ITR 101 Supreme Court of India
[5] Article 5(1) of OECD Model Tax Convention on Income and Capital

> Needless to say that, profits arising to an enterprise in a source state would be only so much as can be reasonably attributable to the operations of PE in the source state.

The first question which arises is whether website which is accessed on computer in source jurisdiction where sale takes place can be considered to be fixed place of business?

In this regard, the OECD Commentary[6] has rightly pointed out that, internet website, which is combination of software and electronic data, does not in itself constitute tangible property. Therefore 'website' which has no facility such as premises or in certain instances 'plant or machinery' cannot be said to constitute fixed place of business. Hence, website has no fixed place of business in source jurisdiction where sales take place.

In cases where in three jurisdictions are involved i.e. website owning enterprise is located in Country A, server is located in country B and sale through website takes place in Country C, the question arises whether, the server constitutes fixed place of business?

The OECD commentary[7] has again rightly pointed out that, server on which website is stored and hosted, which is nothing but a piece of equipment may constitute the "fixed place of business" of the website owning enterprise.

The next question which arises is that, whether enterprise carries on the business through such fixed place i.e. whether the website owning enterprise has the server at its disposal for carrying on the business?

It will be pertinent to recall the two illustrations given in technological framework to answer the above question.

In **Illustration 1,** the website owning enterprise in Country X paid fees to server owner located in Country Y for disk space. Let country in which purchase through website takes place be Country Z. However, it does not have any control over server activities or its function. The server owner may give facility to website owner to update the website from remote location. However, server owner has the overriding right to modify such update or disable the website. As the website owner has no authority or control over the server, the disposition test is not satisfied i.e. the server is not at disposal of the website owning enterprise. Thus, the server cannot be said to be permanent establishment of the website owning enterprise. Though OECD Commentary is silent on this aspect, some double taxation avoidance agreements (by virtue of Article 12) could consider the fees paid for disk space as royalty income received in respect of grant of right to use industrial, scientific, commercial equipment. As far as business income arising to the website owning enterprise from sale through website is concerned, in absence of permanent

[6] Para 42.2 Of OECD Commentary Page 110
[7] Supra

establishment either in state of sale (Country Z) or in state of server (Country Y), such income can only be subjected to tax in the state in which website owning enterprise is a resident (Country X).

The issue which is left to be examined is whether the server owning enterprise (Internet Service Providers i.e. ISPs) can be deemed to constitute Agency PE in country Y of website owning enterprise located in Country X as per Article 5 of OECD Model Tax Convention?

Guidance can be reliably taken from OECD commentary[8] which states that, providing disk space for storing and hosting websites is part of normal/usual business transactions of Internet Service Providers. Such ISPs provide disk space on their servers to several website owning enterprises, further ISPs generally do neither have authority to enter into and conclude contracts on behalf of website owning enterprises. Hence, ISPs are independent in nature and cannot be said to constitute the deemed Agency PE of website owning enterprise.

Further, as website does not have tangible existence of its own (i.e. website cannot be considered as place of business), even such website cannot be said to constitute agent of website owner.[9]

In **Illustration 2**, the website owning enterprise in Country X either owns or takes on lease entire server located in Country Y. Let country in which purchase through website takes place be Country Z. In this case, the complete control over the server and website lies with the website owning enterprise in country Y. It is the website owning enterprise which will fully control the functioning of server and the website, and would further have an authority to update and modify the contents of the website. Hence, it can be said that, the server is at the disposal of the enterprise. Hence, the server can said to constitute the permanent establishment of the website owning enterprise in Country Y.

3. Need for Digital Permanent Establishment (Digital PE) :

It's the generally accepted notion that, existing domestic tax laws and double tax treaties have not been able to keep pace with developments in modern technology. No doubt that, the notion is extremely correct.

The above analysis has shown that, the existing legal framework has led to revenue leakage in state of sale or source country due to absence of permanent establishment or business connection of website owning enterprise in source state.

[8] Para 42.10 of OECD Commentary Page 111.
[9] Supra

The existing concept of permanent establishment which stipulates that, the enterprise needs to have a physical presence in the form of fixed place of business at its disposal to be liable to tax in source state has made it practically impossible for the source state to levy tax on the sales made through website in that state.

Further, even in case contemplated by **Illustration 2** above, if both server and website owning enterprise are situated in low tax jurisdictions or tax havens, then the business income arising from sale of goods through a website may either escape taxation or may be taxed at a negligible rate.

Thus, it can be conveniently concluded that, the business income arising from e-commerce transactions in majority of cases escapes the taxation net.

In this regard, it would be extremely important for us to study some statistics which will help us to put forward a case of 'Need for Digital Permanent Establishment (Digital PE)'.

A report published by World Trade Organization (Year 2013) titled "E-Commerce in Developing Countries"[10] makes following important observations:

- As per International Telecommunication Union (ITU), in year 2011, about 2000 million people on the globe were using internet. Out of this figure of 2000 million, about 1.3 billion people were from the Asia Pacific Region, the Middle East, and Latin America.

- In 2013, the global business-to-consumer e-commerce i.e. B2C (means business enterprises selling to general public) sales are set to pass the USD 1.25 trillion mark.

- According to US Based International Data Corporation, it is estimated that Global Business-to-Business e-commerce i.e. B2B (means business transaction between a manufacturer and a wholesaler, or between a wholesaler and a retailer) amounted to USD 12.4 trillion at the end of year 2012.

- It is estimated that, B2B and B2C e-commerce transaction transactions will account for about 5 per cent of all inter-company transactions and retail sales by 2017.

- With internet on cell phones, the quantum of e-commerce transaction is set to expand several times.

With the advent of 'Smart Phone Age', the e-markets like iStore (of Apple), Android Play (of Google), Windows Market (of Windows), have occupied important place for the e-commerce transactions. Purchases through smart-phones/tablets on these virtual e-markets take place every

[10] http://www.wto.org/english/res_e/booksp_e/ecom_brochure_e.pdf

minute. Much of the business income arising out of sale on these virtual e-markets escapes taxation net due to smart tax planning by Multi-National Enterprises.

With such a growing magnitude of e-commerce transactions, it has become utmost important and necessary to lay down a rational legal framework to allocate the taxing rights among jurisdictions and especially to the source states which are deprived of taxation of this e-commerce income.

After analyzing the short-comings in the existing legal framework and citing the global e-commerce transaction statistics, I hereby put forward a case of 'Need for Digital Permanent Establishment (Digital PE)'.

Part Two : Proposed Legal Framework in Domestic Tax Laws & Treaties

4. Permanent Establishment : A Dynamic Concept

In the field of international taxation, the concept of Permanent Establishment (PE) can be said to be most dynamic concept. This is because, though general definition of PE as given in Article 5(1) remains same/identical across all model tax conventions and double taxation avoidance agreements (tax treaties), the tax treaties across the globe have made various modifications/additions/deletions to other paragraphs.

It is important to note that, even the model tax conventions viz. OECD, US and UN differ from each other with respect to their content of paragraphs of Article 5. This is because, the OECD Model Tax Convention seeks to protect the interest of capital exporting nations (developed nations), while UN Model seeks to provide a model to capital importing (developing) nations which they can adopt while negotiating tax treaties with developed nations. In order to protect the interest of capital importing nations (developing countries).the UN model tax convention has adopted a broader definition of the term 'permanent establishment' as compared to OECD model. For example: while OECD Model Convention and US Model Convention stipulate in connection with a building site or construction or installation project that such a site, etc., will not lead to a permanent establishment unless it lasts for 12 months, UN model Tax convention reduces this minimum period to six months. The UN convention also departs from OECD and US in that it expressly includes supervisory activities and, in Article 5(3)(b) extends the permanent establishment concept, under conditions specified therein to cover furnishing of services.[11] The extension of PE concept to furnishing of services is termed as 'Service Permanent Establishment (Service PE).

[11] Klaus Vogel on Double Taxation Conventions, Commentary on Article 5(3), Page 305, (3rd Ed)

Further, modified forms of PEs have been inserted in by contracting states while negotiating tax treaties in order to rope in wide gamut of transactions within taxation net of source states.

A simple example will be Service PE clause in India –US Double Taxation Avoidance Agreement (DTAA). Unlike UN Model which gives service PE clause in Para 3 of Article 5, the India – US DTAA contains service PE clause in Para 2 of Article 5. Article 5(2) gives the illustrations of the term Permanent Establishment, however these illustration actually constitute PE only if they satisfy the requirement of general definition of PE as given in Article 5(1). This means that, to constitute service PE, the enterprise must not only render services through its employees/other personnel in the contracting state but also satisfy the conditions stipulated by Article 5(1) viz. presence of fixed place of business and satisfaction of disposition test. This is in clear contrast to UN model which has inserted Service PE clause separately in Para 3 on an independent footing with the help of opening words "the term permanent establishment likewise encompasses furnishing of services through employees….." Thus, the wordings of Article 5(3) of UN Model clearly show that, the service PE clause is independent of general definition given in Article 5(1) of the said convention. While UN Model Convention stipulates that, service PE is constituted if the enterprise provides services through its employees in the contracting state for period of periods aggregating more than 6 months within any 12 month period, the India –US DTAA stipulates the lesser period or periods aggregating more than 90 days within any 12 month period.

The most interesting aspect of Service PE clause in India – US DTAA is that, if services are performed by enterprise through its employees in a contracting state for an Associated Enterprise (AE), then the service PE of the enterprise is constituted in the aforesaid state even if the services are provided for the period of 1 day. In short, the minimum period of 90 days given for uncontrolled service transactions is removed for the service transactions carried out by an enterprise for its related party.

Thus, the concept of PE can be modified or additional clauses can be inserted to Article 5, as per the requirements of the day.

5. Concept of Digital Permanent Establishment (Digital PE) & Proposed Framework

It is a pleasure to inform readers that, the term 'Digital Permanent Establishment (Digital PE)' is coined by me[12].In this regard, it is important to recall the well known English proverb 'necessity is the mother *of all inventions'.*

However, before introducing any framework for tax treaties, it would be essential to introduce the provisions in domestic law of all contracting states for taxing the digital transactions. This is because; originally the contracting state has the right to levy tax on sources of income arising in

[12] **Sagar S. Wagh, International Tax Specialist**

that state according to its domestic tax laws. The role of DTAAs is to limit the application of domestic tax laws and tax the non-residents in source state as per bilateral consensus.

5.1 Digital Taxation in Municipal/Domestic Tax Laws:

To impose tax on digital sales transaction, significant insertions might be required in 'scope provisions' of the domestic tax laws.

Further, major amendments in banking & regulatory laws may be instrumental in keeping vigilance over e-commerce transactions especially website and transaction traffic.

We will study the propose framework in Steps which are like a roadmap needed to be implemented for imposing digital taxation.

Step 1: Introduction of Vigilance Laws by country's Central Bank

The primary function of Central Bank is to manage nation's money supply (monetary policy), through active duties such as managing interest rates, setting the reserve requirement, and acting as a lender of last resort to the banking sector during times of bank insolvency or financial crisis. Central banks usually also have supervisory powers, intended to prevent bank runs and to reduce the risk that commercial banks and other financial institutions engage in reckless or fraudulent behavior[13].

The supervisory powers of the central bank can be extended to vigilance function over the e-commerce transactions taking place in the country. This can be established by introduction of strict and robust reporting system in relation to e-payment transactions.

It is essential for every country to frame laws which would make it mandatory for every bank, credit card companies and aggregators like PayPal to report details of every e-commerce transaction taking place through them to the central bank of that country.

The remitting banks, credit card companies and aggregators may be asked to submit details regarding the website on which transaction is taking place, the number of transaction through such website and quantum of transaction in monetary terms to the central bank.

This would help central bank and correspondingly the government of that country to keep track on the number of transactions taking place on a particular website in any twelve month period. The central bank should submit this information periodically to revenue authorities of the country so as to enable them to effectively conduct tax audit.

[13] http://en.wikipedia.org/wiki/Central_bank

Step 2: Defining Degree of Permanence in Domestic Tax Laws

It is essential that, a country defines the criteria which can be regarded as degree of permanence for a website to have an existence in the country in the form of business connection or permanent establishment.

<u>Days vs. Number of Transactions</u>

It is seen that, model conventions define the degree of permanence of certain types of business transactions in terms of days. For e.g.: Para 3 of Article 5 of OECD Model Convention provides that - a building site, or construction or installation project constitutes PE only if it exists more than “twelve months”. Hence, as per Article 5(3) of OECD Model Convention, a twelve month period is said to be indicator of degree of permanence of existence of business activity in the economic life of the country.

Readers may also recall the provisions of India-US DTAA in respect of service PE (discussed earlier) wherein a threshold of 90 days is given for an enterprise to constitute a service PE in a contracting state.

However, defining criteria of degree of permanence in terms of days may not be feasible as well as desirable for e-commerce transaction. This is because, a website might have only handful of transactions in certain number of days. For example, a website having only 5 transactions over a 180 day period cannot be said to have continuous business activity in a country.

In case of a website, a degree of permanence can be inferred by the number of transactions taking place on the website in that country. The number of transactions on the website is the indicator of the business activity carried on by the website with the subjects of that country.

Hence, the domestic tax laws of country should state that:

> ***“A website with ‘n’*** **number of transactions in the country deems to constitute a** ***business connection/permanent establishment in that country”***

The country should be free to decide the number of transaction (i.e. defining ‘n’) taking place in that country which would constitute the permanent establishment in that country.

Step 3: Taxability of e-commerce transaction

Once the degree of permanence and criteria of website constituting a PE/business connection in a country is defined clearly, it is essential to provide that income arising from such PE/business connection would be subjected to tax.

This is because; no tax can be collected except authority of law. To collect tax, the charge of tax should be clear, unambiguous and the machinery provisions laying down the charge of tax should expressly lay down the scope of charging section. In short, the scope provisions should provide that:

> ***"A website with 'n'* number of business transactions in the country deems to constitute a business connection/permanent establishment in that country and income and income arising from such transactions would deemed to accrue or arise in that country"**
>
> **Note:** *Words 'in the country' and 'in that country' will be replaced by country name* while providing in the domestic statute

The term business transaction is wider in scope than term 'sale transactions'. The term business transaction is used to cover wide range of transactions like sale of goods, provision of services, financial lease transactions and hire purchase transactions. Hence, tax abuse due to usage of term like 'sale transactions', which has narrower interpretation to cover only 'sale of goods' can be avoided.

In case of 'share revenue sale transactions' i.e. sale through iStore (iOS/apple market) or Google Play (android market) wherein the sale revenue from sale of app are shared by smart phone market platform company (Google or Apple) and app developer (generally 30% is taken by market platform company and 70% is passed on to app developer), smart phone market platform company should report its income in source jurisdiction and pay tax on its own account with respect to its share of income (i.e. 30%) and balance (i.e. 70%) in the name of app developer. While doing so, it would act as an agent of app developer in the source jurisdiction. As the taxes will be paid by smart phone market Platform Company in the name of App developer, the App developer will be able to avail tax credit or exemption in its own residence jurisdiction. However, it is the market platform which will be first and last point of identification for PE purposes. Similar framework should be stipulated in case of transactions wherein the website just acts as meeting place between seller and consumer and gets part of sale revenue as fees for hosting seller on website.

Step 4: Voluntary Registration by Websites & other related compliance

The domestic tax laws of the country should provide that, the website exceeding a 'certain' number of transactions in a particular 12 month period should register with the revenue department of that country.

This would make it easier for website enterprise and revenue department to carry out tax audit formalities easily.

The website constituting PE/business connection should also be asked to file annual return of income in that country.

Step 5: Penal Consequences for Non-Compliance/Tax Evasion

It is duty of the revenue authorities to cross-verify the report of central bank with its own registration records to verify that, all the websites who have crossed stipulated number of transactions have registered with the revenue department of the country.

If it is found that, the website has not registered or evaded taxes, then revenue authorities of the country should recommend government to suspend the operation of the website. Alternatively, the revenue authorities can request central bank to suspend remittance activities through such website (this can be achieved by central bank further issuing mandatory advice to credit card sites, banks and aggregators).

The following steps can help the source countries to impose tax on sale transactions taking place through website in their country.

5.2 Countering problem involving difference in jurisdiction of sale and jurisdiction of remittance :

A significant problem regarding determination of source jurisdiction may arise when purchase is made and delivery is taken in Country A while the payment is made from bank account/credit card located in Country B.

In this regard it is important; income for taxable purpose accrues to arise in a jurisdiction by the virtue of sales transaction and not by the reason of bank remittance. Hence, it is the Country A which is the source jurisdiction and not country B

As the remittance is made through Country B, it might not be reported to Central Bank in Country A. This may result in tax evasion as website may not pay tax on such sale in country A.

The problem may be countered by additional vigilance laws as follows:

- In case of physical delivery in the country, the customs authorities should verify whether the importer has booked transaction on website. If yes, then such transaction should be reported to revenue (income tax) authorities of that country
- In case of digital delivery i.e. ‘delivery by download’, such delivery should be subjected to the reporting to & clearance by the cyber department of the country of delivery. For

this to happen, the country should have strict cyber laws and advanced technology for cyber department to have track on the transactions. The cyber department can report such digital deliveries to revenue authorities of the contracting state

To track the above mentioned transactions, the countries need to be proactive and have robust regulatory and reporting mechanisms.

5.3 Digital Permanent Establishment (Digital PE) in Double Taxation Avoidance Taxation Avoidance Agreements (tax treaties)

The role of Double Taxation Avoidance Agreements (DTAAs) is to impose limitation over application of domestic laws of the contracting state through bilateral consensus (in case of two countries). Hence, prerequisite to introducing a provision in DTAA is a provision in domestic tax law, as proposed earlier.

As discussed earlier, a website does not have tangible existence and hence cannot constitute fixed place of business. Further, the current versions of model tax conventions do not contain effective legal provisions to tax e-commerce transactions in source jurisdiction. This is because, under current treaty provisions, it is practically impossible for an enterprise to have permanent establishment in the jurisdiction where actual sales take place i.e. source state.

A separate para in treaty (model conventions) is required corresponding to above proposed provisions in domestic tax laws because, in absence of corresponding provisions in treaty, the taxpayers may avoid tax by claiming that, in absence of corresponding provisions in treaty to tax e-commerce transactions, the treaty provisions are favorable and as such treaty provisions override the provisions of municipal law, the e-commerce transaction may escape taxation.

In order to tax the e-commerce transactions, I propose to introduce Para 7 in OECD Model Tax Convention on Income and Capital and correspondingly Para 8 to both UN Model Tax Convention and US Model Tax Convention.

The Digital PE provision in model conventions/treaties will be on separate footing independent from general definition of permanent establishment as given in Article 5(1). Thus, a PE will exists without a fixed place of business in other contracting state but the one which will be defined by a certain degree of permanence criteria.

The degree of permanence in a treaty will be defined by 'number of transactions' taking place through a website in any twelve month period. It is not essential that such number be same as that provided in domestic tax laws of the contracting state. The number will be generally arrived by consensus through negotiations between contracting states.

The wordings of the proposed Para may be as follows:

> **"*The term permanent establishment likewise encompasses the 'n' number of* transactions taking place through a website in a contracting state within any twelve month period*"***

The introduction of above Para will grant distributive right to a source state to tax the e-commerce transaction taking place in that state.

6. Attribution of Profits to Digital Permanent Establishment :

The traditional provisions of attribution of profits to PE/business connection of a non-resident in the country based on functions it performed, assets it owns and risks it undertakes may not help for attribution of profits to Digital PE/business connection.

It is important to keep in mind that, Article 7 Business Profits gives right to the contracting state to impose tax on '**business profits*'*** arising to the permanent establishment of the enterprise in the other contracting states. The word ***'business profits'*** means the surplus by which the receipts from a business exceed the expenditure necessary for the purpose of earning those receipts[14] . Hence, Article 7 seeks to grant right to contracting states to tax business profits and not the receipts arising from business.

The moot point which arises is that, as the website does not have any tangible existence in the other contracting, no expenditure is actually incurred in respect of the website in the other contracting state. In absence of expenditure, we are left with only gross receipts. Hence, this makes the application of Article 7 next to impossible. Thus, the website owning enterprise may escape taxation stating that, source state does not have right to tax the income arising from business transaction taking place through a website under Article 7 of DTAA between contracting states.

Significant problems may also arise if an attempt is made to introduce a new paragraph in Article 7 with a non obstante (i.e. notwithstanding) clause on an independent footing separated from other paragraphs, so as to tax gross receipts arising in source state rather than taxing business profits because, the website owning enterprise may not able to effectively avail credit on tax paid in source jurisdiction. The reason for this is that, the enterprise would pay tax on gross receipts in state of source while the tax in state of residence would be imposed on business profits. Even state of residence providing exemption to income earned outside the residence state may not help the case of the taxpayer.

[14] Russel v Aberdeen Bank 2 TC 321 House Of Lords UK

Further, role of tax treaty is to impose limitation on the provisions of domestic tax laws. Hence, it is essential to have provisions for attribution of profits arising from business transactions carried out through website to website owner's business connection/PE in the source state. Also the provisions in the domestic tax laws should not be rendered to nullity by application of DTAA.

The analysis made hereunder will throw a light on the proposed methodology to attribute profits to Digital PE both in domestic laws and treaties of contracting states:

6.1 Attribution of Profits to Business Connection/PE as per Domestic Laws

It is reiterated that, website does not have tangible existence. Hence, enterprise may not actually incur any expenditure in respect of income arising from business transactions through a website in particular contracting state.

However, it might be illogical to state that; website owning enterprise does not incur any expenditure in respect of income arising from business transactions carried out through its Business Connection/Digital PE in source state. Under sound accounting principles, each and every item of expenditure or allowance which the enterprise may claim in its financial statements in residence jurisdiction is directed towards earning the total income of the enterprise (i.e. global income).

Following provisions by the way of steps should be provided in domestic laws of country to arrive at business profits of a business connection/digital PE by reducing the expenditure from gross sale receipts in that country:

- Step 1: Arrive at gross receipts arising from business transactions of Digital Business Connections/Digital PE in the country …. (1)
- Step 2: From the total expenditure incurred by website owning enterprise on the global level, identify the expenditure attributable directly to source state sales transactions. For e.g.: Marketing expenditure incurred for marketing initiatives in source state …..(2)
- Step 3: From total expenditure and allowances reduce the expenditure identified under step 2. The balance common expenditure should be apportioned to all the jurisdictions in which sale (i.e. business) transactions are undertaken by the website. The apportionment should in ratio of sales made in the countries. Thus, one would arrive at the common expenditure attributable to the website's business transactions in a particular state ….(3)
- Step4: This is final step to arrive at 'business profits' of digital business

connection/digital PE in a country. The business profits are arrived by subtracting expenditure figures arrived at in step 2 and step 3 from gross receipts arrived at in step 1 [i.e. subtracting (2) and (3) from (1)]

The above provisions would enable a website owning enterprise to arrive at business profits arising to the digital business connection/PE in a country. Hence, the source country would impose tax on the 'business profits' of the digital business connection/PE and not on the gross receipts.

6.2 Attribution of Profits to Digital PE under Article 7

The current paragraph 3 of Article 7 as given in OECD Model Tax Convention may be modified to limited extent so as to grant right to the source state to impose tax on the proposed digital PE. Such desired modification already exists in Article 7 of many bilateral treaties.

In this regard, it will be pertinent to note the provisions of Para 3 of Article 7 of the Model Tax Convention:

"In determining the profits of the permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of permanent establishment , including executive and general administrative expenses so incurred, whether state in which permanent establishment is situated or elsewhere"

The above Article 7(3) can be modified as given in DTAAs of India entered into with US, UK, Canada, Netherlands etc;. Such modification in Article 7(3) is witnessed in most of the DTAAs entered into by India with other countries. The modified DTAA is as under

"In determining the profits of the permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of permanent establishment, including executive and general administrative expenses, **whether incurred in the state in** which permanent establishment is situated or elsewhere, **in accordance with the provisions of and subject to the *limitations of the taxation laws of that State."*** (the words in bold & italics refer addition/modification to the Article 7, para 3 as given by OECD Model Tax Convention)

The wordings 'in accordance with the provisions of and subject to the limitations of the taxation laws of that State' would help the treaty provisions to be at par with the attribution provisions of domestic tax laws proposed in **6.1** above.

Thus, the profits can be effectively attributed to Digital Permanent Establishment of the enterprise.

6.3 'Force of Attraction Principle' should not apply :

The 'force of attraction' stipulates that, where there is PE, the state of PE should be allowed to tax all income derived by enterprise from sources in that state irrespective of whether or not such income is economically connected with PE[15].

The force of attraction principle should not apply in the case wherein the website owning enterprise undertakes off-website transaction on its own account with certain customer in source state where the digital PE of the said enterprise exists (if proposed framework is adopted). This is because, the enterprise neither interposed website to execute the off-website transaction nor did it take the help of the website to carry out such off-website transaction.

Hence, in absence any involvement of the PE in such off-website transaction, no income can be directly or indirectly attributed to it using force of attraction rule.

6.4 'Effectively Connected to PE' will continue to apply

The words effectively connected to PE are seen in distributive Articles like Dividend (Article 10), Interest (Article 11) and Royalty & FTS (Article 12). The income of the enterprise in respect of dividend, interest and royalty are said to be effectively connected to its PE in the other contracting state if the dividend is paid in respect of investment held by PE, interest is paid in respect of debt granted by PE or the PE grants right to use certain property respectively.

Hence, if the website grants a certain right to use to a customer in the state where the PE of the website already exists then the income in respect of right to use is taxable as business income under Article 7 and not under Article 12.

6.5 Countering problem of 'Disguised Agent'

I am discussing the concept of disguised agent because; such arrangements are generally entered into by Multinational Enterprises (MNEs).

Following is the illustration of the arrangement wherein disguised agent exists:

The website owning enterprise is located in Country A. The website owning enterprise has a subsidiary in country B. Also the website's customers are located Country B.

The primary role of subsidiary in country B is carrying out software development and other miscellaneous operations on its own account. Apart from conducting business operations on its own account, the subsidiary company located in Country B markets the products or services listed on website to customers located in country B. Further, the subsidiary also enters into

---

[15] Klaus Vogel on Double Taxation Conventions, Commentary on Article 7, Page 409 (3rd Ed)

negotiation and is responsible for concluding the contracts. However, the final transaction takes place on the website and billing is done on website too.

The subsidiary company does not neither declares that it is carrying out any activity on behalf of its associated enterprise nor receives any compensation for its activities from its holding company located in Country A. Hence subsidiary company is a ‘disguised agent’.

Under existing legal framework, the subsidiary company should ideally report itself as Agency PE under Article 5(5) of the OECD Model Convention and the income from sale transaction should be attributed to the subsidiary based on arm’s length principle. However, due to disguised nature of operation of subsidiary and as the sales transaction is carried out on website, no PE is said to exist in country B. Thus, the source state i.e. country B loses substantial amount of tax revenue which should be rightfully attributed to that state.

Partial Solution due to Digital PE: Digital PE would solve the problem for source state partially as entire sales taking place in a source state through a website which would constitute digital PE would be taxable in source state as per proposed framework. However, to constitute ‘digital PE’ proposed framework, the website should cross certain number of transaction limit. Hence, if number of transactions taking place through a website due to marketing & negotiating activities of subsidiary company but the amount in monetary terms is high, then the website owning enterprise may escape taxation.

Way to counter ‘Disguised Agent’ problem completely: Alertness among revenue authorities and efficient vigilant network is essential to tackle the problem of ‘disguised agent’. Stringent penal laws should be place to counter the ‘disguised agent’ problem. If the ‘Digital PE’ legal framework is in place, then revenue authorities should conduct investigation of cases involving huge monetary transactions where the number of actual transactions is less. This would help to counter the revenue leakage problem posed by ‘disguised agent’.

6.6 Credit/Exemption for Taxes Paid in PE state

The taxes paid by digital PE in permanent establishment will either be exempted by state of residence of website owning enterprise by exemption method (Article 23A) or credit for such taxes can be granted by residence state as per credit method (Article 23B).

7. Conclusion:

I would like to conclude research paper by stating that, with growing e-commerce transactions, the figure reaching trillion marks, the introduction of legal framework introducing ‘Digital Permanent Establishment’ both in domestic tax laws and tax treaties is inevitable. Hence, ‘Digital Permanent Establishment’ is road ahead for e-commerce taxation.

Closing comments:

I do not claim to be master of the subject, but as a forever student of 'international tax law', I believe in finding possible solutions for challenges faced by existing legal framework due to ever evolving nature of global economy and developments in science and technology. I may not provide the perfect solutions, but I believe that a small idea can trigger a revolution and I hope to come up with such idea for the betterment of the world.

By Sagar Wagh,
Mumbai, India,
June 2013.