Virtual Service Permanent Establishment: Navigating Tax Challenges in the Digital Era

In this growing era of digitalisation, businesses operate seamlessly across borders, relying heavily on technology and remote operations. While countries have entered into bilateral tax treaties to determine the taxable presence of entities operating across borders and ensure a fair distribution of tax revenues, companies have strategically leveraged their digital presence to generate substantial revenue in countries with low tax rates, minimizing tax liabilities. This gradual shift towards the digital economy has led to a host of new challenges and raised important questions about how traditional international tax laws may struggle to keep pace with how these companies operate. Consequently, this has prompted proposals to redefine the idea of what constitutes a taxable presence in a foreign country in such a world, including the introduction of Virtual Permanent Establishment.

Overview of Permanent Establishment (PE)

The concept of PE has long been a cornerstone of Internation Taxation. Under the current framework of tax treaties between India and other countries, PE is defined as a "Fixed place of business through which the business of an enterprise is wholly or partly carried on."

This definition outlines three fundamental aspects: the existence of a place of business, its fixed nature, and the conduct of business activities through it, either in whole or in part. It covers a broad scope of physical establishments, including branches, factories, workshops, as well as sites for natural resource extraction such as mines, oil and gas wells etc.

Certain tax treaties, including Singapore, USA, UAE, Australia, Switzerland, Mauritius, etc. explicitly include provisions for Service PE, enabling the taxation of services where the presence of employees or other personnel of a foreign entity exceeds a defined threshold. For instance, under Article 5 of India-Singapore tax treaty, a foreign entity is deemed to constitute a service PE if the number of days the presence of the employees/ other personnel exceeds 90 days in any fiscal year and in case of services provided to related enterprise, 30 days in any fiscal year in the other country.

However, the advent of digital age has given rise to new business models that challenge the concept of Service PE. That said, the notion of Virtual Service PE may become relevant as a mechanism to address these challenges.

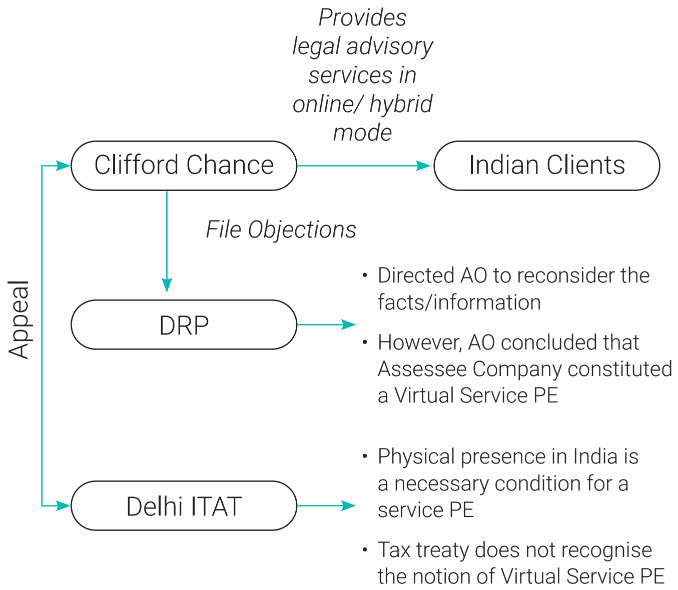
Understanding Virtual Service PE

Virtual Service recognizes that a company could have a taxable presence in the other country based on its digital activities or virtual operations, rather than relying on mere physical presence. In a nutshell, it may be defined as a business having a significant digital footprint in a country without a need to carry out activities physically through employees/other personnel in that other country.

The case of Clifford Chance PTE Ltd. v. ACIT, involving the law firm Clifford Chance Pte. Ltd. has brought this issue to the forefront, highlighting the growing disconnect between existing tax frameworks and evolving nature of digital activities.

Case overview- Clifford Chance PTE Ltd. v. ACIT

Facts: Assessee Company, a tax resident of Singapore, provided legal advisory services to Indian clients through hybrid mode—partly remotely from outside India and partly through the physical presence of employees in India and remotely from outside India in AY 2021-2022. Assessing Officer ('AO') pointed out that the firm had significant gross receipts from Indian clients in both the years but had claimed these as exempt in its income tax returns. Accordingly, AO proposed addition to the total income on account of constitution of service PE in India.



Question: Whether Assessee Company constituted a virtual service PE on account of employees providing services in online/ hybrid manner?

Contention of AO: AO contested that Assessee Company constituted "virtual service PE" as duration of provision of services is important and duration of physical presence in India is not material. Reliance was placed Bangalore Income Tax Appellate Tribunal (ITAT) in the case of ABB FZ LLC v. Deputy Commissioner of Income Tax ('Dy. CIT') and OECD Interim report (2018).

ITAT Decision: The physical presence of employees or other personnel in India is pre-requisite for service PE. ITAT also addressed AO's assertion of a virtual service PE, stating that India-Singapore tax treaty does not recognize the notion of virtual service PE. Accordingly, services rendered by Assessee Company do not establish a Virtual Service PE.

The above case law emphasises the requirement of physical presence for establishing a service PE and that prevailing tax laws do not recognise the idea of a virtual service PE.

OECD on Virtual PE

OECD's 2018 interim report titled "Tax Challenges Arising from Digitalisation" addresses "virtual service PE". It highlights a minority view expressed by some countries for definition of Service PE, as under Article 5(3)(b) of the UN Model Tax Convention, holding that "furnishing of services" refers to services "used" or "consumed" in the source country, and can include services performed from a remote location if other requirements of PE definition are met. However, such a stance is not adopted by OECD Model Tax Convention and the prevailing interpretation is that "service PE" provision focuses on where services are rendered, thereby necessitating a physical presence in the source country, either through employees or other personnel.

The report further acknowledges that Saudi Arabia has officially endorsed the concept of "virtual service PE", and it has also been recognized in case laws in some jurisdictions. It contends that the impact of this measure may extend beyond online activities, potentially encompassing remote services rendered to a market, such as consultancy offerings and call centre operations. Nevertheless, in the absence of amendments to existing tax treaty provisions, these measures run the risk of being challenged by taxpayers in court.

Additionally, OECD released a report titled "E-commerce: Transfer Pricing and Business Profits Taxation" in 2005. The report proposed changes that would require a fundamental modification of existing rules, including modification of the definition of PE as follows:

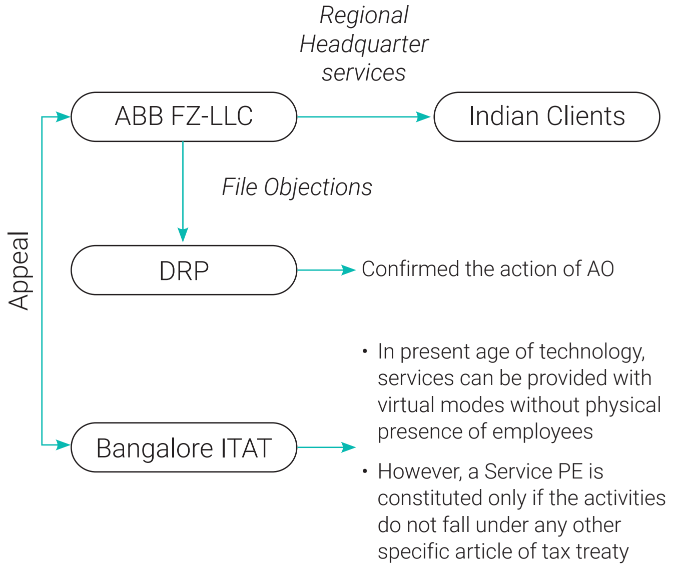
- **Virtual Fixed Place of Business** *(i.e. electronic equivalent of the traditional PE):* This alternative suggests that where the enterprise maintains a web site on a server of another enterprise located in a jurisdiction and carries on business through that website, the website itself can be said to create a PE, without the need of a physical presence.

- **Virtual Agency** *(i.e. electronic equivalent of the dependent agent PE):* This alternative seeks to extend the dependent agent PE concept to other circumstances where contracts are habitually concluded on behalf of the enterprise with persons located in the jurisdiction through technological means, for example, a web site regardless of the location of the server.
- **On-Site Business Presence:** This alternative proposes a new threshold for source taxation to ensure the taxability in case of substantial level of economic activity, including a minimum time during which enterprise regularly operates within the jurisdiction, or monetary thresholds, or limitations on activities covered.

Illustrative case scenario

Let us now discuss another case law, ABB FZ-LLC v. Dy. CIT, where the concept of physical presence of employees is briefly discussed.

Facts: ABB FZ-LLC, a UAE-based company, rendered regional headquarter services to ABB India primarily through virtual means—emails, calls, video conferences—with physical presence of employees for 25 days in India. Assessee Company contended that in the absence of an Fee for Technical Service clause under the India-UAE DTA tax treaty, the income falls under Article 22 (Other Income) and is taxable in India only if a PE exists. However, AO held that the income is taxable as Royalty.



Although it was ultimately held that the receipts were taxable as royalty, the case law briefly addressed that the physical presence of employees in India is not an essential condition to establish a Service PE. This interpretation stands in contrast to the position adopted by Delhi ITAT in Clifford Chance Pte. Ltd. v. ACIT.

The divergence in judicial opinions indicates that there may be a necessity for clearer, more nuanced international tax regulations that effectively address both traditional business models and emerging virtual business models.

Concluding Remarks

It may be appropriate to conclude that this notion of Virtual PE highlights the mounting tax challenges faced in an increasingly border-less world where traditional international tax laws —relying on the premise of physical presence within a country— may not be adequate to address the realities of businesses operating remotely. The case of Clifford Chance Pte. Ltd. v. ACIT and ABB-FZ LLC v. Dy. CIT, by demonstrating these challenges, serves as key developments for businesses involved in cross-border digital activities. While OECD has acknowledged the idea of virtual service PE in its reports and has proposed modifications to tax treaties, there is still no global agreement on how to treat such businesses. Hence, in the absence of clearer rules, both the businesses and tax authorities may face challenges, thus leaving the issue open-ended.

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