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Permanent Establishment in Digital Economy: The Conundrum of Proving Nexus for Taxation

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ABSTRACT

Taxes augment socio-economic development of a nation. The source-based model of taxation extends taxing rights to the jurisdiction where value is created, by establishing nexus between the source country and income earned due to existence of taxpayer's 'Permanent Establishment' in the source State. Thus, some 'physical presence' in the source State is essential to establish its right to tax. However, digitalisation of economy has virtualised the world enabling enterprises to make money in foreign jurisdictions without having any tangible physical presence in their territory. This has posed concerns about the efficacy of physical presence based 'Permanent Establishment' rule for taxation of the digitalised economy. The focus of this paper is to study the applicability and relevance of Permanent Establishment rule in the digital economy, and critically analyse national and international initiatives undertaken to modify the rule.

Keywords: *Permanent Establishment; Digital economy; OECD; Physical presence; Significant digital presence.*

1.0 Introduction

Taxes are compulsory contribution to the State's coffers by the individuals and businesses earning income within its jurisdiction. They enable State's to perform their functions effectively and carry out welfare activities for the people. States derive their power of taxation either on basis of residence of assessee or source of income being situated in their jurisdiction. A State can impose taxes on certain income, only if a nexus is established between the taxing jurisdiction and the income sought to be taxed.

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This nexus can be established on two basis, firstly, if the person earning the income is a tax resident in the State (i.e. Resident based taxation), or the source of the income is situated in the State (i.e. Source based taxation). So, income of a non-resident can be taxed by a country if the source of income exists there.

As cross-border trade has increased, individuals and enterprises resident in one country earn income across the globe from different countries. This has amplified the significance of 'source-based taxation' which seeks to tax income in the jurisdiction where actual value is created i.e. from where income is derived. The connection between the source State and income earned is substantiated based on presence of a 'permanent establishment' of the assessee in the source country. Permanent Establishment is understood as a fixed place used by an assessee to carry out its business in a foreign country. Therefore, some physical presence in the foreign land is essential to establish the required nexus for taxation in the source State.

The digital economy has been blooming at a fast pace in the recent years (The Economic Times, Dec 2022). In today's time, every necessity and luxury of life can be bought and sold online. From ordering food or cloths, to attending business meetings, everything happens in the online mode. The digital enterprises earn income from different countries across the globe without establishing any physical presence in their jurisdiction. The lack of any physical nexus in source jurisdiction makes taxation of such digital enterprises difficult.

The existing physical presence based rules of taxation are inapplicable to digital enterprises. Hence, there is a need for reform in rules of international taxation. Several initiatives have been undertaken at the international level by organizations like Organization for Economic Cooperation and Development (OECD), United Nations (UN) and European Union (EU) to modify the 'Permanent Establishment' rule and adopt other measures to tax the emerging digital economy. Similarly, at the national level, the Indian government has also adopted unilateral measures like introduction of 'Equalization levy' and 'Significant Economic Presence' concept etc. to tax digital enterprises making money from our soil. However, the changes are inadequate, and it is requisite to extend the ambit of 'Permanent Establishment' beyond physical presence to include virtual presence.

2.0 Concept of Permanent Establishment

The concept of Permanent Establishment emerged as a solution to deal with the problem of double taxation arising due to conflicting claims between residence and source country to tax income arising out of cross-border trade (Kobetsky, 2011, p. 110). In 1899, the first bilateral tax treaty was entered into by the Austro-Hungarian Empire and Prussia

which incorporated the Permanent Establishment concept to divide the taxing rights between the two nations. The treaty provided that the source State will be entitled to tax income made by a permanent establishment situated in its territory, and any other income will be taxed by the residence State (Kobetsky, 2011, p. 110).

Later, 'Permanent Establishment' concept also found place in the first Model Tax Treaty developed by the League of Nations as a guide for States to negotiate bilateral treaties amongst themselves to resolve conflicting claims to taxation (League of Nations, Draft Model Treaty, 1928). The Model Tax Treaty by the League of Nations laid the foundation of modern Model Tax Treaties made by OECD and UN (Hentschel, 2020, p. 39-43). As per the Model Tax Conventions, 'Permanent Establishment' can be broadly categorised into the following types:

1. **Fixed place permanent establishment:** According to Article 5(1) of the OECD Model Tax Convention (hereinafter referred as OECD MTC), a permanent establishment is "a fixed place of business through which the business of an enterprise is wholly or partly carried on." (OECD, 2017). To ascertain if a Fixed Place Permanent Establishment exists, certain tests have emerged:
   - Firstly, the Location/ Permanence test, indicates that the business should be carried out from a particular geographical location for a long period of time. The term 'Fixed Place' of business indicates a sense of permanence attached to the place. It should be thus possible to associate the business to an identifiable physical location, and such location should not be used temporarily but for a long time. For example, an office, a branch, a workshop, a factory etc. are considered as fixed places of business (OECD, 2017, art. 5(2)). However, if a foreign company opens its subsidiary in the source State, that does not create a Permanent Establishment, as subsidiary is a separate entity, having independent existence distinct from the foreign company (*DDIT* v. *Daimler Chrysler AG* (ITA 2955/ Mum/ 2010); *Motorola Inc.* v. *DCIT* (2005) 96 TTJ Delhi 1).
   - Secondly, the Business activity test, requires that the fixed location should be used to carry out the core activities of the business of the enterprise. Mere carrying on of preparatory and auxiliary activities like, providing facility for storage of goods, or collecting information for the enterprise in the source State, which do not constitute the main business of the enterprise concerned, does not lead to formation of a Permanent Establishment (OECD, 2017, art. 5(4)).
   - Thirdly, the Disposal test, the place of business situated in the source country should be at the disposal of the assessee enterprise. It is immaterial if the assessee owns or rents out the place of business in the source State, but what matters is that

the place should be accessible by and under the control of the non-resident assessee concerned at all times (OECD Commentary, 2017, art. 5).

Only if all these tests are satisfied, a fixed place Permanent Establishment is said to exist. The courts in various cases have held the following to constitute a fixed place Permanent Establishment in India, like, existence of courier office of a foreign courier company in India through which it delivers local packages (*ACIT* v. *DHL Operations BV* (2007) 13 SOT 581 (Mum) (Trib) (SB)), an earmarked space with a logistics service provider for storage and smooth delivery of goods of the non-resident (*In Re Seagate Singapore International Headquarters Pvt. Ltd*. (AAR No. 831/ 2009)) etc. However, no permanent establishment exists in case of delivery of goods to a customer who stores them as a bailee (*Airlines Rotables Ltd.* v. *JDIT* (131 TTJ 385 (Mum))).

A much-debated judgement on this topic is the Supreme Court ruling in the case of *Formula One World Championship Ltd. (FOWC)* v. *Commissioner of Income Tax (CIT)* (Civil Appeal No. 3849 of 2017), in which FOWC had entered into a contract with an Indian company (Jaypee Sports) to carry out a three day racing event at the Budh International Circuit in exchange of a payment of 40 million USD to FOWC. The issue pertained to the taxability of this payment by the Indian government. The Supreme Court, in this case held that the Budh International Circuit constituted the Permanent Establishment of FOWC in India, and thus the payment was taxable in India. The court observed that all the tests to establish a Fixed Place Permanent Establishment were satisfied in this case, i.e., the Budh International Circuit constituted a fixed place through which the business (i.e. racing event) of FOWC was being carried out. It was observed that having regard to the wholesome arrangement between the Indian company Jaypee and FOWC and its affiliate companies, the Budh International Circuit was at the disposal of FOWC. As far as the "fixed" nature of business was concerned, it was noted by the court that permanence of place depends upon the nature of a business, thus in some cases a short duration of use may also constitute Permanent Establishment as long as the place is at the disposal of the assessee during such period.

The above judgement came under the critical lens, as some experts opined that such a short duration of use of a place cannot be said to constitute a Permanent Establishment (Schwarz, 2017). Previously in a case, the AAR had held that a week-long golf event did not constitute a fixed place Permanent Establishment in India (*Golf in Dubai* v. *ADIT* (2008) 306 ITR 374 (AAR)). So, such a wide interpretation in the FOWC judgement is likely to deter foreign enterprises, from entering India.

2. **Construction permanent establishment:** A foreign enterprise carrying out construction related work or project in the source State can constitute a permanent establishment in the State provided that the work is carried on for a certain duration.

In such a case, the construction site is to be considered as the permanent establishment of such enterprise. The OECD and UN MTCs provide different durations to constitute a construction Permanent Establishment. While the UN MTC requires that the construction project should last for at least six months (UN, 2017, art.5(3)(a)), the OECD MTC requires a longer duration of atleast twelve months (OECD, 2017, art. 5(3)).

3. **Service permanent establishment:** A service permanent establishment is constituted if employees or personnel of a foreign enterprises are deployed in the source State for a period of 183 days or more in a financial year for the purpose of providing services to its clients (UN, 2017, art.5(3)(b)). For example, deployment of employees of a foreign enterprise to provide consultancy services to an Indian client firm would constitute a Service Permanent Establishment. However, employees of a foreign company working on deputation in source State, constitute a permanent establishment, only if the foreign company continues to exercise control over such employees but not otherwise (*DDIT* v. *M/S Tekmark Global Solutions LLC* (2010 ITR Mum); *In re Centrica India Offshore Pvt. Ltd.* (AAR 856/ 2010)). Further, employees of a foreign company sent on stewardship basis to equip the employees in source State with required standards followed by the foreign enterprise, does not create a service permanent establishment (*DIT (International Taxation)* v. *Morgan Stanley & Co.* (2007) ITR 416/ 210).
4. **Agency permanent establishment:** If activities of a foreign enterprise are habitually carried out by an agent working on behalf of the enterprise in the source State, such enterprise is considered to constitute an Agency Permanent Establishment in the source State. However, the person acting as an agent should be habitually engaged in the business of the foreign enterprise and exclusively work for it. Therefore, an independent agent working in course of its own business and not exclusively for the assessee does not form a permanent establishment (OECD, 2017, art. 5(6). So, if a foreign company has an agent in India who regularly secures orders on its behalf and sells its goods to customers in India, it will constitute a Permanent Establishment of the foreign company in India. But if a person works as an agent for various foreign companies and secures orders on their behalf, then there will be no permanent establishment in such case.

Thus, it is evident that some kind of physical or representative presence is essential for existence of a permanent establishment (Goyal & Goel, 2018, p. 25), either there should be a permanent location of business of foreign enterprise in source State, or some personnel or agent should be present in the source State carrying out the activities of the

foreign enterprise. However, there have been some cases in which the court has diverted from the traditional approach. For instance, in a recent case, it was observed that physical presence of employees in the source State is not essential to form a service permanent establishment, if services are provided in the source State for more than the specified period (*ABB FZ LLC* v. *DCIT* (International Taxation) (2017) 162 ITD 89 Bang ITAT).

India follows a hybrid mix of both residence and source-based models of taxation to generate tax revenue. The income of non-residence can be taxed in India if it is sourced from India i.e. if it is received, deemed to be received, accrued or arise, or deemed to accrue or arise in India (The Income Tax Act, 1961, s. 9). A non-resident assessee is deemed to have a source of income in India if such income arises from a 'Business connection' in India. The term 'Business Connection' was explained in the case of *CIT* v. *RD Aggarwal* (1965 AIR 1526) to postulate, "a real and intimate relation between trading activity carried on outside the taxable territories and trading activity within the territories, the relation between the two contributing to the earning of income by the non-resident in his trading capacity."

So, the concept of 'Business Connection' which is corresponding to 'Permanent Establishment' exists in Indian Income tax law. However, to avoid double taxation, India has entered into bilateral tax treaties with other States, which provide for taxation of non-resident if its permanent establishment exists in India. Section 92F(iiia) of the Income Tax Act, 1961 provides that "permanent establishment includes a fixed place of business through which the business of the enterprise is wholly or partly carried on." In the *CIT* v. *Visakhapatnam Port Trust* ((1983) 144 ITR 146 (AP)), it was observed that,

"The words 'permanent establishment' postulate the existence of a substantial element of an enduring or permanent nature of a foreign enterprise in another country which can be attributed to a fixed place of business in that country. It should be such as that it would amount to a virtual projection of the foreign enterprise of one country into the soil of another country." (Vishakhapatnam Trust, 1983, para 53)

So, existence of permanent establishment shows economic integration of foreign enterprise in the source State which helps in drawing a connection between source State and income of foreign enterprise. (Goyal & Goel, 2018, p. 25)

Though, the concept of 'Business Connection' is wider in scope than 'Permanent Establishment' for taxation in source country, but its applicability is subject to the 'Permanent Establishment' concept. In *Ishikawajma-Harima Heavy Industries Ltd. v. Director of Income Tax, Mumbai* (2007) 288 ITR 408 (S.C.), the court observed that, "The concepts 'profits of business connection' and 'permanent establishment' should not be mixed up. Whereas business connection is relevant for the purpose of application of Section 9; the concept of permanent establishment is relevant for assessing the income of

a non-resident under the DTAA." Thus, in case of DTAA between countries, the existence of permanent establishment is must for establishing right to tax of the source jurisdiction.

3.0 Permanent Establishment in Digital Economy

Physical presence has been of essence in matters of taxation. Whether it is residence or source basis of taxation, both rely on some sort of physical presence to establish nexus between the taxing jurisdiction and the taxable income. With digitalisation of economy however, businesses are now being run in a virtual space. For instance, contracts which were concluded in person or through agents earlier can be concluded over the World Wide Web in today's times, intangible goods like softwares can be delivered digitally, further payments can be made in the digital mode by the customers etc. Thus, digitalisation has made remote operations of business a reality. This has raised a challenge for tax administrators to establish a nexus between a jurisdiction and income for purpose of taxation of digital enterprises.

Various attempts have been made to protect the rights of the source States to tax income. Like, the OECD has analysed the application of 'permanent establishment' concept to internet websites and servers. In case of websites, it has been observed by the OECD that, "an internet website, which is a combination of software and electronic data, does not in itself constitute tangible property." (OECD Commentary, 2017, p. 113). Therefore, existence of a website cannot justify a jurisdiction's right to tax income generated by the website. A pertinent judgement related to online businesses is *ITO* v. *Rights Florists Pvt. Ltd.* (143 ITD 445 Kol. 2013), in which an Indian firm was denied deductions of payments made to online service providers Google and Yahoo for online advertisements of the Indian firm run on these search engines. These payments were held to be business profits, and since the above-mentioned search engines had no physical existence in India, their income was not taxable in India. Though, the court had noted that, "clearly, conventional PE tests fails in this virtual world even when a reasonable level of commercial activity is crossed by foreign enterprise" (Right Florist, 2013, para 12). However, considering that physical presence was the basic test for source taxation, websites of Google and Yahoo were held not to create a permanent establishment in India.

On the other hand, unlike websites, internet servers on which websites are hosted can constitute permanent establishment as they fulfil the tests essential for establishment of a fixed place permanent establishment (OECD Commentary, 2017, p. 113). The servers are computer equipments which need to be located at a fixed physical location which checks the physical location and permanence tests. The server used to perform business

functions of the foreign enterprise, also checks the business activity test. Thus, a web server engaged in provision of mere preparatory or auxiliary services, like, providing communication links, advertising etc. would not lead to existence of a permanent establishment. Further, to constitute a permanent establishment, the server should satisfy the disposal test, i.e. the place where the server is located should be accessible by and under the control of the assessee enterprise. In *Galileo International Inc* v. *DCIT* ((2009) 116 ITD 1), the foreign company owned a computer reservation system for booking online tickets and installed computer hardwares at travel agents' location in India. The foreign enterprise was held to have a fixed place Permanent Establishment in India, as the computer hardware was located in India on which the software was being managed by the foreign enterprise. Further, the foreign company exercised complete control over the computers installed with travel agents as they could not be shifted without the consent of foreign enterprise.

The reason why a 'permanent establishment' is deemed to be created on existence of a server but not a website, is because website has no tangible presence whereas a server has a tangible presence. So, say for instance, the foreign enterprise does not have any physical control over the place where the server is located, but has virtual control over the server, would the disposal test still be satisfied is a debatable issue (Khincha *et al.*, 2020, p. 139). Whereas virtual control over the server is more important than physical control in the digital economy, as a person may have physical access to the place where the server is located but would not be able to access the server unless it has passwords etc. for the same (Khincha *et al.*, 2020, p. 139). However, the heavy reliance on physical tangible presence is evident in the OECD commentary, which indicates that it is the access to place where the server is located which is important rather than the access to the computer equipment that is the server. Thus, the application of existing Permanent Establishment rule to digital economy is very limited.

Furthermore, digital businesses have certain unique features, which create challenges in allocating taxing rights of income generated from such businesses amongst jurisdictions (OECD, 2018, P. 51). The unique features of digital businesses are:

1. **Scale without mass:** This means that with digitalisation businesses can operate remotely and can create a huge user base in different countries without opening offices, hiring agents, or deploying personnel in those jurisdictions. For example, an online gaming application can have users in different jurisdictions without opening any physical offices or hiring agents or employees in those jurisdictions. So, in the digital era, businesses can establish a user base in foreign country without having any physical presence in that territory.

2. **Heavy reliance on intangible assets:** Intangible assets, like copyrighted software's, patented technologies etc. are used to do business operations, which has reduced the need for tangible assets. The functions which were performed by humans earlier, can now be done by the machines. Thus, tangible presence of enterprises has vanished as operations have become aerial.
3. **High volume of data and user participation including network effects:** In the 21st century, it is said that 'data is the new oil' (phrase coined by Clive Humby, British mathematician and data scientist). Digital businesses are built and developed on basis of user data available with them. Thus, user data is crucial for growth of such businesses. For example, user data is very important for building a user base and generating revenue for a social media platform which may use it for purpose of targeted advertising.

Thus, the traditional concept of Permanent Establishment based on requirements of 'physical presence' is unsuitable for taxation of digital economy (Goyal & Goel, 2018, p. 34). The movement from physical to virtual world has made existing physical presence based rules to create nexus for the purpose of taxation outdated and redundant. Thus, the existing rules to determine the existence of 'Permanent Establishment' need to be modified.

4.0 Initiatives: National and International

The various steps undertaken by international organisations working in the area of international taxation and the Indian government towards the taxation of digital enterprises, are discussed hereunder.

4.1 International initiatives

4.1.1 OECD BEPS Action Plan 1

OECD has been actively engaged in simplifying rules of international taxation to make them adaptable to the changing business landscape. In 2015, OECD released the Base Erosion and Profit Shifting (BEPS) report incorporating 15 Action plans to provide solutions for the problems faced in international taxation due to activities of multinational enterprises (MNEs) which engaged in tax evasion and avoidance (OECD/G20, 2015). Action Plan 1 and 7 of the BEPS report dealt with issues associated with taxation of digital economy, and artificial avoidance of permanent establishment rule by MNEs respectively. The BEPS report suggested the following alternatives for effective taxation in the digitalised economy:

1. **Significant presence rule:** This alternative suggests that an enterprise should be deemed to have a 'Permanent Establishment' in the source State if it has a significant digital presence in that country. Factors like number of users, gross revenue, use of local payment gateways, local domain names etc. can be used to determine if there is significant digital presence of an enterprise in a jurisdiction. However, determining thresholds for these different factors, and establishing uniform consensus on the same is a tedious task. Re-negotiation of tax treaties for adoption of such rule requires global consensus.
2. **Final withholding tax:** This alternative suggests deduction of tax by the consumer of goods and services before making payment to the online seller. It may be a plausible solution for transactions entered into between businesses but cannot be effective for transactions between businesses and consumers. Further, it will also involve renegotiation of tax treaties.
3. **Equalization levy:** It is an independent charge levied on gross payments made by consumers to non-resident e-commerce enterprises. It is a unilateral measure which does not require amendment of existing tax treaties between nations.

However, the OECD left it to the countries to adopt any of the above-mentioned alternatives or adopt any other unilateral measures for taxation of digital businesses. However, unilateral measures cannot provide a long-term solution to problems of international taxation. Thus, the OECD along with G20 nations started working on a 'Unified Approach' consisting of 'Two Pillar Statement' to deal with taxation challenges arising from digitalisation and globalisation of economy. Pillar One of the inclusive framework aims to provide for fair allocation of taxing rights to market jurisdictions, even if big firms do not have physical presence on their land (OECD/G20, 2021). The work on the above project is currently under progress.

4.1.2 Amendments to OECD and UN MTC

As far as, the Permanent Establishment concept is concerned, the BEPS report highlighted that the MNEs engaged in widespread manipulation of Permanent Establishment rule by engaging in activities like, contract splitting, commissionaire arrangements, fragmentation of activities etc. (OECD/G20, 2015). The report made several suggestions to avoid the misuse of Permanent Establishment rule by international enterprises for tax avoidance. This led to amendments in Article 5 of the OECD as well as UN Model Tax Conventions respectively. The amendments include, the inclusion of 'anti fragmentation rule', limiting specific exemptions, broadening ambit of Agency Permanent Establishment etc. (OECD, 2017 & UN, 2017). In particular, the list of exempted activities has been restricted by adding a condition that the activity should be of a 'preparatory or

auxillary' character to be excluded from formation of a Permanent Establishment. Thus, there is no blanket exemption on activities, like delivery or storage of goods etc., which were deemed to be mere additional activities in case of traditional businesses. Such activity may be the core business activity in case of digital enterprises. Further, an anti-fragmentation rule has been added to prevent the division of activities between closely related enterprises to create the illusion of preparatory or auxiliary activities, which when combined, form core business activity of the enterprise.

Also, the Agency Permanent Establishment has been widened to incorporate cases where actual contract might not be concluded by the agent, but important negotiations which lead to the closing of the contract are made by such agent habitually (OECD, 2017, art. 5(5)). Furthermore, an agent loses its independent character if it is effectively working only for a closely related enterprise of the foreign enterprise whose taxability is being assessed (OECD, 2017, art. 5(6)).

However, Permanent Establishment concept in its amended form still relies upon existence of physical presence. No new concept of virtual Permanent Establishment has been added. The amendments aim at dealing with the manipulation of existing rules by enterprises to avoid Permanent Establishment. However, the issue in case of digital enterprises is not the avoidance of permanent establishment but proving nexus between such an enterprise and source State based on existence of a permanent establishment in the first place. Thus, these amendments to Article 5 of both MTCs have failed to address the taxation of digital enterprises in the source country (Goyal & Goel, 2018, p. 36).

4.1.3 United Nations

Apart from amendments to Article 5 of the UN MTC which modified the Permanent Establishment rule. The UN MTC was again amended in 2021 to add a new Article to provide for taxation of income of automated digital services by the contracting State from which such income arises (UN, 2021, art. 12B). Automated digital services include services like, online gaming, online education, advertising etc. The new Article has been added due to inappropriateness of 'permanent establishment' concept in taxing enterprises functioning virtually through use of digital technology (Commentary on UN, 2021, art. 12B).

4.1.4 European Union (EU)

European Commission has also suggested taxation based on 'Significant digital presence' in source country where there is no physical presence. Significant digital presence can be ascertained on basis of revenue thresholds, user-base in source country,

number of contracts concluded etc. (European Commission, Corporate Taxation of Significant Digital Presence, 2018).

4.2 National initiatives

At the national level, the Indian government has been proactively dealing with the taxation of the digital economy. India was one of the first countries to introduce an independent digital tax. To prevent the digital businesses from escaping taxation, the Indian government has introduced various measures like:

1. **Equalization levy:** After the OECD came out with the BEPS report in 2015, India introduced an 'Equalization levy' to be charged at the rate of 6% on payments made to a non-resident from a person resident in India or non-resident having Permanent Establishment in India for provision of online advertising related services. However, such a charge is not applicable in case of receipt of services for personal use, or if aggregate payment made to foreign service provider in the last financial year is below rupees one lakh, or if foreign service provider has a Permanent Establishment in India from which such services are provided. (The Finance Act, 2016, s. 165)
2. **Equalization levy 2.0.:** The Finance Act, 2020 introduced a new 'Equalization levy' to be levied at the rate of 2% for money paid to foreign e-commerce operator for supply of services to resident Indian, or person using internet protocol address located in India, or sale of advertisements targeting Indian consumers, or sale of data of Indian consumers to non-resident. However, such charge is not leviable, if equalization levy under Section 165 of the Finance Act is payable, or foreign e-commerce operator has a permanent establishment in India, or its gross sale in the previous financial year is less than rupees two crores. (The Finance Act, 2020, s. 165A)
3. **Concept of business connection broadened:** Firstly, Section 9 of the Income Tax Act, 1961 has been amended to broaden Agency Business Connection in lines with the BEPS multilateral instrument (OECD, 2017), and is no longer restricted to habitual conclusion of contracts by an agent. Now, business connection can be established if the agent has a lead role in finalisation of contracts of non-resident in India. Further, if an agent is working exclusively for the non-resident, or for non-resident and its closely related enterprise, such an agent cannot be considered an agent of independent status (The Income Tax Act, 1961, expl. 2(a) to s. 9(1)(i)).

Secondly, to tax digital enterprises making money from India, the Parliament has amended the Income Tax Act, by adding Explanation 2A to Section 9(1)(i) by introducing the concept of 'Significant Economic Presence'. As per the explanation, a non-resident has a 'Significant Economic Presence' in India if it sells goods or services including download of softwares in India, or it solicits business from India by engaging with users

in India. Thresholds for sale revenue and number of users have been prescribed by the Central Board of Direct Taxes, as, payment of INR 20 million or above, and number of users 3 lakh or above (CBDT, Notification No. 41 of 2021).

Although the concept of Significant Economic Presence has been introduced in India to facilitate the taxation of digital businesses earning income from India which earlier escaped taxation. But, the Significant Economic Presence concept is inapplicable in case India has entered into a DTAA with a country. In such cases, taxes would be payable only if the foreign enterprise has a permanent establishment in India. As noticed earlier, permanent establishment still relies upon physical presence even after amendment. Thus, unilateral measures at the end of the day will not be fruitful in matters of international taxation. An international consensus to deal with tax issues associated with the digital economy is pertinent.

As is evident from the above amendments, India has been very active in introducing new regimes to tax digital businesses earning income from India. However, having multiple tax regimes, like Equalization levy, significant economic presence, Permanent establishment etc. may lead to overlapping taxes, and make compliance with such taxes costly and complicated. Such measures induce uncertainty and are likely to increase risk of double taxation of income (Hentschel, 2020, p. 357). Further, on one hand whereas it is important to protect the tax base of India, but also it is pertinent to maintain ease of doing business in India. Multiple tax regimes might affect foreign investment in India.

5.0 Conclusion

The purpose of 'Permanent Establishment' concept is to establish nexus for taxation in source country to enable it to tax income generated within its jurisdiction. However, emergence of digital economy requires reconsideration of the physical presence based permanent establishment concept. Amendments to Article 5 of the OECD & UN MTCs are insufficient to create nexus in case of foreign enterprises operating digitally. Furthermore, unilateral measures on part of India, cannot go a long way in protecting our fiscal interests unless international consensus is reached for taxation of digital economy.

A new nexus rule has to be established for taxation of digital economy in the source State. A different approach for taxation of digital businesses from traditional businesses would not be against the fundamental principles of taxation like neutrality, equity etc. Rather, rules for taxation of digital economy will prevent discrimination between digital and traditional business, and also local and foreign digital enterprises.

A Virtual Permanent Establishment concept should be incorporated in Article 5 of the Model Tax Conventions, based on significant digital presence of the foreign enterprise in the source State. Significant digital presence can be established on the basis of revenue earned from the source State, and the user base established in such State. Thresholds should be prescribed keeping in mind the different demographics and financial position of different countries.

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