

Base Erosion & Profit Shifting ('BEPS') – Digital Economy and Virtual PE



With the advancement of hardware and software resources, network connectivity and usage of virtual servers located in the cloud, many multinational companies ("MNC") have effectively adopted tax friendly business structures to avoid taxable presence in a foreign land, through fragmenting business functions among multiple group entities in different geographical locations. While doing so, the MNC ensures that each of the fragmented business locations falls below the permanent establishment threshold¹. This can be achieved through ensuring the categorisation of each of such business locations as being preparatory and auxiliary in nature. Such types of tax structures result in the erosion of tax base of the market/source jurisdiction². As the name suggests, Base erosion and profit shifting ("BEPS") means shifting of taxable profits from one jurisdiction to another through taking advantage of the gaps and mismatches in the tax rules of different countries, where the other tax jurisdiction has low tax, with no real business activity happening in such low tax jurisdiction resulting in the avoidance of corporate tax at an overall level. Read on...

E-commerce has gained substantial significance in most economies of the world. In the backdrop of information explosion and the ever expanding reach of the internet, businesses have become global, culminating into the advent of digital economy. Digital economy can be defined as an economic setting conceived through the interplay of business

models primarily based on information and communication technology. Such an economically advantageous situation can be achieved by business houses, by utilising worldwide broadband connectivity, mobility of intangibles and business functions, utilising network effects *etc.* Few of such novel businesses *viz.* digital content trading, online advertising, cloud computing, e-services, app stores *etc.* were not heard of a decade ago. This has also resulted in a change in business models from the "traditional brick and mortar set ups" to "commercial existence through virtual presence".

As there are two sides to a coin, similarly the so called 'boon' of digital economy also has its own set of perils/challenges, especially in establishing tax-



CA. Parul Mittal

(The author is a member of the Institute. She can be reached at ca.parulmittal@gmail.com)

¹ 'Preparatory and auxiliary activities' are defined in the exceptions contained in Para 4 of Article 5 of OECD Model Convention

² Market jurisdiction refers to government of the country where the market for goods/ services is present

trail for e-transactions from the tax perspective. This can be explained through a simple example where the concept of permanent establishment can become completely obsolete with the arrival of new technological developments. The traditional concept of permanent establishment is focused on the identification of substantial physical presence in a foreign country to establish qualification. These days, it is possible to be heavily involved in the economic life of another country without having a fixed place of business or a dependent agent therein.

It is an established international tax principle hailing from model tax treaty that tax residency of a corporate can be established through meeting either the test of place of incorporation or the place of management. This principle was based on peculiar business circumstances that existed in the 'pre-digital' age, when the tax treaties were negotiated. In that point in time, a company would have compelling reasons to carry out its business activities through physical presence from the place of its incorporation. Also, the fixed place of management could be established with ease in the yesteryears, due to such meetings being conducted through forming a quorum of all the board members present at one location at a single point of time. Today, the situation has reversed with the presence of the technologically advanced video conferencing tools that have posed as game changers in the business world. Today, conducting a virtual board meeting is possible, irrespective of the geographical location of the quorum forming key board members who can connect through video chats and can discuss and take important business decisions without there being any need for travelling to a particular location. Hence, in the present scenario, OECD has also emphasised the need for "place of effective management".

BEPS – A Case of Double Non-Taxation

Base erosion and profit shifting (BEPS) concerns have mostly arisen due to the application of complex tax avoidance structures by transnational corporations to earn 'stateless'³ income, primarily resulting in double non taxation. It is an accepted international tax principle that business income is taxed in the home country unless the taxpayer has a permanent establishment in another country. The concept of permanent establishment is geographical in nature and entails qualification either through a physical

Base erosion and profit shifting (BEPS) concerns have mostly arisen due to the application of complex tax avoidance structures by transnational corporations to earn 'stateless' income, primarily resulting in double non taxation. It is an accepted international tax principle that business income is taxed in the home country unless the taxpayer has a permanent establishment in another country.

existence or the presence of an agent in the host country. However, with technological advancements and arrival of e-commerce, establishing business nexus by way of physical presence has become a difficult task.

This can be explained by way of an example. A typical e-commerce company ('Company A') plans its operations in such a way that it can sell its products in any country through operating a worldwide website. Company A intentionally holds its server at a remote tax haven jurisdiction so that it doesn't have any physical presence in the market jurisdiction. Apart from the server being located in a tax heaven, Company A also undertakes certain research activities in the market country either through a wholly owned subsidiary or a liaison office. Such subsidiary undertakes research activities in order to understand the tastes and preferences of customers in the market country, so the products on the website can be placed accordingly. Such research activities fall under the exceptions contained in para 4 of Article 5 of the tax treaty.

Through designing its operations in the above fashion, Company A avoids taxable incidence in the market country by virtue of not having any physical presence there. Physical presence is done away with through planting the server that hosts the website, in a remote tax friendly jurisdiction. The Indian subsidiary of Company A also escapes becoming a permanent establishment, since it undertakes preparatory and auxiliary activities like market research and stock maintenance functions. The stated functions fall under exceptions to Article 5. In this way, the corporate tax from sale of products in the market country is completely absolved, irrespective of the mega revenues earned by the e-commerce company from such country.

In the set up discussed above, other taxes are escaped too, like no VAT is paid on the effected

³ A stateless income suggests that a cross border transaction is planned in a way to escape getting taxed by any of the involved taxing states/jurisdictions

online sales. Also, websites attract a lot of viewers as also online advertisement revenue from various local businesses. In the above example, Company A earns substantial advertisement revenue also from the market jurisdiction. No wonder why companies like Facebook and Youtube have a free user access worldwide. Their main revenue stream is online advertisements. Since online advertisements do not involve any use or right to use any industrial, commercial or scientific equipment and no technical service is being made available, such payments neither fall under the definition of fee for technical services nor equipment royalty. Resultantly, payments are made by the advertisers without deducting any withholding tax in the market country. Though the revenue from such advertising services constitutes business income of Company A, such revenue does not get taxed due to the absence of permanent establishment of Company A in market jurisdiction. Presently, under the Indian domestic tax law, there is no statutory provision that can impose withholding tax on foreign companies earning online advertisement revenue through operating websites in India.

Many multinationals have devised novel ways of abusing tax loopholes/favourable tax regimes, to avoid payment of taxes on their worldwide income with the support of advanced wireless communication networks. One such instance is the contractual allocation of risks and legal ownership of intangibles among intermediate subsidiaries in low or no tax jurisdictions. In this way, multinationals generate excessive deductible payments towards such intermediate subsidiaries as payments for rights of using such intangibles. Such multinational corporations generally demonstrate that the functions performed, assets used and risks assumed

In a nutshell, many multinational companies in the recent past have taken advantage of the boom in digital technological advancements by planning their business in such a way that they can take advantage of gaps in the tax rules and treaty provisions. In this way, such multinational corporations either avoid paying taxes completely, popularly called 'double non-taxation' or end up paying a miniscule amount of collective taxes on their global income which in most cases is less than what they would have paid in a single country in a normal scenario.

by the parent company is limited in nature and hence, profits get parked in low tax jurisdictions. Alternatively, an intermediate subsidiary can be created in market jurisdiction that may make substantial payments to its head office located in a low tax jurisdiction for use of centralised services received therefrom. Such centralised services could be head office expenses/management fees.

In a nutshell, many multinational companies in the recent past have taken advantage of the boom in digital technological advancements, by planning their business in such a way that they can take advantage of gaps in the tax rules and treaty provisions. In this way, such multinational corporations either avoid paying taxes completely, popularly called 'double non-taxation' or end up paying a miniscule amount of collective taxes on their global income which in most cases is less than what they would have paid in a single country in a normal scenario. This is not a happy situation for governments of many jurisdictions, as it results in loss of valuable corporate tax revenue and other taxes. Besides, this also provides undue competitive advantage to MNCs over their counterparts, due to them having bigger pockets than other companies. This may also urge the investor community to invest in such MNCs, thereby distorting their investment decision in favour of tax avoiding enterprises.

In the background of the above repercussions, in February 2013, the OECD published a report on "Addressing Base Erosion and Profit Shifting" iterating the need for analysing the issue of tax base erosion and profit shifting by global corporations. The OECD followed it up with publishing an Action Plan on Base Erosion and Profit Shifting (BEPS Action Plan) in July 2013. The BEPS action plan identifies fifteen actions to address BEPS in a comprehensive manner and sets a deadline to implement those actions. BEPS has identified digital economy as challenging, both from direct and indirect tax aspects and has considered setting up a task force for addressing concerns posed by digital economy as one of its action steps.

Indian scenario

In the Indian scenario, permanent establishment is recognised through establishing 'business connection'. Though the definition of 'business connection' has not been changed much, for the limited purpose of interest, royalty and fee for technical services, an amendment⁴ to the concept

⁴ Explanation to section 9 of the Income Tax Act, 1961

The traditional business models are changing and hence our traditional international tax law also needs overhauling. Conducting business through a website cannot be taxed by adopting traditional tax methodologies since a website is not tangible and it has no location. Hence, a newer concept of virtual permanent establishment should be manifested.

of 'deemed to accrue and arise in India' has been brought about in Finance Act 2010. As per the amendment, the income of a non resident shall be deemed to accrue or arise in India whether or not such services are rendered in India or such resident has a place of business or business connection in India. In this limited way, the Indian legal law is slated for a ramp up to mitigate the criterion of establishing physical nexus for advancing taxability. However, even a change in domestic law can be overridden by virtue of treaty benefit being available. Therefore, the need to recognise virtual permanent establishment as an internationally accepted concept is of prime importance.

Further, the Indian jurisprudence is filled with cases that analyse the position as to whether the existence of a computer server outside India can result in a creation of a permanent establishment. Most of such decisions are decreed by the Tribunals of different states and are largely fact based. Contrary views on the same matter can also be found in abundance, that leaves the taxpayers in an ambiguous situation. Few of such cases are analysed in this article for putting forward the revenue's perspective on the matter.

In case of *Galileo International Inc.*⁵, Galileo maintains and operates Computer Reservation System (CRS) services through maintaining a master computer system consisting of many mainframe computers connected to its main server located in USA. This main server is connected to airline servers in different countries including India that regularly exchange data. The airlines pay part of booking fees generated through use of such CRS services to Galileo. The Tribunal held that by virtue of computer systems being placed in India and used by the subscribers of CRS, there exists a fixed place of

business and a business connection in India. Hence, the presence of permanent establishment could be established. The stated findings of the Delhi Tribunal that Galileo has a permanent establishment in India has been upheld by the Delhi High Court and has also found favour in case of *Amadeus Global Travel Distribution SA*⁶, where it was held that business connection was established due to the presence of computer systems in India that constituted equipment permanent establishment in India.

However, contrary views were expressed by the Delhi Bench of ITAT in case of *Western Union Financial Services*⁷. It is important to note that the facts of this case were a little different from Amadeus and Galileo. One such difference was that the taxpayer operated in India through establishing a Liaison office with RBI's approval, which as per the Tribunal were preparatory and auxiliary in nature and fell under the negative list of Article 5 of the India-US tax treaty. The Tribunal further observed that mere use of software from the premises of its agents cannot lead to the conclusion that premises cum software constitute permanent establishment of the taxpayer in India.

On the other hand, in the case of *Right Florists (P) Ltd*⁸, the Indian taxpayer, a florist, used the search engines of Google and Yahoo for advertising its business and generating revenue therefrom. The revenue challenged that the payments made by the Indian taxpayer to Google and Yahoo, stating that it should be subject to withholding taxes on account of online advertisement revenue earned by the two enterprises in India. The Tribunal held that Google's and Yahoo's presence in India could not be constituted as a permanent establishment in India. The Tribunal relied on the OECD Model Convention in stating that permanent establishment would not be created unless the servers on which websites are hosted are also located in India since websites are intangible in nature. In the case of *Pinstorm Technologies (P) Ltd*⁹, similar advertisement charges were paid by an Indian taxpayer, Pinstorm to Google. The Mumbai Tribunal decided the matter in favour of the Indian taxpayer. However, the revenue's appeal against the stated Mumbai Tribunal's ruling has been admitted by the Bombay High Court on taxability of online advertisements.

⁵ *Galileo International Inc. and Maruthi Info. and Tech Centre vs. DCIT [(2007)(114TTJ 289)(Delhi ITAT)]*

⁶ *Amadeus Global Distribution S.A. vs. DCIT and DDIT [(2007) 113 TTJ 767 (Delhi ITAT)]*

⁷ *DDIT vs. Western Union Financial Services Inc. [TS-5-ITAT-2012 (Delhi)]*

⁸ *ITO vs. Right Florists (P) Ltd [(2013) 32 taxmann.com 99 (Kol' ITAT)]*

⁹ *Pinstorm Technologies (P) Ltd vs. ITO [(2010) 54 SOT 78 (MUM)]*

It is clear from the above analysis that conventional permanent establishment tests fail in virtual world and contrary views by different Tribunals further complicate the matter. Hence, verdict from higher courts could provide the much needed clarity on the issue in hand.

Virtual PE - Concept in the Making

The above discussion is deficient without concluding that the traditional business models are changing and hence our traditional international tax law also needs overhauling. Conducting business through a website cannot be taxed by adopting traditional tax methodologies, since a website is not tangible and it has no location. Hence, a newer concept of virtual permanent establishment should be manifested. Virtual permanent establishment as a concept entails the envisioning of a deemed permanent establishment that overrides the evidencing of a physical nexus to establish business presence. Governments of different jurisdictions need to take suitable remedial measures, to protect

the revenue base of their respective countries through devising principles around identification and taxation of virtual permanent establishments. Few of such alternative options suggested by OECD discussion draft on issues faced by digital economy are:

- Identification of '*virtual fixed place permanent establishment*' in cases where enterprise carries on business through a website and maintains its server with an enterprise located in a different jurisdiction; or
- Identification of '*virtual agency permanent establishment*' in cases where cross border contracts are habitually concluded through technological means rather than through a person.

Though the above mentioned suggestions are in the preliminary stages of conception, BEPS action plan is endeavored to provide a finishing line and course of action towards the achievement of internationally uniform tax practices in relation to the tax challenges posed by digital economy. ■



Non-Receipt of *The Chartered Accountant Journal*

This is for the information of Members/subscribers who fail to receive *The Chartered Accountant* journal despatched to them either due to un-intimated change of address or postal problems.

Members and Students are requested to inform the respective regions immediately after you change the address to ensure regular and timely delivery of journals to you as the mailing list is drawn from ICAI's centralised database updated till 15th of every month. Subscribers are requested to mail their changed address to eb@icai.in.

Members can also update their address online in the 'Members' section placed on the top bar of ICAI website. The required link in the 'Members' section is titled 'Members: Update Your Residential and Professional Addresses' (<http://www.icai.org/addupdate/>). Fill the Membership No and Date of Birth to open the Form. Fill the Form to update your changed address.

After updating the address online, the member is also required to download the updated Form and submit the same at their respective regions with their signature. Please note that once updated in the respective regional head offices' records, the new address gets automatically updated in the centralised data base of the Institute, from where the journal mailing list is prepared.

While updating the address members can opt for their 'Residential Address' to receive the copy of the journal by clicking the option "Do you want to get your journal on Residential Address" at the bottom of the Form. Thereafter you will get your copy of the Journal at your residential address.

Any queries or complaints in this regard can also be sent by email at journal@icai.in (for members) and eb@icai.in (for students and Subscribers) or contact at 0120-3045921.