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An overview of Virtual Permanent Establishment in Digital Economy.

Ibrahim Mu'azu Usman;

Dr.Tapash Ranjan Saha: tapashsaha@hotmail.com

Lincoln University College, Malaysia.

mribrahim@lincoln.edu.my

ABSTRACT
The digital economy stimulates innovation, growth, and competition. Rapid technological progress leads to social and economic transformations.It is essential to analyse the foundations of international direct taxation in order to detect conceptual conflicts that currently exist. In order to govern foreign taxes, national tax laws adapt to global aspects of how and by whom money is created. Despite the intricate nature of international trade and the heterogeneity of local income tax regimes, international tax concepts are incredibly similar in several nations. Furthermore, they rely on a limited number of concepts: (1) The application of certain principles, such as residence and source-based taxation, to determine how domestic source income earned by non-residents and foreign source income earned by residents are taxed; (2) The application of the concept of permanent establishment in establishing the economic nexus requisite to impose business profits; and (3) The application of the concept of permanent establishment in identifying the economic nexus necessary to impose business profits. These international taxations are being challenges in practical application at source country by the development of digital economy. This paper discusses the concepts of virtual permanent establishment, taxation based on both residence and source. It further assesses the relationship between the digital economy and international permanent establishment, permanent establishment, and virtual permanent establishment.

KEYWORDS: digital economy,residence, source, permanent establishment (PE), virtual permanent establishment.

1.0 INTRODUCTION

The digital economy is the digitization of current and prospective information in the economy and is therefore a component of every business from every market segment. Current corporate income tax rules have created a mismatch between the location where profits are taxed and the location where value is created. The current laws are no longer appropriate for the contemporary environment, in which cross-border internet commerce with no physical presence has become a fundamental part of the digital economy. (Sarıçimen, 2018)

Non-residents are taxed in the source state only if they have a permanent establishment (PE). The business location must be primary. A foreign PE should allocate its tax revenues to that PE, while in its home country double taxation avoidance applies. Thus, taxation abroad can be reduced or eliminated by limiting physical presence on foreign markets, i.e. by organising business activity so sales profits are not tied to the business's foreign location. Business models can avoid the tax-presence criterion by automating order placement online, contacting customers remotely (via phone, e-mail, videoconferences), fragmenting the business, or using formally independent foreign agents. Digitalization is the biggest contributor since the industrial revolution.

Digital economy has been the preferred option because of its simplicity and rapid method to interact, notably due to COVID. In this context, tax concerns abound. Some are about tax fairness, others about abuse. New digital taxes are an instrument for state survival and considering the potential of a digital PE's structure is logical. (Dulevski, 2021) Base erosion and profit shifting (BEPS) exploits loopholes and mismatches in tax laws to transfer profits to lower or tax-free locations. A state may have a digital PE definition, but another may not. (Antonov, 2021)

This paper contains relevant literature review of permanent establishment and virtual permanent establishment, theoretical gaps in permanent establishment, virtual permanent establishment concept and its application in digital economy. This paper was necessited by the need to critically appreciation the defects of the exiting framework of permanent establishment in the digital economy.

1.1 RESEARCH METHOD

The study employs the qualitative approach by the means of thematic search and review as appropriate on the exiting literature. The study is basically explorative in nature as secondary data is sourced from journal articles, official reports, discussion papers and others via EBSCOhost and Scopus. The theoretical sampling is adapted to process the data collected for the purpose of the theoretical review.

2.0 LITERATURE REVIEW

It is crucial to examine the underpinnings of international direct taxation in order to identify existing conceptual contradictions. National tax laws adapt to global features of how and by whom money is made in order to regulate international taxes. E-commerce has tax implications and enables international trade. Even if e-commerce does not create new problems, a model that makes it easier to perform the transactions that first gave rise to these problems exacerbates any problems associated with the difficulties of coordinating or integrating numerous separate taxing systems. (Basu, 2010).

Internet and e-commerce have raised the requirement for international firms to have a fair and efficient tax treatment. As cross-border activity increases, the majority of countries' current mechanisms for assigning tax bases across jurisdictions and preventing double taxation are complicated and will be strained further. As globalisation evolves, double taxation agreements will be no longer required because they imply country's tax sovereignty. How can we assign Online sales to a specific region? How much does this cost? How is tax assessed? Bernstein (2000) asserts, "Every country wants its fair share of profit taxation," but what constitutes a fair share and what are taxable profits? The creation of income tax treaties occurred prior to the advent of digital technology, when the preponderance of transactions and commercial law included physical property.

Despite the intricate nature of achieving corporate objectives and the diversity of local income tax regimes, international tax concepts are remarkably similar in most countries. Additionally, they rely on a narrow number of concepts:

(1) The application of such principles, such as residence and source-based taxation, to determine how national source income earned by non-residents and foreign source income earned by residents are taxed;
(2) The application of the concept of permanent establishment in establishing the economic nexus required to tax business profits; and
(3) The application of the concept of economic nexus to tax business profits.
(4) The use of permanent establishment to establish the economic link necessary to tax business profit. (Basu, 2010)

2.1 THEORETICAL GAPS

In general, countries employ their legal right to tax money based on its source or location. In the sphere of e-commerce, the precision of these two concepts is likely to deteriorate. The determination of a taxpayer's domicile for tax purposes is reasonably uncomplicated if their country of residence corresponds to the location in which they have the greatest personalities. As e-commerce has grown, however, the location of a company's incorporation has become less significant than it once was. Does residency-based taxes impact electronic commerce?

Corporate decisions at the highest level are critical. E-commerce can render the integration test even more artificial. Video conferencing enables simultaneous communication between directors from various countries. Boards are no longer required to meet at a specific location. Consequently, determining a "place of effective management" is complicated. Where is the board meeting held? (Pinto, 2005).

Another aspect of theoretical gaps is the taxation by the source (origin). Origin refers to the specific location where transaction is established. If the taxable entity engages proportionally in economic life, the country of origin should prioritise taxing income from activities undertaken within its borders. Consequently, in the initial phase, there is debate on whether commercial activity in the source country should be taxed and how the proper tax features should be stated.In a second phase, it must be established if there are taxes issues based on the stated tax characteristics in the nation of origin. To determine the amount of tax in the source country, an appropriate threshold and accompanying tax features must be established. Current tax regulations impose a tax on business income only if a company maintains a permanent presence in the country. Services are taxed in the country where they are performed, not where they are provided or consumed. Consequently, the taxation of income in the source country depends on the presence of PE and the nature of the income. Would the presence of a foreign computer server cause such a person to manifest? (Basu, 2010).

Since a corporation can receive money and provide value without having a physical presence in the source country, a company's level of physical presence within a jurisdiction does not necessarily correlate to its level of economic participation in that jurisdiction. Due to this, the company's use of a certain website could no longer contribute significantly to income generation.

According to source-based taxes, all income derived in a country is primarily taxed in its place of origin. The principle of feasibility dictates that a tax system must be effectively implemented to promote justice and efficiency. For the purposes of taxes based on the source principle, tax attributes in the country of origin must be readily discernible, and all opportunity for manipulation must be eliminated.

It could be argued that the fundamental concept that underpins the current OECD nexus and income attribution legislation, which specify that revenue should be attributed to the location where value is created, is outmoded.

The Nexus should not be determined solely by the location of digital economy advertising, research, manufacturing, as well as other wealth-generating activities. Instead, the location of consumption can generate direct tax nexus as well. Some individuals believe that changes are necessary to the tax policy, while others believe that changes are necessary to the economic development policy for developing and emerging economies.

Significant recommendations for reform are made. Given the weak correlation between physical and economic presence, the current definition of a PE can result in aberrant outcomes and a contradiction of the preceding tax principles.

The PE model neither predicts nor accounts for a correlation between intangible economic activity and international trade. (Basu, 2010).

2.3 PERMANENT ESTABLISHMENT & VIRTUAL PERMANENT ESTABLISHMENT CONCEPT

Article 5(1) of the OECD Model Convention defines a "permanent establishment" for purposes of allocating firm earnings to a source nation as "a fixed place of business through which the business of an enterprise is wholly or partly carried on."

The modern concept of a permanent establishment has its antecedents in German domestic law, which aimed to avoid double taxation by Prussian cities. Subsequently, Prussian courts amended the concept so that physical presence can be used as a geographical description, and the country in which this physical presence is located was given the ability to tax the source's profits. (Skaar, 1995).

The concept needed either a physical or an intangible component, i.e., the company needed a set location (i.e., the physical need) as well as, secondly, the company needed to strategize to engage economic activity at that fixed place (i.e., the mental requirement). This criterion for a "fixed place of business" was widely relied upon in 1899, when Austria-Hungary and Prussia signed the first international tax treaty, and also in 1909, as the German Double Taxation Act had been enacted. (Skaar, 1995). (Young, 2012).

After World War I, global trade in overseas countries grew significantly, and businesses were committed to create branches in countries where they conducted business. As a result of the expansion of international business, the League of Nations drafted the first treaty on double taxation in 1927. It applauded the concept of a permanent establishment and cited examples including branch offices, factories, agencies, and offices. First, the strategy recommended a balance between the allocation of corporate earnings to economically viable enterprises and the administrative expense of diversified distribution. (Skaar, 1995).

In favour of a source-state based system of commercial activity taxes without the requirement of a permanent establishment, the League of Nations produced the first Model Tax Treaty for Developing Countries more than ten years afterward. Subsequently, the Model Tax Treaty was changed to demand a permanent establishment as a prerequisite for the source taxation of corporate profits.

In the first OECD report, the League of Nations' recommendations for permanent establishment were incorporated. This document also defined "permanent establishment," a term used in the OECD's 1963 Income and Capital Tax Draft Convention. This core definition and rules for defining a permanent establishment have been maintained in all succeeding OECD Model Tax Conventions, thereby solidifying the current conception of a permanent establishment.

Permanent establishments fulfil two primary functions. First, a global company's permanent establishment indicates that it performs considerable business in the state of source. The second rationale for adopting the idea of permanent establishment is that a foreign entity that earns a profit in the source state by a permanent establishment is doing so because the source country provides commercial opportunities.. These profits should be taxed by this state. This approach is a compromise between exporting countries that tax value added during production and importing countries that tax sales income. International equity encourages trade. (Skaar, 1995). (Young, 2012).

The PE was created to strike a balance between the taxing rights of the source state and the resident state. The PE idea was designed as a major exception to the exclusive taxation by this country, as it was able to handle all circumstances in which a company's frequent exploitation of a foreign market necessitated the relocation of a portion of the company to that country. Typically, business income is produced from the organisation of production elements, which is constrained to the enterprise's home state. (Hongler & Pistone, 2015).

Permanent establishment continues to address the economy's physical requirements. It has evolved into a trap for the taxation jurisdiction of the market country, which can be circumvented through international tax planning to confine the business activity of non-residents outside the PE framework. A non-resident company can conduct business with foreign clients without establishing a permanent establishment (PE). (Hongler and Pistone, 2015)

2.3.1 VIRTUAL PERMANENT ESTABLISHMENT CONCEPT.

In tax reform projects, private equity is utilised. Article 5 of the OECD Model Tax Convention recommends virtual PE. Once a foreign firm's revenues in a jurisdiction exceed a specific threshold, the company is considered to have a permanent establishment (PE), and the source jurisdiction may tax the company's revenues from this virtual PE. A source state that has a significant client base can tax its own revenues. (Sprague & Hersey, 2003). (Basu, 2010).

The concept of "virtual PE" was first discussed during 1998 Ottawa Ministerial Conference on Electronic Commerce, which had been conducted after the OECD committee on Fiscal Affairs ("CFA") agreed on such a resolution on June 1, 1996. (Jha, 2019).

Until 2015, when the OECD evaluated it briefly as part of BEPS Action 1 to address tax issues created by the digital economy, the concept of virtual PE actually gained minimal analysis. Without commenting on the viability of virtual PE in mitigating risks, the OECD affirmed it was unnecessary to depend on any standard other than amending the specific exemptions to PE status under Article 5(4) of the MTC to ensure that they are readily accessible only for preliminary or auxiliary activities. (Jha, 2019).

The development of a substantial permanent establishment was among the preliminary ideas advocated. It argued that the best way to address the problems caused by e-commerce is to establish a tax nexus in the source country despite the absence of a physical presence for the company; that is, the tax nexus components as a fiction by empowering jurisdiction exclusively for the purpose of taxation based on a practically permanent establishment in the source country.

The framework of the virtual permanent establishment principle is the complete removal of the requirement for a physical, fixed place of business in the source country, thereby removing what is generally regarded as the most significant barrier to implementing the traditional source principles in the adoption of digital trade.

The major objective of the new PE concept is to enable the state of source to maintain exercising control over the taxation of business income received from operations integrally connected to its territory and jurisdiction, not to increase taxes at the source. (Hongler & Pinstone, 2015).

It is asserted that this resolution is artificial and, as a result, deceptively effective, because it makes it difficult to discern the method to be utilised when transferring commercial revenues to a purportedly permanent organisation. Furthermore, even if a method to correlate business earnings to a "virtual permanent establishment," could be developed, it would only be feasible in the situation of active business benefits because it is just so difficult to apply in the case of passive firm income.

One of the key requirements of the Nigerian Finance Act is the deployment of "digital permanent establishment" ("Digital PE") for multinational businesses. The Finance Act stipulates that a foreign company that "transmits, emits, or receives signals, sounds, messages, images, or data of any kind by cable, radio, electromagnetic systems, or any other lectronic or wireless apparatus to Nigeria in connection with any activity, including electronic commerce, application stores, high frequency trading, electronic data storage, online advertisements, participatory network platforms, and online payments" and has a "significant economic presence" in Nigeria is subject to a withholding tax. (Dasun, Nwodo, & Oladele, 2020).

The Finance Act authorises the Minister of Finance to determine by order what constitutes "significant economic presence" for a foreign corporation in Nigeria. Nigeria is a participant of the Inclusive Framework on Base Erosion and Profit Shifting (BEPS), which is collaborating with the OECD to address, among other things, the tax issues of the digital economy. We anticipate that the Minister will apply the OECD's definition of "Significant Economic Presence" when determining how to tax the digital economy. (Dasun, Nwodo, & Oladele, 2020).

CONCLUSION AND LIMITATION

It is established that virtual permanent establishment concept is to enable the source country to maintain exercising control over the taxation of business income received from operations integrally connected to its territory and jurisdiction, not to increase taxes at the source. The Nigerian government made regulations for enactment of virtual permanent establishment

This paper presents an exploratory description of new tax knowledge requirements emerging from digitalization-related situations and transactions. The digital economy is always changing, therefore new transactions and occurrences may demand tax knowledge not included in this study.

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