In 2011, we published a three-part series called "How Is Your Cloud Taxable?" This series discussed, among other things, how many companies are searching for ways to gain a competitive edge while mitigating costs. IT departments have begun using cloud computing as a cost-effective way to grow their infrastructure. However, many tax professionals are unsure of the impact that cloud computing could have on a company's tax footprint and effective tax rate.

Recent developments in India have added more uncertainty to this complicated area of taxation. In a February 7, 2012, decision, the country's Authority for Advance Rulings (AAR) ruled that a foreign company's server constitutes a permanent establishment, or PE, for tax purposes, and the profits arising from it are taxable in India. According to Abhishek Goenka (partner) and Sharath Rao (director) at BMR Advisors in India, "The issue of a server or other IT infrastructure constituting a PE is very fact specific and may impact web hosting companies that have any Indian presence in the form of servers, cargo industries where tracking equipment is placed in India, and telecommunication companies where leased equipment is used to provide continuous connectivity."

In light of these recent developments, this article will discuss the concept of a server as a PE under the Organisation for Economic Co-operation and Development (OECD)'s view and the lack of U.S. guidance on this issue. It will also look at how multinational companies can limit the risk that their servers might create a PE in the countries in which they are located.

Permanent Establishments

The term PE is found in most, if not all, international income tax treaties. A PE is generally defined as "a fixed place of business through which the business of an enterprise is wholly or partly carried on" and is required for a country subject to a treaty to tax the business profits of non-residents. In order to have a PE, a non-resident has traditionally had to have a physical presence in the jurisdiction in question.

As an illustration, let us consider the AAR ruling that a foreign company's server constitutes a PE for tax purposes. The AAR determined that the presence of a server in India is sufficient physical presence to constitute a taxable presence in the country. Accordingly, companies with servers in India may be subject to Indian tax on any profits attributable to the servers. In the absence of this ruling, companies may have been able to locate their servers in India without the fear that they would be subject to Indian tax due to the server's activities. As we can see, the existence of a PE is an extremely important concept in that once a PE has been established, the country in which it is located has the full authority under the applicable treaty to tax business profits attributable to the PE.

Servers as Permanent Establishments

As stated above, a PE is a fixed place of business that constitutes a physical presence in a jurisdiction. Thus, at first glance, it seems quite logical that a server could constitute a PE. Servers are tangible objects that, when placed in a particular country, constitute a physical presence. Furthermore, servers are capable of storing and transmitting large amounts of data that companies use to conduct business. In the case of web-based companies, servers store and transmit every piece of information for an entire business. For web-based companies, the server is the business.

It seems clear that under the fixed-place-of-business principles, a server may constitute a PE. However, under most treaties,
having a fixed place of business in a country may not be enough to create a taxable presence. For example, under the OECD Model Tax Convention on Income and on Capital, the term PE does not include:

- the use of facilities solely for the purpose of storage, display of or delivery of goods or merchandise belonging to the enterprise;
- the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;
- the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;
- the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information for the enterprise; or
- the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character.

Accordingly, even if a server can constitute a PE, the mere presence of a server in a jurisdiction should not be enough to create a taxable presence. The server must perform certain activities in order to create a PE under the traditional concepts of the term. Determining what activities a server must perform in order to constitute a PE has proven very difficult and, as discussed below, is still a work in progress.

U.S. Guidance (or Lack Thereof)

To date, there is no direct U.S. authority analyzing whether a person’s activities constitute a PE in situations involving e-commerce. The OECD has published a number of commentaries addressing various aspects of the taxation of income generated through e-commerce, but these commentaries are not controlling over U.S. principles of taxation. Still, they may be helpful by providing some insight.

The OECD's View

The OECD provides a forum in which governments can work together, sharing experiences and seeking solutions to common economic, social and environmental problems. One of the OECD’s major accomplishments is the OECD Model Tax Convention on Income and on Capital, which serves as a template for many, if not most, of the income tax treaties in the world.

In January 1999, in the midst of the Internet boom, the OECD Committee on Fiscal Affairs set up the technical advisory group on monitoring the application of existing treaty norms for taxing business profits (known as TAG). TAG has been charged with opining on the topics governing the taxation of e-commerce activities.

TAG has stated that, despite it being difficult or even impossible to trace the location from which e-commerce transactions are performed, it is on the other hand fairly easy to: (a) pinpoint a server in a low-tax jurisdiction; (b) divide business functions related to a commercial transaction between separate servers; and (c) have websites hosted by Internet service providers, or ISPs. TAG has realized what is both patently obvious and extremely difficult about the taxation of e-commerce ---- the fact that the concept of a PE was created during a time when brick-and-mortar businesses were all that existed. Accordingly, a PE premised on a physical presence within a jurisdiction was adequate. However, with the intangible nature of e-commerce, this traditional view of a PE has been greatly undermined.

Although the OECD’s final views on the taxation of e-commerce have yet to be released, the organization has released the following insights:

1. Websites do not constitute PEs.
2. Website hosting facilities should not produce PEs for the entity carrying on business through the website.
3. ISPs should not represent an agency position and give rise to a PE.
4. Servers located in a jurisdiction for a suitably long period may be considered fixed and constitute a PE.

The OECD has suggested that when an enterprise operates computer equipment at a particular location, a PE may exist at the server location even though no personnel of the enterprise are present at the location of the server. Thus, in the OECD’s view,
fixed, automated equipment that can perform important and essential business functions (i.e. servers) may be sufficient to create a PE at the equipment location without the presence of human beings.

The OECD addressed the application of the PE article in the context of e-commerce in a commentary published in December 2000. According to the commentary, an enterprise may be considered to have a PE at the location where it maintains a server. Such a server, however, may constitute a PE only if the enterprise has the server at "its own disposal."

The OECD’s stance seems to be that a server may only constitute a PE when the automatic functions carried out by the equipment have been set up by the principal enterprise and continue to be operated, controlled and maintained by the same principal enterprise. This level of activity by the principal enterprise establishes the fact that the server is appropriately permanent, fixed and at its own disposal. Thus, it would seem that under the OECD’s view, the leasing of server space in a particular country to simply house and use proprietary data should not create a PE. Conversely, an enterprise that owns a server in a designated location in a particular country, operates the server, and controls and maintains the equipment may have a PE under the OECD’s view.

Alvarez & Marsal Taxand Says:

The recent developments in India, combined with the lack of direct authority, U.S. or otherwise, in dealing with the server as a PE issue should raise a bit of a red flag for companies that conduct business using servers in various countries. This includes many, if not most, multinational companies. A risk exists for companies with servers in foreign jurisdictions. They may have a taxable presence in those jurisdictions, the U.S. included, and not even know it.

For multinationals using servers in foreign jurisdictions, there are ways to minimize the risks that their servers create a PE, such as the following:

1. Learn your local jurisdiction's rules. As we have seen, the U.S. has issued no official guidance on this issue. However, the local jurisdictions in which your company's servers are located may have done so. Knowing these rules will help your company structure its server’s activities in a manner that minimizes the risks that they create a PE.

2. Consider forming a legal entity in the country in which the servers are located. Although there may be some tax leakage associated with having a taxable entity in the country, the income associated with it can be defined, thus limiting other income of the multinational from being subject to tax.

3. Consider utilizing a service provider in the local jurisdiction that owns, controls and services the servers and other hardware, rather than taking ownership of the servers themselves.

As discussed, the lack of clarity means that there is currently no way of eliminating all potential risk. However, these ideas can start to mitigate some of the concern.

Footnotes:

OECD, Committee on Fiscal Affairs, Commentary on Article 5 Concerning the Definition of Permanent Establishment, Section 1.1, at 92 (July 2010).


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