[2025] 180 taxmann.com 115 (Article)

[2025] 180 taxmann.com 115 (Article)©
Date of Publishing: November 5, 2025

From Brick to Click: The New Geography of Permanent Establishment

RISHABH AGARWAL

Chartered Accountant, LL.M (International Taxation-Vienna)

EKTA MANOT

Transfer Pricing Analyst

1. Introduction:

For decades, the concept of Permanent Establishment ("PE") has served as the bedrock of international taxation, the legal threshold that allows a country to tax the business profits of a foreign enterprise. Traditionally, the test for a PE was physical presence: a branch, an office, a factory, or a place of management. In essence, tax nexus followed tangible footprints.

However, the global economy has outgrown geography. In an era where multinational enterprises conduct substantial business through websites, apps, and cloud infrastructure, the question arises: Can a server, a piece of metal housed in a data centre, constitute a taxable office?

What this article covers:

- How traditional PE rules were designed for a physical, location-based economy and why they are insufficient today.
- How servers, despite being intangible touch points for users, can qualify as a fixed place of business when core functions are performed through them.
- How OECD guidance, BEPS initiatives, and domestic measures like SEP are redefining nexus beyond geography.
- How courts worldwide are shaping the modern meaning of presence through critical server-related jurisprudence.
- Where cloud-based architectures further complicate the nexus test, pushing tax rules toward functional presence.

Together, these developments demonstrate a progressive shift from physical to digital taxability and provide the reader with a structured understanding of how global taxation is evolving.

The article seamlessly progresses from classical PE principles to modern digital interpretations, showing how each development logically builds upon the previous one.

2. Evolving Scope of PE: From Physical to Functional Nexus:

Traditionally, establishing a PE relied heavily on physical presence and the duration and nature of activities performed in a country. Key traditional indicators of a PE included having a fixed place of business (such as an office or workshop) or engaging in substantial activities over a defined period, as seen in construction site PE duration rules.

Another critical element was the activity of agents. A presence could be established through a Dependent Agent PE, where an agent habitually concludes contracts on behalf of the enterprise, while an independent agent typically would not create a PE. The logic was straightforward: if a foreign enterprise physically operates in another country, it benefits from that jurisdiction's infrastructure and must therefore share part of its profits through taxation.

This classical framework reflects an era when revenue generation required people, property, and physical proximity. However, with the advent of e-commerce and cloud computing, multinational enterprises began generating significant revenues from countries without physical presence.

For example, a foreign company could sell software subscriptions, stream digital content, or facilitate transactions through online platforms, all without personnel, offices, or equipment locally.

This challenged the fixed place test, since operations increasingly existed only in cyberspace.

The OECD recognized this gap and, in its 2017 Commentary, clarified how servers and digital infrastructure may constitute a fixed place of business.

3. OECD Commentary and International Consensus:

The OECD's 2017 Commentary on Article 5 explicitly addresses this issue:

A website may in itself does not constitute a place of business because it lacks a physical presence. However, the server on which the website is stored and through which it is accessible may constitute such a place if it is at the disposal of the enterprise.[1]

The commentary further distinguishes between core and auxiliary activities:[2]

- If the server merely hosts the website (auxiliary), no PE arises.
- If it performs essential functions (core business operations), it may constitute a PE.

This nuanced approach ensures that digital operations with substantive economic presence are taxed, while mere hosting or passive infrastructure use is not.

4. Server Based Nexus:

In response to this digital transformation, tax frameworks now recognize Digital/virtual PE. This concept expands the scope of a taxable presence beyond traditional brick-and-mortar structures to encompass digital assets and infrastructure.

4.1 The Physical Server as the 'Taxable Office'

The core of this shift lies in recognizing the functionality and importance of physical servers. While a server is a physical piece of hardware, its role as the fixed digital location where the core functions of a business are maintained has led authorities to argue that the presence of such a server constitutes a PE. The sources indicate that simply having a server contributes to establishing a significant digital presence.

Conditions for a Server PE[3]:

- If a foreign enterprise owns or leases the server, and controls its operation, it could create a server PE in that jurisdiction.
- However, if the server is merely hosted by a third-party service provider, and the enterprise has no access or control over it, the disposal test typically fails.

- In this context, control and core business functionality are the deciding elements.

However, the increasing adoption of cloud computing has rendered the fixed, tangible nature of the physical server insufficient for defining a tax nexus, leading to the more complex challenge of the virtual server which is discussed in the ensuing section.

4.2 The Challenge of Virtual/ Cloud Servers

The debate now extends beyond physical servers to virtual servers and cloud infrastructure, distributed networks where data and processes are replicated across multiple jurisdictions.

Under traditional PE concepts, fixity and place of business are difficult to apply to virtualized environments that are location-agnostic.

For instance:

- A website hosted on Amazon Web Services (AWS) may be processed across several countries simultaneously.
- The enterprise may not know where its data resides at any given time.

This raises a profound question:

Can a PE exist when the place of business is diffused across the cloud?

Current OECD guidance[4] suggests only computer equipment with a physical location, owned or leased and at the enterprise's disposal, can constitute a fixed place of business. While not addressing cloud servers directly, its reasoning implies that remotely accessed infrastructure lacks geographical permanence, prompting a shift toward functional nexus concepts. We have summarized various business models below:

Deployment Pattern	Disposal / Control Evidence	Core Functions Present or Not?	PE Risk Level
Enterprise-owned physical server in target jurisdiction	Full ownership or lease; exclusive access and operational control	Yes: order processing, transaction validation, data management	High
Co-located server (third-party data centre)	Partial control via dedicated rack space; contractual access rights	Depends on functionality and extent of control	Medium
Third-party hosted server (shared infrastructure)	No direct access; only service-level agreement with provider	Typically, no: auxiliary hosting only	Low
Virtualized or cloud-based server	No identifiable physical location; rotating IP or load-balancing setup	Generally, no identifiable control or fixity	Very Low / Indeterminate
Hybrid deployment (local caching, global cloud control)	Limited local storage: partial functionality hosted locally	Possibly yes if caching servers perform value-generating functions	Moderate

The rise of cloud computing underscores the inadequacy of traditional nexus tests, which depend on identifying a single, geographically fixed point of business. In a world where data and processing shift dynamically across jurisdictions, the idea of a place of business becomes meaningless. Recognizing this, tax policymakers have begun redefining nexus in functional and economic terms rather than geographic ones, leading to the emergence of the Significant Economic Presence (SEP) framework.

5. Significant Economic Presence (SEP):

Under BEPS Action 1[5] and the OECD's ongoing Two-Pillar Solution[6], the test for taxing rights is shifting to focus on economic engagement rather than physical presence.

The SEP framework aims to capture profits where value is created digitally, including through user participation and data monetization.

Key features:

- Physical presence is no longer required
- Nexus can be triggered through revenue thresholds, number of users, or digital interaction intensity within a jurisdiction
- The focus is on sustained and significant digital engagement with the market

India[7] has unilaterally introduced the SEP concept into their domestic law. Under CBDT Notification No. 41/2021 dated 3 May 2021, SEP is triggered when a non- resident (applicable since FY 2021-22):

- Conducts transactions in goods, services, or property with any person in India **exceeding INR 2 crore** in a financial year: or
- Engages in systematic and continuous solicitation of business or interaction with **300,000 or more users in India** during the year.

However, the SEP provision carries an explicit treaty-override caveat. It applies only where no DTAA governs the transaction. Where a treaty exists, the nexus continues to be determined under Article 5 (Permanent Establishment) of that treaty.

By introducing SEP, India has effectively shifted from a physical to a digital nexus test, aligning conceptually with BEPS Action 1 and 7, but going further by codifying thresholds that capture virtual or server-based economic participation even in the absence of traditional presence.

6. Lowered Nexus Threshold in the Digital Economy:

Digital tax reforms have dramatically lowered the bar for triggering a PE. Under the modern interpretations, even a strategically important server that performs essential digital functions, such as data storage, payment processing, or content delivery, can establish tax nexus.

OECD BEPS Action 7[8] strengthens this position by curbing artificial fragmentation of activities. Earlier, enterprises could spread digital infrastructure across multiple servers or jurisdictions and claim that each was merely auxiliary. Action 7's anti-fragmentation rule now allows tax authorities to aggregate related server functions to identify a functional PE, ensuring that enterprises cannot escape taxation by scattering integrated digital processes globally. Therefore, it supports a substance-based interpretation, one that treats digital infrastructure performing core business operations as capable of giving rise to a Server PE.

7. Judicial Perspectives:

The interpretation of a PE in the digital era is being shaped by landmark court decisions across the globe, emphasizing functional and economic presence over mere physical location.

(a) Landmark Case: MasterCard Asia Pacific Pte. Ltd. (2018)[9]

A landmark Indian ruling by the Authority for Advance Rulings (AAR) in MasterCard Asia Pacific Pte. Ltd., profoundly shaped India's stance on server PE and digital presence.

• Facts in brief:

MasterCard, a Singapore-based entity, provided electronic payment processing services to Indian banks. Transactions initiated in India were routed through MasterCard's global network, with key servers located in the U.S. and Belgium. The company also had a liaison office (LO) in India for coordination and marketing support.

• Revenue's contention:

The Indian tax authorities argued that the servers abroad constituted a fixed place PE in India since they played a critical role in processing Indian transactions. Further, the Indian LO acted as a dependent agent PE and a part of the integrated business structure.

• AAR's findings:

The AAR held that:

- The network infrastructure, including servers, switches, and processing systems, formed an integrated and unified set of business facilities;
- Even if physical servers were located outside India, the automated processing of Indian transactions through those servers established a *nexus* with India;
- The liaison office's role, combined with the server operations, created both a fixed place PE and a dependent agent PE for MasterCard in India.

In essence, the AAR emphasized functional and economic presence over mere geographic location. The focus shifted from where the server sits to where value is created and used.

This ruling was one of the first in India to treat technology infrastructure as an extension of the enterprise's office, signalling a major shift in the interpretation of PE in the digital era.

(b) *Director of Income-Tax* v. *Galileo International Inc.* (Delhi High Court, 2009)[10]

A similar judicial position was observed in *Director of Income-Tax* v. *Galileo International Inc.* (Delhi High Court, 2009), the Delhi High Court held that a computerized reservation system accessed by Indian travel agents constituted a PE in India. Subscriber terminals connected to foreign servers enabled booking functionalities integral to the enterprise's business. Although servers were located abroad, the enterprise had virtual presence in India and derived commercial benefit through systematic digital engagement.

(c) *ITO* v. *Right Florists Pvt. Ltd.* (ITAT Kolkata, 2013)[11]

In the ruling *ITO* v. *Right Florists Pvt. Ltd.*, the Tribunal held that online advertising revenues earned by foreign enterprises through Indian user traffic did not create a PE in India where servers were located outside India and the enterprise lacked disposal and control over such servers. The case illustrates that mere user access or market reach, absent server control, is insufficient to constitute PE.

(d) Schleswig-Holstein Tax Court (Germany, 2001)[12]

The Schleswig-Holstein Tax Court held that a German company had a permanent establishment in Switzerland because its server, installed on leased premises there, hosted and provided access to programs for Swiss customers. The server was under the company's control and performed essential functions of its business. It was not a mere data-storage facility but an integral part of the company's commercial activity.

8. Conclusion:

The evolution of PE rules reflects a fundamental shift: value today is created digitally, not by brick-and-mortar establishments. While servers once served as the anchor of digital nexus, the taxable office of the internet age, the rise of cloud computing has made the idea of a fixed place of business increasingly obsolete.

As economies move online and governments seek to tax profits where digital value is derived, PE must transform from a test of physical presence to a test of economic engagement. The frontier of nexus is no longer defined by buildings or staff, but by servers, data flows, and sustained interaction with users across borders.

In this borderless economy, economic significance is the new presence, and the rules of taxation are being rewritten to follow where value truly lives.

Therefore, as jurisdictions gravitate toward functional and user-centric nexus standards, the relevance of digital presence will only intensify. Going forward, tax systems must balance administrative practicality with economic fairness, ensuring that profits are taxed where value is digitally realized rather than merely where infrastructure happens to be located.

■■

1. OECD, Model Tax Convention on Income and on Capital: Condensed Version 2017, Commentary on Article 5, para. 123
2. OECD, Model Tax Convention on Income and on Capital: Condensed Version 2017, Commentary on Article 5, para. 128-130
3. OECD, Model Tax Convention on Income and on Capital: Condensed Version 2017, Commentary on Article 5, para. 124
4. OECD, Model Tax Convention on Income and on Capital: Condensed Version 2017, Commentary on Article 5, para. 123-124
5. OECD/G20 Base Erosion and Profit Shifting Project, Addressing the Tax Challenges of the Digital Economy, Action 1: 2015 Final Report, para 345
6. OECD/G20 Base Erosion and Profit Shifting Project, Tax Challenges Arising from Digitalisation – Interim Report 2018,Inclusive Framework on BEPS, para 381
7. Under Explanation 2A of Section 9(1)(i) of Income tax Act' 1961
8. OECD/G20 Base Erosion and Profit Shifting Project, Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7: 2015 Final Report, para 14-15
9. [2018] 100 taxmann.com 220 (AAR - New Delhi)
10. [2009] 180 Taxman 357 (Delhi HC)
11. TS-137-ITAT-2013(Kol)
12. Finanzgericht Schleswig-Holstein, Decision of 6 Sept 2001, Case No. II 1224/97, EFG 2001, 1535