# Clicks and Mortar: Taxing Multinational Business Profits in the Digital Age

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International tax treaties generally provide for the business profits of multinational enterprises to be taxed in the jurisdiction where the enterprise has a fixed base or "bricks and mortar" establishment. Technological developments have contributed to the deterioration of the tax base in many countries. Digital technologies, such as the Internet, challenge international norms that rely upon physical presence as the basis for jurisdictional income taxation. The growth of electronic commerce and the increasing use of tax havens have spurred pleas for international tax reforms.

International tax reforms must satisfy accepted tax policies, including the principles of neutrality and inter-nation equity. Income from e-commerce ("clicks") should be treated in a similar manner to traditional business income ("mortar"). Equity concerns question whether the permanent establishment rule for taxation of multinational business income unfairly impacts the treasuries of less developed countries. Treaty rules typically preclude countries from taxing business profits derived from activities within their jurisdiction, unless these activities can be connected to a physical establishment located within the jurisdiction. The country where the buyer resides foregoes tax jurisdiction in favor of the nation that is home to the business enterprise. These treaty rules effectively represent a mechanism of reverse foreign aid—potential tax revenues flow from the treasuries of poor countries to the treasuries of wealthy or developed nations.

The current imbalance in the distribution of tax revenues and other inadequacies of the prevailing international tax regime could be ameliorated through the adoption of treaty rules that

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replicate the domestic tax rules adopted by most countries, including the United States. In other words, international tax reforms should restore the primacy of "market country taxation" of multinational business profits by abandonment of the treaty concept of permanent establishment.

## INTRODUCTION

The emergence of electronic commerce (e-commerce) casts a daunting specter over the current regime of international income taxation. Existing tax rules were established to handle transfers of physical goods and services across borders. Globalization, e-commerce and the increasing use of tax havens have created a fiscal crisis that threatens the security of the tax base of most industrialized nations.[1] As a result, many of the world's national tax authorities are struggling to utilize unstable mechanisms and outdated tax rules to identify and collect crucial revenues.[2]

Numerous governments ponder the potential impact that the Internet and electronic commerce would have on prevailing tax rules.[3] The approaches favored by domestic tax authorities vary considerably. The United States (U.S.) and other industrial nations generally recommend *ad hoc* modifications to existing international tax laws and

1. *See* Reuven S. Avi-Yonah, *Globalization, Tax, Competition, and the Fiscal Crisis of the Welfare State*, 113 HARV. L. REV. 1573, 1578–80 (2000) (noting that while the growth of international trade has escalated the importance of tax revenues from cross-border business activities for the treasuries of many countries, international tax competition represents a serious challenge to the tax base of most nations).

2. Although the tax authorities of many nations appear to acknowledge that business profits are being manipulated by technological mechanisms, they continue to rely upon and apply historical international tax rules to e-commerce. *See* Arthur J. Cockfield, *Balancing National Interests in The Taxation of Electronic Commerce Business Profits*, 74 TUL. L. REV. 133, 137–38 (1999).

3. For United States Treasury initiatives see: Office of Tax Policy, U.S. Department of the Treasury, SELECTED TAX POLICY IMPLICATIONS OF GLOBAL ELECTRONIC COMMERCE (Nov. 1996) [hereinafter U.S. E-Commerce Report]; President William J. Clinton & Vice-President Albert Gore, Jr., A FRAMEWORK FOR GLOBAL ELECTRONIC COMMERCE (1997); and Advisory Commission on Electronic Commerce, REPORT TO CONGRESS, *available at* http://www.ecommercecommission.org/acec_report.pdf (last visited June 3, 2003). For Canadian reports on e-commerce taxation see The Minister's Advisory Committee on Electronic Commerce, ELECTRONIC COMMERCE AND CANADA'S TAX ADMINISTRATION: A REPORT TO THE MINISTER OF NATIONAL REVENUE FROM THE MINISTER'S ADVISORY COMMITTEE ON ELECTRONIC COMMERCE (Apr. 1998) [hereinafter Canada E-Commerce Report], *available at* http://www.ccraadrc.gc.ca/tax/business/ecomm/ecom2e.html. For the United Kingdom see Inland Revenue & HM Customs and Excise, ELECTRONIC COMMERCE UK POLICY ON TAXATION ISSUES (Oct. 1998) *available at* http://www.inlandrevenue/gov.uk/e-commerce/release128_98.htm. For Australia, see Australian Tax Office, TAX AND THE INTERNET: DISCUSSION REPORT OF THE ATO ELECTRONIC COMMERCE PROJECT (Aug. 1997) *available at* http://downloads.ato.gov.au/content/business/downloads/ECOM_P1.rtf.

norms to deal with e-commerce.[4] In contrast, tax authorities from developing countries tend to propose the abandonment of the traditional tax treaty principle of "permanent establishment" and the adoption of international tax norms that could apply to electronic commerce as well as to traditional cross-border business activities.[5] One of the few points of agreement is that the application of prevailing tax treaty rules will lead to unsustainable inequities and distortions in the taxation of international business profits.

This Article argues that governments should abandon the treaty concept of permanent establishment and adopt international tax reforms that restore the primacy of "market country"[6] taxation of multi-

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4. *See* OECD Committee on Fiscal Affairs, ELECTRONIC COMMERCE: TAXATION FRAMEWORK CONDITIONS 4 (1998) [hereinafter OECD Framework] *available at* http://www.oecd.org (where the OECD indicates that its members prefer the extension of historical international tax principles and concepts to electronic commerce). *See also* OECD, ELECTRONIC COMMERCE: THE CHALLENGES TO TAX AUTHORITIES AND TAXPAYERS (1997); OECD, THE ECONOMIC AND SOCIAL IMPACT OF ELECTRONIC COMMERCE: PRELIMINARY FINDINGS AND RESEARCH AGENDA 12 (1999) [hereinafter OECD E-Commerce Report]. The Organization for Economic Co-operation and Development (OECD) is a multilateral organization comprised of thirty member countries that share "a commitment to democratic government and the market economy." The OECD is currently the lead organization entrusted with the task of developing rules and policies for the taxation of cross-border e-commerce transactions. In addition to having a representative from the European Union (EU), the current membership of the OECD is comprised of representatives from the following nations: Australia, Austria, Belgium, Canada, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Iceland, Italy, Japan, Korea, Luxembourg, Mexico, Netherlands, New Zealand, Norway, Poland, Portugal, Slovak Republic, Spain, Sweden, Switzerland, Turkey, United Kingdom, and the United States of America. For information as to the membership of the OECD and to view all of the OECD documents referred to in this Article, visit http://www.oecd.org.

5. Tax authorities in India recently recommended "that the concept of permanent establishment should be abandoned and a serious attempt should be made within OECD or the United Nations to find an alternative to the concept of permanent establishment." India Ministry of Finance, REPORT OF THE HIGH POWERED COMMITTEE ON E-COMMERCE AND TAXATION, at Executive Summary 11–12 (Sep. 2001) [hereinafter India E-Commerce Report] *available at* http://www.bmck.com/ecommerce/India%20E-Commerce%20Report.pdf. Developing nations have historically opposed the use of the tax treaty concept of permanent establishment since its inception on the basis that the principle favours developed countries and capital exporting nations. *See* Sonia Zapata, *The Latin American Approach to the Concept of Permanent Establishment in Tax Treaties with Developed Countries*, 52 BULL. FOR INT'L FISCAL DOCUMENTATION 252 (1998).

6. Tax literature generally refers to the country where a business is incorporated or has its head office as the "residence country" and the country where income is generated as the "source country". The terms "residence" and "source" are problematic when used in the global context of electronic commerce. For instance, it would be difficult to utilize the typical residence-source distinction where a U.S. citizen downloads British music through a web server located in Bahamas while the consumer is working in Canada. Since traditional definitions of residence and source are increasingly blurred by e-commerce, I introduce the concept of "market country" to mean the jurisdiction where the consumer ordinarily lives and works. When used in the context of e-commerce, the term "residence country" refers to the nation where the central place of management of the e-commerce vendor is situated while "source country" refers to the nation where the buyer resides, which can generally also be referred to as the host or "market country."

national business profits promoted by domestic tax laws. Part I explores several emerging e-commerce issues that demonstrate the tension of introducing traditional tax norms to a digital environment. Part II reviews historical and recent developments in the international taxation of business profits and looks at the underlying trends and sentiments for reform of the existing system of global taxation of business income. Part III canvasses several prominent international tax reform alternatives proposed by governments, multilateral organizations and tax commentators around the world. Finally, Part IV proposes the adoption of tax rules and norms that allow each nation unfettered jurisdiction over business income, including e-commerce profits, derived from transactions completed within that country's borders.

## I. TECHNOLOGY AND THE CHALLENGE TO GLOBAL TAX REVENUES

### A. *Types of Electronic Commerce*

The quintessential electronic commerce transaction involves the sale and delivery of intangible products and services through computer networks. E-magazines, music, video games, software and travel services are all intangible items that can be procured over the Internet without ever manifesting themselves outside of a computer. The process of marketing, distribution, payment and delivery of an intangible good or service may be completed electronically without the need for physical delivery of the product or service. It is the intangible nature of electronic commerce that fundamentally challenges traditional international tax concepts and practices.[7] The distinction between the sale of a digital good and the delivery of a service over the Internet can be obscured to suit the commercial intentions of the parties. The online purchase and delivery of an intangible good or service is distinguishable from the purchase of physical products using the Internet.

Consumers can purchase tangible goods and services such as books, groceries, clothing, and travel tickets by merely interfacing with a vendor's web site. The major distinction between these two types of e-commerce is that most tangible products and services require physical delivery even if marketed or purchased through a digital medium. E-commerce transactions involving the sale and delivery of physical goods and services are similar in many respects to traditional

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7. *See* Jinyan Li, *Rethinking Canada's Source Rules in the Age of Electronic Commerce: Part 2*, 47 CAN. TAX J. 1411, 1413 (1999).

modes of commerce. When a tangible product is purchased online, the Internet acts as a modern communication device, similar to a telephone or facsimile machine, for the promotion and sale of goods and services in the marketplace. While the increasing popularity of online purchases of tangible goods and services presents several challenges to international tax authorities, such transactions are less problematic than their purely electronic counterpart.

### *B. Emerging Issues: Taxation and the Digital Economy*

The growth of electronic commerce raises important issues for the taxation of international income. The following sections outline several aspects of e-commerce that present difficulties for the collection of taxes in a digital environment.

#### 1. Elimination of Intermediates and the Threat to Tax Collection

Current rules and practices cannot resolve the difficulties of collecting taxes in a digital environment. At present, tax authorities rely upon various intermediaries as crucial sources of information as well as for the collection and remittance of taxes. E-commerce circumvents traditional audit and collection points by eliminating or redefining the role of intermediaries.[8] The absence of traditional intermediaries in the electronic world constitutes a serious problem for tax authorities because governments have been unable to devise an efficient system to handle the due and timely processing of e-commerce tax revenues.[9] The loss of crucial audit or verification points will eventually undermine the administrative efficacy of the entire income tax system.[10]

While tax authorities are seriously concerned about the impact that e-commerce will have on the income tax system, the collection

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8. The Internet has started to replace traditional retail outlets in certain countries. In Sweden, electronic commerce accounts for thirteen percent of total sales. *See* Organisation for Economic Co-operation and Development, INFORMATION TECHNOLOGY OUTLOOK—HIGHLIGHTS, 7–8 (2002) *available at* http://www.oecd.org/EN/statistics (indicating that over thirty percent of all households in Sweden regularly purchase goods and services over the Internet). In the United States, e-commerce sales totalled $27.29 billion (USD) in 2000, approximately $32 billion (USD) in 2001, and over $43 billion (USD) in 2002, now accounting for about 1.5% of total sales in the country. *See* U.S. Department of Commerce, *U.S. Census Bureau News Release*, (May 23, 2003), *available at* http://www.census.gov/mrts/www/current.html.

9. *See* Andrew L. Shapiro, *Symposium Article: Digital Middlemen and the Architecture of Electronic Commerce*, 24 OHIO N. U. L. REV. 795 (1998).

10. The self-reporting nature of most income tax systems will exacerbate the collection difficulties associated with the Internet's removal of intermediaries. *See* Arthur J. Cockfield, *Transforming the Internet into a Taxable Forum: A Case Study in E-Commerce Taxation*, 85 MINN. L. REV. 1171 (2001) (arguing that tax authorities should expect that multinational firms will conduct various tax arbitrage and transfer pricing strategies to take advantage of the Internet disintermediation process).

and remittance of sales and other indirect taxes on electronic transactions represents an even greater problem for many tax jurisdictions.[11] The laws of most jurisdictions conscript traditional retailers to collect and remit taxes on behalf of the national treasury. It is difficult to apply collection obligations to the digital forum due to inconsistencies in the tax base and the absence of verification controls. Tax authorities recognize that the potential for lost revenue is particularly acute in respect of a state's collection of value-added taxes and other sales taxes.[12] Discrepancies between the tax treatment of e-commerce goods and traditional products also serve to distort or unduly influence market behavior.[13] The absence of any effective regulatory controls on the Internet restricts the ability of tax authorities to monitor taxable transactions. E-commerce vendors can bypass tax collection mechanisms with relative impunity because of the absence of any stringent governmental verification mechanisms. In so far as the Internet eliminates the use of traditional intermediaries, it exposes deficiencies inherent in a self-reporting tax system. The pitfalls in existing collection, administration and enforcement mechanisms will necessarily correspond to reduced national tax revenues.

### 2. Challenges to the Present System: Identification of Taxpayers and Taxable Transactions

Tax authorities must be able to identify and monitor e-commerce transactions in order to determine the existence of tax liability and to

11. *See* Committee on Fiscal Affairs, OECD, ELECTRONIC COMMERCE: A DISCUSSION PAPER ON TAXATION ISSUES 18 (Sept. 1998) ("Problems concerning the application of consumption taxes are generally recognized as having more immediacy than the issues concerning direct taxation."). The United States General Accounting Office estimates sales tax losses for U.S. states will exceed $1 billion (and may be as high as $12.4 billion) in 2003 if electronic commerce sales continue to be allowed to escape state sales taxation. *See* United States General Accounting Office, SALES TAXES: ELECTRONIC COMMERCE GROWTH PRESENTS CHALLENGES; REVENUE LOSSES ARE UNCERTAIN 20–21 (June 2000) *available at* http://www.gao.gov/new.items/g600165.pdf; *see also* Donald Bruce & William F. Fox, *State and Local Sales Tax Revenue Losses from E-Commerce: Updated Estimates,* STATE TAX NOTES 13 (Sept. 2001) (estimating that state and local governments in the U.S. actually suffered total revenue losses of $13.3 billion in 2001 as a result of e-commerce) *available at* http://cber.bus.utk.edu/ecomm/ecom0901.pdf.

12. *See* Cockfield, *supra* note 10, at 1185.

13. Existing sales tax laws within North America treat items differently depending on whether the taxable item constitutes a tangible product, a service, or an intangible good. *See* Aldo Forgione, *E-Taxation: International Taxation of E-Commerce, in* A. GAHTAN ET AL, EDS., ELECTRONIC COMMERCE: A PRACTITIONER'S GUIDE 16.38–46 (Carswell ed., 2003) (reviewing the federal government of Canada's goods and services tax, Canadian provincial governments' harmonized and retail sales tax rules and the sales and use tax treatment of e-commerce by state and local jurisdictions in the United States).

collect the tax from the taxpayer.[14] The Internet, however, is a relatively anonymous medium.[15] E-commerce operates in a realm where identities and national borders are blurred. Consequently, governments are concerned about the absence of uniform means to identify Internet participants. These challenges are compounded by the difficulties of identifying and linking taxpayers to the particular e-commerce transaction, and become even more daunting when the products involved are intangible goods or services with parties residing in separate jurisdictions. In so far as e-commerce presents opportunities for a new breed of entrepreneurs to conceal their identities and activities, such transactions challenge one of the core features of a national tax system. The need for effective tax regulation is necessary because commercial activity that escapes taxpayer identification and tax collection threatens government treasuries.[16]

### 3. Tax Havens and the Manipulation of Tax Rules

Multinational business profits are *prima facie* subject to taxation in the jurisdiction where the company resides.[17] National tax laws invariably determine corporate residence by looking either to the place of incorporation of the entity or to the location of the company's central management.[18] The fragmented system of international income tax rules provides ample opportunity for multinational enterprises to structure e-commerce activities in a manner that escapes taxation entirely.[19] Consequently, a standard that ties tax jurisdiction to the state

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14. *See* Canada E-Commerce Report, *supra* note 3, at 4.1.1 (describing the following four tasks as essential to the effective administration of an income tax system: (1) identification of taxpayer; (2) identification of taxable transactions; (3) proving a link between taxpayer and taxable transactions; and (4) collection of tax from the taxpayer).

15. *See* U.S. E-Commerce Report, *supra* note 3, at 17–18.

16. The current system for exchange of information between national tax authorities does not effectively deal with exchanges of digital information. *See* Sara K. McCracken, *Going, Going, Gone . . . Global: A Canadian Perspective on International Tax Administration Issues in the "Exchange of Information Age"*, 50 CAN. TAX J. 1869, 1883 (2002).

17. A corporation that is considered a resident of the United States, for instance, is subject to U.S. income tax on its worldwide income from all sources. *See* James M. Gannon & Jeffrey A. Weiss, *Federal and International Income Taxation of E-Commerce* in KARL A. FRIEDEN, CYBERTAXATION: THE TAXATION OF E-COMMERCE 440 (CCH Inc., 2000). The tax treatment of nationals will be explored at Part II.A *infra*.

18. The "place of incorporation" refers to the state or country under whose law the company is created; the "place of central (or effective) management" is a standard developed by the courts that attempts to determine the jurisdiction where central management and control takes place, but this common law test is not based on any single uniform concept across Anglo-Saxon tax laws. *See* RICHARD L. DOERNBERG ET AL, ELECTRONIC COMMERCE AND MULTIJURISDICTIONAL TAXATION 74–75 (Kluwer Academic Publishers, 2001).

19. The avoidance of income taxation through the use of existing residency laws can take a variety of forms. *See* Organization of Economic Cooperation and Development, THE OECD'S REPORT ON HARMFUL TAX PRACTICES: THE 2001 REPORT (released Nov. 14, 2001) [herein-

where the corporation is created is subject to manipulation. For many multinational enterprises, the incorporating jurisdiction does not correlate to the location of the effective management and control of the company.

Tax authorities that turn to the common law place of management standard for determining corporate residency in a digital environment are encountering a new set of problems. Global corporations are now capable of utilizing new technologies in a manner that allows officers, directors, and even management to maintain residences in different jurisdictions.[20] For instance, the place of central management test is difficult to apply when video conferencing and the Internet allow directors, officers, and managers to attend meetings and govern business affairs without leaving their desks. E-commerce and technology businesses do not need physical headquarters in order to carry on business activities within a jurisdiction.[21] Current tax laws effectively allow multinational entities to elect the tax regime applicable to their foreign business operations.[22]

Tax authorities are particularly concerned about technology businesses and financial institutions establishing residence in tax havens.[23] For example, intensely mobile e-commerce businesses have the technological capacity and the financial incentive to shift commercial operations and corporate residency to a jurisdiction that reduces the company's total tax liability.[24] Technological developments enable multinational enterprises to shift business income to tax havens and to relative low-tax jurisdictions. In response, governments and interna-

after OECD Harmful Practices Report]. In the United States an increasing number of companies that derive income from "clicks" (e-commerce sales) and from "mortar" (retail and other sales activities) separate their corporate activities by incorporating an affiliate and conducting the enterprise's online operations through the isolated affiliate company. *See* John A. Swain, *Cybertaxation and the Commerce Clause: Entity Isolation or Affiliate Nexus?*, 75 S. CAL. L. REV. 419 (2002); *see also* Arthur J. Cockfield, *Walmart.com: A Case Study in Entity Isolation*, 25 STATE TAX NOTES 633 (Aug. 26, 2001).

20. *See* Taylor Morgan Hoffman, *The Future of Offshore Tax Havens*, 2 CHI. J. INT'L L. 511 (2001) (showing that the combination of innovative technologies and the globalization of capital markets has encouraged the use of low-tax jurisdictions by multinational corporations).

21. "The application of nexus standards to e-commerce transactions is a uniquely difficult undertaking." FRIEDEN, *supra* note 17, at 357.

22. Brian J. Arnold, Jacques Sasseville, and Eric M. Zolt, *Symposium: Summary of the Proceedings of an Invitational Seminar on the Taxation of Business Profits Under Tax Treaties*, 50 CAN. TAX J. 1979, 1982 (2002).

23. "Until recently, the number of tax-haven financial institutions was limited as was practical access to them. Today, it is estimated that over $2 trillion in assets are managed by offshore financial institutions—a business that is growing at the rate of 15% per annum." Canada E-Commerce Report, *supra* note 3, at 4.2.2.9.

24. Li, *supra* note 7, at 1418 (arguing that technological developments enable new businesses to more readily shift residence and still carry on serving clients in foreign jurisdictions).

tional organizations struggle to develop solutions to the prospect of revenue losses as e-commerce gains further prominence. The application of static residency rules for tax purposes is increasingly difficult in a digital economy. These challenges are compounded by the absence of multilateral consensus on how to determine the residency of a global e-commerce business or how to attribute e-commerce income to a particular taxpayer.[25] So as long as tax authorities place great emphasis on the residency of the taxpayer, there will be a gradual diminution of the tax base of many industrialized countries and the loss of significant tax revenues.

4. Establishing Transfer Prices for Intangible Products

Multinationals and related enterprises often have offices, networks and web sites that serve more than one country; and frequently transfer goods, services and capital among themselves. Since prices established for such transfers are typically shown as income to the supplier and as a corresponding expense to the recipient, multinational enterprises are financially motivated to inflate the firm's income in a low tax jurisdiction and reduce the net income claimed by the firm in a relative high tax jurisdiction. If left unchecked, global enterprises will establish prices for transfers of products and services in a manner that shifts taxable revenues beyond the jurisdiction of the authorities. Tax authorities around the world have responded to perceived transfer pricing abuses by enacting rules that generally utilize an arm's length standard for the determination of prices between parties.[26] Current transfer pricing guidelines permit tax authorities to review transactions on a case-by-case basis in order to find comparable transactions

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25. There exists no internationally agreed approach on how attribution of income to a web site should be accomplished and no accepted means to determine ownership of existing web sites. Daniela Ivascanu, *Legal Issues in Electronic Commerce in the Western Hemisphere*, 17 ARIZ. J. INT'L & COMP. L. 219, 244 (2000).

26. The United States, which is undoubtedly the most active government in establishing guidelines for setting transfer prices among related entities, generally promotes the arm's length standard for establishing transfer prices (i.e. tax authorities look to taxpayers in comparable circumstances that are engaged in comparable transactions in order to determine the appropriate transfer price between the parties). Many other countries rely heavily on the Organization for Economic Cooperation and development guidelines. *See* Committee on Fiscal Affairs, Organization for Economic Cooperation and Development, THE TRANSFER PRICING GUIDELINES FOR MULTINATIONAL ENTERPRISES AND TAX ADMINISTRATION (loose-leaf, 2003) (concluding that "to date practical experience has shown that, in the majority of cases, it is possible to apply traditional transaction methods" to determine the price two arm's length parties would have agreed was a reasonable price in a transaction involving related parties).

and establish an objective arm's length price for the product or service being transferred.[27]

While incidences of preferential transfer pricing have escalated due to increased trade globalization, the growth of e-commerce has greatly complicated the application of prevailing anti-tax avoidance rules.[28] As multinational enterprises continue to decentralize their functions, the development of telecommunications and information technology has made it easier to shelter increasingly complex transfer price transactions from tax authorities. The growth of e-commerce, particularly in the business-to-business sector, presents a tremendous challenge to existing transfer pricing mechanisms because digital products and services tend to be highly integrated and intangible in nature. As a result, it is extremely difficult to apply a transactional or functional arm's length standard to technology and e-commerce businesses that utilize valuable intangible properties, patents, trademarks, and licenses to earn income in multiple jurisdictions.[29]

United States tax authorities have responded to perceived abuses by formulating policies and enacting legislation that arbitrarily establish prices for intangible assets and benefits accrued to intellectual property rights.[30] Unfortunately, these policies and legislative provisions represent a potential minefield for multinational technology-

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27. The U.S. Treasury has the legislative authority to redetermine the income of any entity subject to U.S. taxation if it appears that there has been an improper shifting of income between the U.S. taxpayer and a related entity in a foreign jurisdiction. I.R.C. § 482 (2002) [hereinafter I.R.C.] of the *Internal Revenue Code of 1986*, as amended, authorizes the Secretary of the U.S. Treasury to adjust transactions between related "organizations, trades or businesses" that are under common control. The U.S. Treasury revised its transfer pricing regulations in the 1990s to permit greater use of "qualified cost sharing arrangements." *See* Treas. Reg. § 1.482-4(9) (2002) and Treas. Reg. § 1482-7(a)(1) (2002). In Canada, tax authorities have the power to adjust prices or transaction amounts established by related companies or other entities not dealing at arm's length pursuant to R.S.C. § 247(2), c. 1 (5th Supp., 1985) [hereinafter I.T.A.], of the *Income Tax Act*, as amended. International Transfer Pricing, Information Circular 87-2R, released on September 27, 1999, makes reference to several approaches that Canadian tax authorities would adopt or consider as appropriate in order to determine the reasonable value or price of the product or service under an arm's length arrangement.

28. Arnold, Sasseville, and Zolt, *supra* note 22, at 1981 (indicating that "recent changes in the economic environment may expose the increasing inability of many countries to tax the business profits of non-resident taxpayers effectively").

29. DOERNBERG, *supra* note 18, at 309 (noting that "the business integration resulting from intra-networking also exacerbates the particular issue of inter-jurisdictional allocation of the benefits of the increased group productivity, synergy effects and strategic bundling of MNE-resources").

30. Section 482 of the *Tax Reform Act* of 1986 added the following sentence: "In the case of any transfer (or license) of intangible property (within the meaning of § 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible." Basically, the value of the income stream generated from an intellectual property right will be used to determine the value or transfer price to be attributed to the intangible property right.

based companies that share or transfer customer lists, licenses, reports, and other intangible intellectual property rights with U.S. entities within the global enterprise. Basically, U.S. government transfer pricing regulations obligate multinational enterprises to report the theoretical value of royalty and license income based on the real value of the intangible.[31] These notional or imaginary royalties would be treated as foreign source income to the U.S. owner of the intangible property and, therefore, subject to U.S. income taxation in the same manner as actual royalties. Since the parties to a challenged pricing arrangement are bound to accept the determination made by the domestic tax authority with very limited recourse, it is possible for double taxation to occur in transactions involving challenged global transfers of digital goods and services.[32]

The process of evaluating and establishing arbitrary market prices for intangible goods and services is an impractical and illusory mechanism for governments to utilize. Judges, bureaucrats and taxpayers have difficulty applying notional value and attribution standards for intangible rights within a digital environment.[33] Tax authorities could apply wildly fluctuating valuations for seemingly similar intangible property rights. The growth of e-commerce and the proliferation of licensing agreements could easily overwhelm tax authorities that continue to rely on arbitrary transfer pricing mechanisms. In sum, application of current international transfer pricing rules to electronic commerce represents an administrative nightmare with no relief in sight.

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31. The Internal Revenue Service, U.S. courts and taxpayers have to varying degrees experienced difficulties in determining the real value or appropriate price of intangible property under I.R.C. § 482. *See* Arup K. Bose, *The Effectiveness of Using Cost Sharing Arrangements as a Mechanism to Avoid Intercompany Transfer Pricing Issues With Respect to Intellectual Property*, 21 VA. TAX REV. 553, 554 (2002).

32. Double taxation could arise in instances where a transfer price is readjusted by the tax authority of one country without the corresponding adjustment to the reported price of the receipt or expenditure being provided by the tax authorities of other countries. For instance, if the U.S. Treasury adjusts the transfer price for a good or service to a higher notional amount pursuant to I.R.C. § 482, the U.S. taxpayer will be responsible for payment of the increased U.S. tax liability even though foreign tax authorities may have accepted the original transfer price arrangement chosen by the taxpayer and the related entity.

33. See Bose, *supra* note 31 for an explanation of how U.S. courts, government authorities and taxpayers are struggling with notional determinations of value for intangibles. Canada's courts have also encountered difficulty in rationalizing transfers of intangible expenses between related companies for tax purposes. *See* Cudd Pressure Control Inc. v. The Queen, 98 D.T.C. 6630 (1998) (holding that a notional payment of rent for equipment by the Canadian permanent establishment could not be deducted). *See also* Twentieth Century Fox Film Corp. v. The Queen, 85 D.T.C. 5513 (1985) (finding that the Canada-U.S. bilateral taxation treaty in effect at that time did not authorize a deduction for the notional payment of royalties from the Canadian permanent establishment to the U.S. head office).

### 5. Computer Servers and Permanent Establishments

Computer servers facilitate the processing and delivery of income-producing goods and services over a digital network. Since international tax law attaches significance to the physical process whereby income is generated, the location of a computer server is becoming increasingly important in connection with the taxation of income derived from e-commerce transactions.[34] Over the past few years, there has been a multilateral movement to extend the permanent establishment definition found in most tax treaties to include computer servers and, under certain circumstances, web sites and Internet Service Providers (ISPs).[35] In lieu of the notion that a web server represents a physical piece of equipment that can be used by the taxpayer for commercial purposes, tax authorities argue that the server and its physical manifestations may constitute a permanent establishment of the e-commerce vendor.[36] This move expressly reaffirms the notion that a taxpayer must have a fixed place of business within a nation in order for the treasury of that nation to tax the income of the foreign business enterprise.[37]

The tax treaty concept of permanent establishment has been in effect for over 100 years.[38] While the initial drafters of the permanent

34. Income derived from the sale of goods and services is subject to taxation to the extent that tax laws legally connect the income to the taxpayer's activities in the jurisdiction. The threshold established by domestic tax laws in respect of the business activities is typically much lower than the nexus requirement established in most international tax treaties. In a typical bilateral tax treaty, a country is authorized to tax only those business profits that are attributable to a "permanent establishment" of the taxpayer in the country. *See* DOERNBERG, *supra* note 18, at 204.

35. The Organization for Economic Cooperation and Development (OECD) released a series of reports in 2001 that basically encouraged its member governments to extend the treaty definition of permanent establishment to include, in some circumstances, computer servers. *See* OECD, TAXATION AND ELECTRONIC COMMERCE—IMPLEMENTING THE OTTAWA TAXATION FRAMEWORK CONDITIONS (2001) [hereinafter OECD Server Proposal]; *and* OECD, ATTRIBUTIONS OF PROFIT TO A PERMANENT ESTABLISHMENT INVOLVED IN ELECTRONIC COMMERCE TRANSFERS (Feb. 1, 2001) [hereinafter OECD PE Report] *available at* http://www.oecd.org.

36. *See* OECD Server Proposal, *supra* note 35.

37. The proposal to include servers within the treaty definition of permanent establishment was implemented by adding a new paragraph 17 to the Commentary on Article 5 of the OECD, MODEL DOUBLE TAXATION CONVENTION ON INCOME AND ON CAPITAL (Paris, 2003) (loose-leaf) [hereinafter OECD Model]. Article 5 of the OECD Model establishes the proposition that a "fixed place of business" constitutes a permanent establishment for tax purposes. For further discussion on whether the definition of permanent establishment ought to include computer servers, web sites, and ISPs, see OECD, Working Party No. 1 on Tax Conventions and Related Questions, CLARIFICATION ON THE APPLICATION OF THE PERMANENT ESTABLISHMENT DEFINITION IN E-COMMERCE: CHANGES TO THE COMMENTARY ON ARTICLE 5 (December 22, 2000).

38. *See* ARVID A. SKAAR, PERMANENT ESTABLISHMENT: EROSION OF A TAX TREATY PRINCIPLE 75–76 (Kluwer Law and Taxation Publishers 1991) (noting that the "[c]oncept of

establishment definition can be excused for not having the foresight to envision the impact that digital technologies and the Internet would have on global commerce, modern tax experts ignore the economic reality of the digital age. For instance, e-commerce vendors are not dependent on physical plant or machinery in order to serve any particular market. International tax authorities ignore the underlying productive aspects of the technology by focusing on the physical or visible aspects of digital technology. The computer server is simply a piece of hardware. In most instances, servers satisfy auxiliary or preparatory functions in the e-commerce transaction.[39] The most essential component in a digital transaction is often the software that enables the business to conduct the functions that generate the income being considered for taxation.

The proposal to extend the permanent establishment definition to include computer servers gives rise to a host of administrative impossibilities.[40] The flexible and mobile nature of web servers could create numerous tax planning opportunities.[41] A computer server can be designed and located in such a manner as to adhere to or avoid the application of tax laws that use the permanent establishment threshold.[42] In addition, e-commerce businesses could incur substantial tax compliance costs if they must file tax returns in all countries where they have computer servers or other deemed agents.[43]

There is broad consensus among international tax experts that the OECD Model's physical presence standard adopts an inappropriate approach to the taxation of e-commerce and cross-border services.[44] Most national tax authorities are opposed to the notion that web site hosting would constitute evidence of a permanent establishment.[45] The business reality is that e-commerce vendors use secon-

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permanent establishment was well established in tax treaty practice from the first international treaty" involving Austria-Hungary and Prussia in 1899).

39. Tax authorities in Germany, for example, have recognized that the activities associated with web servers are preparatory in nature and not meant to be encompassed by the usual treaty definition of permanent establishment. Friedrich E.F. Hey, *German Tax Authorities Rule that Server Does Not Constitute Permanent Establishment*, 1999 WTD 153-1 (Aug. 10, 1999).

40. Since e-commerce businesses employ server arrays that permit a website and its functions to be dispersed over many servers located in multiple jurisdictions, the OECD proposal "raises the ludicrous spectre of tax authorities pouring over, on a case-by-case basis, thousands of line of computer code." Cockfield, *supra* note 10, at 1197.

41. *Id.* at 1195 (indicating that "the most straight-forward tax planning strategy would involve the placement of a server within a country that does not impose any income taxes on business profits").

42. U.S. E-Commerce Report, *supra* note 3, at 7.2.3.1.

43. *Id.* at 22.

44. *See* Arnold, Sasseville, and Zolt, *supra* note 22, at 1991–92.

45. In an earlier OECD report, it was agreed that website hosting would not create a permanent establishment within the source or market country. *See* OECD, Working Party No. 1

dary servers in target markets for advertising, storage and other auxiliary activities.[46] Instead of introducing a new concept or definition that could conceptually and logistically apply to electronic commerce, the OECD recommended a piecemeal approach to the addition of computer servers to the model treaty definition of permanent establishment.[47] The OECD server proposal effectively affirms the case-by-case application of the permanent establishment definition to technology and e-commerce companies.[48] The preoccupation of governments and other authorities with the maintenance of the physical presence standard for taxation sidesteps the need to introduce new tax concepts that address the economic and tax realities of the digital age.

6. Income Characterization: Royalty or Business Income?

One of the most important issues in the area of electronic commerce taxation involves the characterization of income derived from the sale or transfer of certain intangible goods and services. Income tax treaties and the domestic source rules of almost every country in the world rely upon the proper characterization of income in order to determine the appropriate tax treatment. Characterization of revenue as either ordinary business income or as royalty income will result in significantly different tax treatment. For example, the sale or licensing of computer software generates fees that can reasonably be treated as either a royalty or as business income.

If software license fees are treated as royalty payments to the vendor, which is understandable as such payments are in essence remuneration for the right to use copyrighted material, then the pay-

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on Tax Conventions and Related Questions, PROPOSED CLARIFICATION OF THE COMMENTARY ON ARTICLE 5 OF THE OECD MODEL CONVENTION, Revised Draft for Comments 3 (Mar. 3, 2000) *available at* http://www/oecd.org/daf/fa/material.

46. "An e-commerce company could still maintain its main server in the residence country or tax haven to perform business activities, and use servers in target markets to perform mere auxiliary or preparatory activities. The source country servers simply could, for example, advertise on a web page and then cache—temporarily store on the server—any orders that would be relayed to the main server in the tax haven." Cockfield, *supra* note 10, at 1196–97.

47. The OECD Commentary delineated several material exceptions to the proposal to include web servers within the definition of permanent establishment. For instance, servers owned by ISPs or foreign companies for the hosting of web sites would be exempt from the definition of permanent establishment as would be web servers that provide communications links, advertise, relay information through mirror servers, gather data, supply information, or generally perform "preparatory or auxiliary activities." *See* OECD Server Proposal, *supra* note 35.

48. Canadian tax authorities have indicated that the issue of whether a computer server would be included within the treaty definition of a permanent establishment "will be dealt with on a case-by-case basis in a manner that is consistent with the Department's current published interpretations and rulings." Herb Dhaliwal, ELECTRONIC COMMERCE AND CANADA'S TAX ADMINISTRATION, A RESPONSE BY THE MINISTER OF NATIONAL REVENUE TO HIS ADVISORY COMMITTEE'S REPORT ON ELECTRONIC COMMERCE 6.3.2.4 (1998).

ment would typically be subject to withholding tax on the gross amount of the royalty by the country where the payment originated (usually referred to as the source country). In such cases, the vendor's country of residence (usually referred to as the residence country) levies further tax on the royalty payment in accordance with its domestic tax rules, but provides a credit to the resident vendor for foreign taxes paid.

However, where a license fee is viewed as generating sales or service income earned in the course of a business, then the international tax treatment of such income would be materially different. If the recipient of the income is resident in a country that has a tax treaty with the payor's country of residence, then the source country will only be allowed to tax the business income if the foreign recipient has a permanent establishment within the source country. Taxpayers will tend to categorize payments arising out of e-commerce transactions in a manner that reasonably minimizes their tax liability.[49]

The OECD released a report in 2001 that offered guidance to the tax authorities of its member states in resolving characterization issues relating to electronic commerce transactions.[50] The OECD was inclined to characterize most license sales and customized software transactions as generating business income on the basis that the capture and use of digital copyrighted information represents only a byproduct of the e-commerce transaction while the real purpose of most commercial transactions is to earn income for the business.[51] Since the classification of a payment as either royalty income or business income influences the amount of tax revenues collected by a country, the characterization of license fees can give rise to conflicting perspectives.

In the absence of clearly established rules, tax authorities will find it difficult to justify the categorization of unique license fee arrangements for the use of intangible goods and services as generating ordinary business income. In order to avoid excessive reliance on ambiguous or arbitrary categorizations of income, the solution may rest in greater harmonization of tax rates among different categories of income. Regretfully, it does not appear that a consensual resolution of

49. Tax authorities recognize that under a self-assessment income tax regime most taxpayers will characterize license fee income to their advantage if reasonable grounds exist to do so. *See* Canada E-Commerce Report, *supra* note 3, at 4.2.3.

50. The Technical Advisory Group responsible for the discussion proposals on characterization issues presented numerous case scenarios that purported to explain the OECD Model approach to various income characterization problems. OECD, TAX TREATY CHARACTERIZATION ISSUES ARISING FROM ELECTRONIC COMMERCE (Feb. 1, 2001) [hereinafter OECD Characterization Report].

51. *Id.*

the income characterization problems associated with information technologies will occur in the near future.[52]

## PART II: TAXATION OF MULTINATIONAL BUSINESS PROFITS

Multinational business income is subject to taxation in accordance with national tax laws. International taxation involves the application of the domestic tax rules of two or more countries to income that could be treated as being earned in multiple jurisdictions.[53] Nations voluntarily enter into bilateral tax treaties to resolve jurisdictional disputes and to apportion tax revenues between states.[54] Domestic tax law may constitute the main source of international tax law, but international tax principles and bilateral tax treaties represent increasingly important factors in determining the apportionment of tax revenues among countries as a result of cross-border business transactions.

### *A. Domestic Treatment of Global Business Income*

Most countries tax the global income of their own resident individuals, corporations and trusts.[55] To determine the taxpayer's world income, the amount of income derived from foreign sources is added to the income earned in the taxpayer's home jurisdiction.[56] Where two

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52. Harmonization of the tax treatment of different categories of income is unlikely even though international tax authorities widely acknowledge that "the present distinctions lack a logical foundation [because] royalties from e-commerce activities might be treated as either business profits or passive income subject to gross withholding regimes." *See* Brian J. Arnold, Jacques Sasseville & Eric Zolt, *Summary of the Proceedings of an Invitational Seminar on Tax Treaties in the 21st Century*, 50 CAN. TAX J. 65, 78 (2002) (noting that national authorities differ about whether treaties should have more or fewer categories and whether the international harmonization of any income category is even feasible or desired).

53. *See* BRIAN J. ARNOLD & MICHAEL J. MCINTYRE, INTERNATIONAL TAX PRIMER 3 (The Hague: Kluwer Law Int'l, 1995) ("international tax law" is a misnomer in that it "is more correctly referred to as the international aspects of the tax laws of particular countries").

54. "Treaties limit a country's tax jurisdiction and represent the compromise that two countries have reached in respect of the sharing of the tax base arising from cross-border transactions. Therefore, international tax law has two main sources: domestic law and treaty law." JINYAN LI, INTERNATIONAL TAXATION IN THE AGE OF ELECTRONIC COMMERCE: A COMPARATIVE STUDY (Canadian Tax Foundation, 2003) (manuscript on file with the author).

55. The tax treatment of business income varies from country to country. The United States is renowned as having the most comprehensive and complex set of rules for the taxation of international income. This section will provide an overview of the domestic treatment of multinational business profits under U.S. tax law. As Canada is the largest trading partner of the United States as well as a significant player in information technologies, this section will also review its domestic tax rules. Like the United States, Canada's income tax laws require its residents to report their worldwide income for each taxation period.

56. Detailed tax rules differ from country to country, but generally, the tax systems of most countries (for example, U.S., Canada, Japan and China) are structured so that residents are taxed on worldwide income. Some countries, most notably France and Germany, exempt the foreign

or more countries seek to tax the worldwide profits of a multinational taxpayer, there is the possibility that the same economic activity will incur double taxation during the same period. In order to avoid double taxation of the same income, the taxpayer's country of residence typically provides unilateral relief from double taxation by granting either a tax credit for foreign taxes paid by the taxpayer[57] or by exempting the foreign source income from domestic taxation.[58]

Non-residents and foreign entities are typically subject to taxation on income derived from business operations or investment sources situated within a given country.[59] Reference to domestic tax rules is required to ascertain whether business income earned by a foreign entity is subject to taxation in a jurisdiction where income may have been earned. Under the current system of international taxation, the determination of the source of business income is critical because it ultimately determines the allocation of tax revenues between jurisdictions.[60] The domestic tax laws of most nations attempt to attribute or connect business income from cross-border activities to commercial operations within the jurisdiction.

Jurisdictional rules for the taxation of multinational income vary significantly from one nation to another and from one income type to another. However, neither the foreign tax credit nor the exemption method would eliminate instances of double taxation that result from

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source income of their residents when calculating taxable income subject to domestic taxation. *See, generally,* HUGH J. AULT, COMPARATIVE INCOME TAXATION: A STRUCTURAL ANALYSIS (The Hague: Kluwer Law International 1997) (noting that there are also some countries, such as Hong Kong, that only tax income earned within the jurisdiction and a few countries that do not follow the world income or exemption models for international taxation).

57. Tax legislation in the United States and Canada allows a resident taxpayer to claim a credit for foreign taxes paid on foreign source business income,with the amount of the credit to be limited, on a country-by-country basis, to the amount of domestic tax that would otherwise be payable on the foreign source income. U.S. foreign tax credit rules are set out in I.R.C. §§ 901-904. Canada's foreign tax credit regime is set out in I.T.A. §§ 113, 126, 20(11) and 20(12).

58. Countries, such as France and Germany, which use the exemption or territorial system for taxation, avoid double taxation by exempting foreign source income from the resident taxpayer's taxable income base.

59. The claim that the "source country" has the primary jurisdiction to tax the business income of non-residents is a well-established and enduring principle of international taxation. *See* Robert A. Green, *The Future of Source-Based Taxation of the Income of Multinational Enterprises,* 79 CORNELL L. REV. 18 (1993); Richard Bird & Scott Wilkie, *Source- vs. Residence-based Taxation in the European Union: The Wrong Question?, in* TAXING CAPITAL INCOME IN THE EUROPEAN UNION: ISSUES AND OPTIONS FOR REFORM 78–109 (Sijbren Cnossen ed., Oxford University Press 2000).

60. Donald J.S. Brean, *Here or There? The Source and Residence Principles of International Taxation, in* TAXATION TO 2000 AND BEYOND 303–06 (Richard M. Bird & Jack M. Mintz eds., Canadian Tax Foundation 1992) (claims that the source principle of taxation also strengthens the efficiency of international capital markets, the real tax competitiveness of nations and the integrity of domestic tax bases in open economies).

overlapping source of income rules.[61] The lack of worldwide uniformity in establishing jurisdictional rules can be attributed to numerous factors, but the primary factors appear to be differences in historical antecedents and in the conscious attempt by governments to expand or protect territorial claims.[62] Industrialized countries are particularly inclined towards protecting their own tax jurisdiction at the expense of sound international tax policy. The domestic tax rules of the United States and Canada adopt a similar approach to the taxation of multinational business income. The following sections, though, demonstrate several important differences in the form and application of the tax rules in each of these jurisdictions.

### 1. United States

The Internal Revenue Code establishes a set of comprehensive rules for the taxation of the worldwide business income of all U.S. persons.[63] United States tax law utilizes different rules for determining the residency of individuals and corporations for domestic tax purposes. An individual is subject to U.S. taxation if he or she is a United States citizen,[64] a resident of the United States,[65] or a non-resident who

61. *See* Nancy H. Kaufman, *Fairness and the Taxation of International Income*, 29 LAW & POL'Y INT'L BUS. 145, 149–50 (1998) (explaining that taxpayers caught in overlapping source of income rules often rely on the provisions contained in an income tax treaty to prevent double taxation).

62. Robert L. Palmer, *Toward Unilateral Coherence in Determining Jurisdiction to Tax Income*, 30 HARV. INT'L. L.J. 1, 6 (1989).

63. United States persons are taxed on their worldwide income. I.R.C. § 61 (2002). Citizens, resident individuals, domestic partnerships and trusts, as well as domestic corporations are among the classes of taxpayers included in the Code definition of a "United States person." I.R.C. § 7701(a)(30) (2002). In addition to its federal and state income taxes, the United States tax system is comprised of state and local sales and use taxes; federal excise taxes; federal Social Security taxes; capital gains taxes; and federal and state taxes on transfers of wealth and estates.

64. The United States is one of the few countries in the world that use citizenship as the basis for national taxation. Although the term "citizen of the United States" is not defined in the Internal Revenue Code, the Regulations provide that "every person born or naturalized in the United States and subject to its jurisdiction is a citizen." Treas. Reg. § 1.1-1(c) (as amended in 1974).

65. A person will be treated as a resident of the United States if the individual satisfies either the lawful permanent residence or the substantial presence tests set out in I.R.C. § 7701(b) (2002). An individual will fulfil the lawful permanent residence standard if he or she has been granted the right under U.S. law to reside permanently in the United States (even if only by "green card"). The substantial presence standard will be satisfied if the individual is present in the United States for at least thirty-one days in the current calendar year and at least 183 days during the three-year period that includes the current tax year with the calculation of residence days being determined in accordance with a formulaic equation depending on the year in question.

earns income from a source within the United States.[66] The determination of the residency of a corporate entity is primarily dependent on the jurisdiction where the entity was created.[67]

While U.S. tax law prescribes that a company incorporated under federal or state laws will be treated as a resident corporation for tax purposes, it is also possible for a corporation to be deemed a resident of the United States if the company's place of central management is located domestically or, more rarely, if the corporation's principal economic activities are conducted locally.[68] The tax treatment of multinational business profits within the United States often involves a complex interaction of federal and state income tax rules with relief from double taxation provided by the application of foreign tax credit rules.

*a. Federal Taxation*

Residents of the United States are subject to U.S. federal income tax on their global taxable income.[69] In addition, all nonresident corporations and foreign individuals are liable for federal tax on any income connected with a U.S. trade or business.[70] Whether a business is engaged in a trade or business in the United States will depend on the facts of each case. Over the years, the courts have described activities that constitute engaging in or carrying on a U.S. trade or business.[71] In order for a foreign entity to be treated as engaging in a U.S. trade or business for tax purposes, the business activities must be of a regular,

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66. Sections 861 to 865 of the Internal Revenue Code are referred to as the "source rules" for determining the taxable income of non-residents under U.S. tax law. *See* Peter H. Blessing, *Source of Income Rules*, TAX MANAGEMENT PORTFOLIO, 1992, at 905 (Tax Management Inc.).

67. The Internal Revenue Code distinguishes between "domestic corporations" and "foreign corporations." A "domestic corporation" is defined as an entity that was "created or organized in the United States or under the laws of the United States or of any State." *See* I.R.C. § 7701(a)(4) (2002). Since a foreign corporation is deemed to be a company other than a domestic corporation, the place of physical incorporation effectively constitutes the starting point for determining the residency of a company.

68. *See* JOSEPH ISENBERGH, INTERNATIONAL TAXATION: U.S. TAXATION OF FOREIGN PERSONS AND FOREIGN INCOME ¶ 4.1, at 3 (2d ed., Aspen Law and Business 1996).

69. I.R.C. §§ 1 (individuals, estates, and trusts), 11 (corporations) (2002).

70. The U.S. tax liability of non-resident individuals is determined under I.R.C. §§ 871–877 (2002). Foreign corporations are subject to U.S. tax under I.R.C . §§ 881–884 (2002).

71. In *InverWorld Inc. v. Commissioner*, 71 T.C.M. 3231 (1996), the Court relied on the decision in *European Naval Stores Co., S.A. v. Commissioner*, 11 T.C. 127 (1948), which in turn quoted the following passage from the Circuit Court of Appeals for the Third Circuit decision in *Lewellyn v. Pittsburgh, B. & L.E.R. Co.*, 222 F. 177, 185–186 (1915):

> "Engaged in business" means occupied in business; employed in business. "Carrying on business" does not mean the performance of a single disconnected business act. It means conducting, prosecuting and continuing business by performing progressively all the acts normally incident thereto, and likewise the expression "doing business," when employed as descriptive of an occupation, conveys the idea of business being done, not from time to time, but all the time.

continuous and substantial nature.[72] Once it is determined that the foreign business is engaged in trade or business within the U.S., then any income connected with the U.S. trade or business is subject to federal income taxation.[73] The U.S.-source income of a non-resident taxpayer will be taxed at the same rates and in the same manner as the income of a resident U.S. taxpayer.[74]

The United States Congress has not enacted any special income tax rules for electronic commerce. Therefore, the same source rules that apply to conventional business activities must be applied to global e-commerce enterprises to determine their U.S. tax liability. So unless the taxpayer falls within the scope of an applicable tax treaty, the determination of whether a foreign e-commerce vendor is subject to income taxation in the United States depends on whether the e-commerce activities are sufficiently regular, continuous, and substantial.[75]

Where an e-commerce business operates a web site from which regular and continuous sales are made to U.S. consumers, the foreign business will most likely be subject to U.S. federal income taxation on all profits effectively connected with such sales.[76] If the foreign enterprise maintains an office, a sales representative or any support staff within the United States, then in most instances the enterprise will be subject to federal—and probably state—income tax rules on all profits derived from the sales made to U.S. consumers.[77] By comparison, the Treasury Department has indicated that "to the extent that the activities of a person engaged in electronic commerce are equivalent to the mere solicitation of orders from U.S. customers, without any other U.S. activity, it may not be appropriate to treat such activities as a U.S. trade or business."[78] It is unlikely that an occasional or isolated

72. This principle is derived from the leading case of *Spermacet Whaling & Shipping Co. v. Commissioner*, 30 T.C. 618 (1958). A substantial amount of U.S. sales by a non-resident may not by itself create a sufficient nexus for tax liability to the United States Treasury. *See* Commissioner v. Piedras Negras Broad. Co., 127 F.2d 260 (5th Cir. 1942).

73. I.R.C. §§ 882(b) and (c) set out the tax base for foreign entities as basically the effectively connected income from all trade or business conducted within the United States less any deductions reasonably attributable to such income.

74. The U.S.-source business profits of a foreign enterprise, like those of a U.S. resident, are subject to taxation on a net basis. *See* I.R.C. §§ 871(b), 882 (2002).

75. *See* I.R.C. §§ 871(b)(1), 882(a) (2002). *See also supra* notes 71–72 *and accompanying text.*

76. A serious argument could be made that a foreign e-commerce vendor that is concluding substantial and regular sales in the United States will be subject to U.S. income taxation on profits arising out of those sales. Cockfield, *supra* note 2, at 142.

77. Whether foreign companies will be subject to U.S. income and sales tax laws rests largely on whether the firm uses dependent agents and other representatives to perform U.S. activities on its behalf.

78. U.S. E-Commerce Report, *supra* note 3, at 7.2.3.1.

electronic transaction will create a nexus for U.S. taxation in the absence of any other substantial business activity within the United States.

Multinational enterprises that earn income from technology and e-commerce sales ("clicks") as well as income from traditional business activities ("mortar") could fall under the scope of the U.S. Treasury rules that correlate or attach income to a physical component of the enterprise within the United States. Since U.S. tax liability depends on the amount of income that is "effectively connected" with the U.S. trade or business, it is possible for foreign source income to be lumped together with U.S. business income.[79] The effectively connected income approach is significant because even though an electronic sale of a good or service by a non-resident may not, in itself, attract U.S. taxation, it is possible for an Internet business operated by a non-resident to be treated as generating U.S. tax liability because of unrelated business activities carried on by the foreign business within the United States. The broad definition of effectively connected income provides an additional mechanism under which the U.S. Treasury may tax the profits derived on e-commerce sales made to buyers in the United States.

### *b. State Taxation*

The U.S. Constitution, federal legislation, and international treaties restrict the taxing powers of U.S. states over multijurisdictional business income. The Commerce Clauses of the United States Constitution provide that an out-of-state business must have a minimum presence in a state before that state can impose any income or transactions tax upon the business.[80] The Due Process Clause requires that states impose income tax only in accordance with historical notions of substantial justice and fair play.[81] U.S. courts have interpreted the constitutional nexus standard in a liberal manner so as to effectively permit a state to tax income arising out of the sale or licensing of products in the state where the buyer or licensee resides.[82]

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79. I.R.C. § 864(c) (2002) defines "effectively connected income" and includes domestic source business income, certain forms of domestic investment income, and, where applicable, certain types of foreign source income.

80. *See* U.S. CONST. art. I, § 8, cl. 3.

81. The Due Process Clause is found in U.S. CONST. amend. XIV, § 1.

82. In *Arizona Dept. of Revenue v. Care Computer Systems, Inc.*, 4 P.3d 469 (2000), the Arizona Court of Appeals determined that even though the taxpayer, a licensed vendor of specialized computer hardware and software, had a minimal physical presence in the State (such as an average of one or two sale visits a year to the State), there was a sufficient nexus between the taxpayer and the State so that the taxpayer was required to pay the State of Arizona's transaction privilege tax, which is a direct tax that applies to a taxpayer's gross sales. Another example of a

Electronic commerce highlights the contentious overlap of federal and state income tax rules. As the popularity of the Internet surged in the mid-1990s, the U.S. federal government sought to limit the imposition of any new state taxes that deter or hinder the growth of the digital medium.[83] In 1998, Congress passed the *Internet Tax Freedom Act*, which restricted state and local tax authorities from imposing any new or additional taxes involving Internet access, electronic commerce or related digital technologies.[84] The tax moratorium, which is due to expire in November, 2003, not only applies to indirect taxes, such as state sales and use levies, but it also extends to any discriminatory changes in income tax rules that adversely affect electronic commerce.[85]

The state where a U.S. business is incorporated has the jurisdiction to tax the company, regardless of the volume of business carried on by the corporate taxpayer within that state.[86] A state may be entitled to tax the income derived by the business activities of a company created in another state only if the taxing state can show that a sufficient nexus for taxation exists.[87] Most states attempt to tax profits

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liberal judicial determination of the nexus requirement is found in the South Carolina Supreme Court decision in *Geoffrey, Inc. v. South Carolina Tax Commissioner*, 437 S.E.2d 13 (S.C.), cert. denied, 114 S.Ct. 550 (1993), where it was held that the State of South Carolina could apply its income tax to a corporation where the income was derived from intangible property owned by the company and used within the borders of the State. By permitting the source state to tax income derived from sales or licenses made within the state, these court decisions establish a nexus requirement for income taxation that differs substantially from the physical presence tests found in sales and use tax cases such as the U. S. Supreme Court decision in *Quill Corp. v. North Dakota*, 504 U.S. 298, 314, 317 (1992).

83. State sales and use taxes could easily represent the greatest administrative burden for e-commerce businesses. The multiplicity of states, counties, cities, towns, and special districts that impose transaction taxes tremendously increases the complexity of complying with indirect taxes in the United States. The U.S. Treasury acknowledged that e-commerce would adversely impact the collection of state and local tax revenues. *See* U.S. E-Commerce Report, *supra* note 3. Since most U.S. states and thousands of localities levy some form of sales or use tax on a diverse number of products and services, the federal government was concerned that conflicting and overlapping sales and use taxes could hinder the growth of electronic commerce, which led to then President Clinton's declaration that "We cannot allow 30,000 state and local tax jurisdictions to stifle the Internet." President William Clinton, U.S. GOVERNMENT WORKING GROUP ON ELECTRONIC COMMERCE, FIRST ANNUAL REPORT (1998) [hereinafter FIRST ANNUAL REPORT] available at http://www.doc.gov/ecommerce/E-comm.pdf.

84. The *Internet Tax Freedom Act*, Pub. L. No. 105-277, 112 Stat. 2681 (1998) [hereinafter ITFA], effectively permits the continuance of taxes in effect prior to October 1, 1998 but prohibits the imposition of new taxes.

85. The *Internet Tax Nondiscrimination Act of 2001*, Pub. L. No. 107-75, 115 Stat. 703 (2001), extended the moratorium until November 1, 2003.

86. WILLIAM H. HOFFMAN, JR. ET AL., CORPORATIONS, PARTNERSHIPS, ESTATES & TRUSTS 15-9 (West Federal Taxation 2002).

87. *See* Tyler Pipe Industries Inc. v. Washington State Department of Revenue, 483 U.S. 232 (U.S. 1987) (nexus can arise via the actions of agents); *see also* Geoffrey, Inc. v. South Caro-

arising out of sales made by a business within the state regardless of whether the taxpayer has a physical presence within the state.[88]

Public Law 86-272 is a special federal statute that prevents states from imposing income taxes on sellers of physical goods where the seller's only contact with the state is the solicitation of orders.[89] Public Law 86-272 does not expressly refer to vendors of intangible property or intellectual property rights. Nonetheless, as the federal law was designed to protect vendors of tangible personal property from discriminatory state income tax practices, this legislative safeguard should be extended to e-commerce and other technology businesses completing sales to customers located throughout the United States.[90]

Any company that conducts business activities in more than one U.S. state must allocate and apportion its income among the states in order to determine its total U.S. tax liability.[91] The test for determining whether the state will tax the multi-state profits of a U.S. business requires the application of a formula apportioning the business income of the enterprise to each state that has a right to tax the entity.[92] When the necessary nexus with one or more states exists, then the business is required to allocate its net income among such states in accordance with the respective amounts of sales, payroll, and property attributable to each connected state. For most modern e-commerce businesses, the application of the traditional apportionment formula would give undue importance to property criteria and de-emphasize

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lina Tax Commission, 437 S.E.2d 13 (S.C.), *cert. denied*, 114 S.Ct. 550 (1993) (nexus can arise through the licensing of intangible assets for use in a particular state).

88. *See* RICHARD A. WESTIN, INTERNATIONAL TAXATION OF ELECTRONIC COMMERCE 94–102 (The Hague: Kluwer Law Int'l 2000) (showing that the nexus for state taxation does not necessarily require the physical presence of the taxpayer within the state).

89. Pub. L. No. 86-272, 73 Stat. 555 (codified at 15 U.S.C. § 381, 2003) was designed to deal with mail order catalogues and telephone solicitations. Nonetheless, the legislation could be utilized by a technology business to effectively exempt individuals and corporations from the income tax rules of most states as long as the business does not have a material presence in the state.

90. When Congress enacted Public Law 86-272, it intended to protect vendors of tangible personal property from the application of a state's income tax under specified circumstances. Since most international tax treaties, multilateral trade agreements, and the U.S. Constitution prevent discriminatory government practices, it could be argued that e-commerce businesses that sell or deliver intangible products and services should be afforded the same limitation on state income taxation afforded by Public Law 86-272 to vendors of tangible property. Until the scope of this piece of federal legislation is expressly extended to apply to intangible and digital products, there remains potential for electronic commerce to be subjected to discriminatory state taxation practices.

91. HOFFMAN, *supra* note 86, at 15-9.

92. To determine the apportionment percentage for each state, the applicable ratio is established based on the factors set out in the state's apportionment formula; although apportionment formulas vary among jurisdictions, the typical formula equally weighs sales, property, and payroll factors for determining state tax liability. *Id.* at 15:14–15.

the relative importance of online sales made to consumers and businesses within the state.

### *c. Foreign Tax Credit*

The foreign tax credit provisions represent a unilateral effort by the U.S. Treasury to provide annual relief from double taxation to its residents and citizens.[93] The U.S. foreign tax credit rules permit that a U.S. resident taxpayer may reduce the amount of U.S. income tax payable upon the taxpayer's worldwide income by the amount of foreign income tax paid on the taxpayer's foreign source income.[94] The Internal Revenue Code limits the amount of total foreign tax credits available to a U.S. taxpayer in order to ensure that the taxpayer does not receive a credit for foreign taxes paid over and above the amount of U.S. tax that would otherwise be paid for the foreign income.[95]

## 2. Canada

The *Income Tax Act* represents the main source of tax law in Canada.[96] Bilateral tax treaties, government rulings and interpretation bulletins, and case law are also considered primary sources of Canadian tax law.[97] Like the U.S. tax system, Canada's income tax rules assert jurisdiction over the global income of residents as well as the domestic source income of non-residents. Canadian residents are taxed on their worldwide income for each taxation year.[98] Non-residents are subject to income taxation in Canada only on income that has a source within the country.[99] The Canadian tax system, like its U.S. counter-

93. In order to qualify for the foreign tax credit, the U.S. taxpayer is required to make an election on a yearly basis. If the taxpayer fails to make the requisite election, the amount of foreign taxes paid may still be permitted as a deduction under I.R.C. § 164(a)(3) (2002).

94. *See* I.R.C. §§ 901, 902 (2002).

95. *See* I.R.C., § 904(a) (2002). The concept is that the domestic tax base on U.S. source income should not be affected by the foreign taxes paid or payable by the U.S. taxpayer. The foreign tax credit limitation is calculated separately for various baskets of income and expenses under I.R.C. §§ 861–65, 904 (2002) so that the total amount of all foreign tax credits as a proportion of the taxpayer's U.S. tax otherwise payable does not exceed the ratio of foreign source income to the taxpayer's worldwide taxable income for the tax year.

96. In addition to federal and provincial income taxes, the Canadian tax system consists of federal excise taxes; capital gains taxes; federal goods and services taxes; provincial sales taxes; and a harmonized federal-provincial value-added tax regime in certain areas of the country.

97. *See* LI, *supra* note 54 (stating that "cases are important in giving more precise meaning to generally worded provisions" in the I.T.A.).

98. I.T.A. §§ 2(1),(2).

99. The tax treatment of non-residents under the I.T.A. depends on the form of income derived by the foreigner. Business income as well as capital gains, employment pay and certain rental income are taxed under Part I of the I.T.A. on a net basis regardless of whether the taxpayer is a resident or non-resident of Canada. Non-residents that earn investment income, in-

part, attaches considerable significance to residency of individuals and corporations. An individual is considered a resident of Canada for income tax purposes if he or she lives in Canada or is substantially present in the country for a lengthy period of time.[100] The residence of a company under Canadian tax law is typically determined by the place of incorporation of the company.[101] However, as in the United States, it is possible for a company that is incorporated outside the country to be treated as a resident of the country for domestic tax purposes.[102] The tax treatment of multinational business profits under Canada's existing tax rules requires one to take note of the interaction of federal and provincial income tax rules, which have not been modified to apply to the advent of global technology enterprises.[103]

*a. Federal Taxation*

Under Canadian tax law, foreign companies "carrying on business" in Canada are subject to Canadian federal income tax on all business income earned in Canada.[104] Tax authorities must establish

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cluding dividends, interest and royalties, from a source in Canada are subject to a withholding tax under Part XIII of the I.T.A. that is calculated on the gross amount of the payment.

100. Under Canadian tax law, the residence of an individual may be determined either by statute or case law. The legislation deems any person that lives in Canada for a period or periods totaling 183 days or more to be a resident of Canada, I.T.A. § 250(1)(a) (2002), and also provides that "a person resident in Canada includes a person who was at the relevant time ordinarily resident in Canada," I.T.A. § 250(3) (2002). Canadian courts generally look to the individual's behavior over a period of years when determining whether the individual was ordinarily resident or sojourning in Canada for the tax year in question. *See, e.g.*, McFayden v. The Queen, *4 C.T.C. 2573* (2000); The Queen v. Reeder, [1975] C.T.C. 256; Thomson v. MNR, [1946] C.T.C. 51 (S.C.C.).

101. I.T.A. § 250(4)(a) (2002) provides that all companies incorporated in Canada at any time after April 27, 1965 shall be deemed to be residents of Canada for tax purposes. Therefore, any company that was incorporated federally or provincially in Canada would *prima facie* be subject to Canadian income taxation on all of its business profits.

102. Canadian courts have developed a series of rules whereby a company incorporated in a foreign jurisdiction may be treated as being resident in Canada for income tax purposes if it can be shown the place of central management or effective control of the company is within Canada. This common law test is derived from a line of English cases such as *Egyptian Delta Land and Investment Co. v. Todd*, [1929] A.C. 1 (where the House of Lords determined that a company would be treated as resident for tax purposes of the country in which the directors of the corporation regularly met and exercised control). The English common law test for basing residency on the basis of *de facto* control was reinforced by the House of Lords' decision in *Unit Construction Co. v. Bullock*, [1960] A.C. 351.

103. In 1998, a Canadian Ministerial Committee recommended that Canada Customs and Revenue Agency issue an Interpretation Bulletin to address the significance of modern telecommunication technology on the concept of residence. *See* Canada E-commerce Report, *supra* note 3, at 4.2.2.1. Nonetheless, Canadian tax authorities have failed to provide any information bulletin or other formal guidance since that important pronouncement.

104. Non-residents are taxable in Canada on their Canadian-source business income on a net basis pursuant to I.T.A. §§ 2(3)(b), 18.

that a non-resident company is carrying on business in Canada before the Canadian treasury can assert jurisdiction to tax any income arising out of the non-resident's business activities. Canada's tax legislation provides that a foreign business will be subject to Canadian income tax if the non-resident "solicits orders or offers anything for sale in Canada through an agent or servant."[105] While the determination of what activities constitute "carrying on business in Canada" depends on the ordinary meaning of the words as applied to the facts of each case, a foreign e-commerce business could be found liable for Canadian taxation if it simply solicits and supplies goods or services to Canadian consumers.[106] The threshold for establishing a nexus to justify income taxation under Canada's domestic laws is very broad. Non-resident e-commerce businesses and other remote sellers could be subject to Canadian tax liability on any offer or solicitation of products into Canada.[107] The tax threshold for source taxation changes substantially when the foreign enterprise is a resident of a country that has entered into a bilateral tax treaty with Canada.

### b. Provincial Taxation

Canadian provinces have the constitutional authority to tax business income that has a source within the province.[108] As a result of shared tax arrangements with the Government of Canada, most provinces allow the federal government to collect corporate income taxes as well as personal income taxes on their behalf.[109] Provincial tax rates

105. *See* I.T.A. § 253(b).

106. Technology and e-commerce businesses that make sales to customers in Canada would likely fall within the scope of Canada's domestic tax rules because the term "solicits orders or offers anything for sale" is so broad as to encompass the selling of businesses wares in Canada from a web site. The interpretation of the phrase "carrying on business" has not been explored often by Canadian courts, but it has been held that a mere invitation to treat or offer to buy or similar form of solicitation would not be sufficient to fall within the scope of the section. *See* Sudden Valley Inc. v. The Queen, [1976] C.T.C. 775 (F.C.A.).

107. A foreign business can be liable for Canadian income tax even if it does not have a physical presence in Canada. The terms "agent or servant" are not defined in Canada's tax legislation. It is conceivable that Canadian tax authorities would consider a web server or an ISP to be an agent or servant of the taxpayer. Therefore, profits derived from the sale of a good or service to a Canadian resident by a foreign e-commerce business using an ISP or any web server could arguably be subject to taxation in Canada because either or both the ISP and the server would be considered as the "agent or servant" of the foreign e-commerce business.

108. Canadian provinces have the power to impose "direct taxation" on income earned in the province and on the global income of persons considered residents of the province. *See* Constitution Act, § 52(1) (1982), *being* Schedule B of the Canada Act, *c. 11* (1982 U.K.).

109. In most cases, the provinces use the federal government's tax base as the basis for determining corporate and personal income taxes payable. All of the provinces in Canada, except Quebec, allow the federal government to collect personal income taxes. In addition to Quebec, the provinces of Alberta and Ontario collect their own corporate income taxes.

for business income vary from province to province.[110] Each province applies its income tax rate to the business profits derived within the province. Canadian and foreign corporations, however, are not subject to provincial tax on their foreign source business income.[111] Since most Canadian provinces utilize the federal tax base and adopt similar apportionment formulas for the allocation of business income among provinces, the provincial income tax systems in Canada are generally more unified with the federal income tax system than is the case in the United States.

#### c. Foreign Tax Credit

When a Canadian resident earns income from a foreign source, it is likely that the foreign jurisdiction will have imposed taxes on that income. Canadian taxpayers are generally allowed to claim a tax credit or deduction for all income taxes paid to other governments on account of foreign source income.[112] Foreign income taxes that are credited against Canadian income taxes will in most instances be limited to the amount of Canadian tax otherwise payable on the foreign source income.[113] Canada's foreign tax credit tax rules, like those in the United States, are effectively structured so that taxes paid to foreign governments cannot be applied to offset taxes on Canadian source income.[114]

### B. *International Taxation Principles*

In order to appreciate the coherence, if any, of the existing regime of international income taxation, it would be useful to review several core tax policy principles, such as neutrality, fairness, inter-

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110. *See* Forgione, *supra* note 13, at 16:19–20 (reviewing the rates of corporate and personal income tax imposed by each of the Canadian provinces).

111. LI, *supra* note 54 (noting that "Canadian corporations are not subject to any provincial tax on their foreign source business income.").

112. Under I.T.A. § 126 (2002), a Canadian taxpayer may claim a credit for foreign taxes paid on foreign business income as well as on foreign non-business income. The amount of the foreign tax credit is calculated separately for foreign business income taxes and other foreign taxes because of the provincial tax treatment of foreign source income. Since foreign business income is not typically subject to any provincial taxation in Canada, the foreign tax credit rules basically provide the credit against the full amount of Canadian tax payable on a country-by-country basis.

113. *See* Ian J. Gamble, *Canada's Foreign Tax Credit System for Multinationals*, 19 TAX NOTES INT'L 1997 (Nov. 22, 1999).

114. I.T.A. § 126 (2002) allows for separate basket calculations for foreign business income and foreign non-business income. I.T.A. §§ 126(7)(a) and (c) defines the terms "business-income tax" and "non-business-income tax" for the purpose of calculating the foreign tax credit that may be claimed by Canadian taxpayers.

nation equity, and administrative simplicity.[115] Discussion of the principles and goals motivating international income tax policy may be perplexing, but the foundational basis of prevailing tax norms represents an essential consideration of a government's domestic and foreign economic policies.[116]

### 1.Neutrality

A tax is considered neutral if it does not distort private investment decisions.[117] Business decisions should be motivated by economic and market factors, and not by tax considerations. Despite this seemingly straightforward objective, the concept of tax neutrality often involves a tension between alternative investments and national perspectives. For instance, in its original report dealing with the tax policy implications of electronic commerce, the U.S. government declared that it would

> ensure that no new taxes are imposed that discriminate against Internet commerce; that existing taxes should be applied in ways that avoid inconsistent national tax jurisdictions and double taxation; and that tax systems treat economically similar transactions equally, regardless of whether such transactions occur through electronic means or through more conventional channels of commerce.[118]

The subsequent enactment of the *Internet Tax Freedom Act*[119] demonstrated the tension between neutrality in the taxation of e-commerce and the equal treatment of economically similar commercial transactions.

Tax neutrality is an essential feature of international taxation because it promotes worldwide economic efficiency.[120] Ideally, tax rules should not affect economic choices about the structure of markets nor influence the location of commercial activities. On a transactional level, neutrality requires that the tax system treat economically similar activities in a similar manner. Tax measures should seek to be neutral

115. OECD Framework, *supra* note 4, at 5–6, lists neutrality, efficiency, certainty, simplicity, effectiveness, fairness, and flexibility as the international tax policy principles to be used as a guide to establish a framework for the taxation of e-commerce, but for purposes of brevity, this Article will focus primarily on the tax concepts of neutrality, fairness, and administrative simplicity.

116. Michael J. Graetz, *Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies*, 26 BROOK. J. INT'L L. 1357, 1363 (2001).

117. Brean, *supra* note 60, at 310.

118. FIRST ANNUAL REPORT, *supra* note 83.

119. ITFA, *supra* note 84.

120. *See* Graetz, *supra* note 116.

between income derived from electronic commerce ("clicks") and income arising out of conventional forms of global business activities ("mortar"). Income earned through electronic means should be taxed in a manner equivalent to business income derived through traditional channels of commerce. Application of the basic principle of tax neutrality requires the adoption of income tax rules that do not discriminate between types of business income nor the mechanisms through which such income is earned.[121]

The concept of transnational neutrality adds jurisdictional considerations to the international tax policy mix. International tax measures are often considered in the context of whether they promote capital-export neutrality (CEN) or capital-import neutrality (CIN). CEN refers to the choice investors face between investing at home and investing in foreign markets.[122] The CEN principle requires tax laws to be neutral about a resident's choice between domestic and foreign investments by ensuring that these investments provide similar pretax rates of return.[123]

The second type of neutrality, CIN, requires that all investments in a given country pay the same rate of income taxation regardless of the residence of the investor.[124] Import neutrality, accordingly, proposes that all business activity within a specific country be subject to the same overall level of taxation whether the activity is conducted by a resident or a foreigner.[125]

Current international tax policy is routinely described as a compromise between export and import neutralities.[126] Export neutrality

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121. More specifically, the tax treatment of income from the sale of tangible products and services should be equivalent to the treatment of licensing fees from the sale of intangible products and services. *See* Charles E. McLure, Jr., *Taxation of Electronic Commerce: Economic Objectives, Technological Constraints, and Tax Laws*, 52 TAX L. REV. 269, 378–79 (1997).

122. Brean, *supra* note 60, at 310 (explaining that the "interaction of domestic and foreign taxes is capital-export neutral if investors are indifferent between domestic and foreign investments with equal pre-tax yields").

123. Export neutrality focuses on the international tax treatment accorded to domestic investors. The adoption of a foreign tax credit regime promotes capital-export neutrality by ensuring that the residence country taxation of the investor's global income is alleviated by immediate credit for foreign taxes paid on foreign investments. *See* Brean, *supra* note 60, at 310–11 (who notes that CEN promotes global allocative efficiency and that domestic measures such as foreign tax credits support CEN, but argues that the foreign tax credit system is not in the national interest of a capital-exporting nation).

124. *See* Graetz, *supra* note 116.

125. Taxation is capital-import neutral insofar as domestic investors and foreign investors receive equal after-tax yields from similar investments in one country. *See* Brean, *supra* note 60, at 311 (declaring that "CIN places domestic and foreign investors on an equal footing in the source country").

126. Reuven S. Avi-Yonah, *The Structure of International Taxation: A Proposal for Simplification*, 74 TEX. L. REV. 1301, 1330 (1996).

is often presented as promoting efficient global business choices while import neutrality is justified on the basis that it promotes the competitiveness of international players in domestic markets.[127] In theory, CEN gives the prime claim to tax international income to the country of residence and CIN awards that right to the country of source.[128] In reality, the existing international income tax regime appears to be governed more by economic and political considerations than by the adoption of any clear neutrality standard.[129]

### 2. Fairness and Inter-Nation Equity

Fairness and equality of treatment have always been dominant objectives of tax policy.[130] These universal tax principles provide theoretical justification for the international tax goal of "inter-nation equity."[131] For taxpayers engaged in cross-border activities, the application of policies that implement the fairness doctrine involve the establishment of jurisdictional tax claims aimed at an equitable division of revenues among nations.[132] The fairness doctrine equates allocation of tax jurisdiction with principles that support the exclusive or pri-

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127. *See* Cockfield, *supra* note 2, at 163–64. *See also* Brean, *supra* note 60, at 310–11.

128. The theoretical ideal of tax neutrality may be unachievable as a practical objective in the international realm. *See* Graetz, *supra* note 116, at 1364 (arguing that it is impossible to achieve CEN and CIN simultaneously in the absence of either a worldwide government or identical tax bases and rates in all nations).

129. Cynics argue that governments often choose the tax policy objective that they feel would best support the tax measure adopted. *See* Michael McIntyre, *Guidelines for Taxing International Capital Flows: The Legal Perspective*, 46 NAT. TAX J. 315, 318 (1993), *available at* http://www.law.wayne.edu/mcintyre/text/NTA_guid_capital.pdf (showing that U.S. international tax rules and guidelines tend to treat the principles of capital export neutrality and capital import neutrality as secondary objectives to the point where it appears that to Treasury officials "capital import neutrality is a lobbying position, not a coherent tax policy goal").

130. *See* Graetz, *supra* note 116, at 1392–93 (the United States adopted an income tax system in 1913 out of the fairness demands of the American people as it was felt that an income tax was more equitable than consumption or payroll taxes). *See also, generally*, Nancy H. Kaufman, *Equity Considerations in International Taxation*, 26 BROOK. J. INT'L L. 1465 (2001) (presenting the historical aspects of the international fairness doctrine in considerable and insightful detail).

131. Professor Peggy Musgrave pioneered the term "inter-nation equity" in reference to the need for the international tax regime to promote an equitable allocation of global tax revenues among nations. *See* Richard A. Musgrave & Peggy B. Musgrave, *Inter-Nation Equity*, *in* MODERN FISCAL ISSUES: ESSAYS IN HONOR OF CARL S. SHOUP 63 (Richard M. Bird & John G. Head eds., University of Toronto Press 1972). For a contemporary discussion of international equity concerns, see Peggy B. Musgrave, *Sovereignty, Entitlement, and Cooperation in International Taxation*, 26 BROOK. J. INT'L L. 1335 (2001).

132. "The scope of the income tax base in a multijurisdictional setting is today a mater of internation, not interindividual, equity." Kaufman, *supra* note 61, at 182.

mary claim of tax authorities to tax income derived or produced by the nation's economy.[133]

The pursuit of international fairness finds support in the theory that a country should have primary tax jurisdiction over wealth and market activities generated within its borders.[134] Under the benefits theory of taxation, an enterprise or person that receives benefits or services from a nation gives rise to the government's entitlement to levy taxes on income generated by the enterprise or person as a result of such benefits or services.[135] The strict application of a benefits rule for tax jurisdiction could be used to support both residence country taxation and source country taxation.[136] Nonetheless, inter-nation equity is concerned primarily with the extent of the entitlement of the source country to taxation of the income generated within its borders.[137]

The principle of inter-nation equity provides legitimacy to the proposition of source or market country taxation of international business income. A system of international income taxation predicated on primary source jurisdiction will undoubtedly require significant international cooperation, particularly if it must address the challenges posed by electronic commerce. The wealthier countries of the world cannot continue to ignore the interests of developing nations in today's era of increased globalization of trade and investment.[138] Neverthe-

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133. *See* Palmer, *supra* note 62, at 32–33 (arguing that the "national tax base theory" could be used to affirm a government's right to tax all income derived by resident and non-resident enterprises from the exploitation of the market country's economy).

134. Kaufman, *supra* note 61, at 187–88 (stating that this widely accepted proposition is commonly referred to as the "benefits theory of taxation" and that virtually every country imposing an income tax today purports to explain its taxation of income at source on the basis of this benefits theory).

135. The concept of benefit can notionally be extended to encompass the income or wealth generated as a result of the purchase or consumption activity of a country's nationals. *See* Palmer, *supra* note 62, at 24.

136. Kaufman, *supra* note 61, at 185 (noting that "under a strict benefit rule, the country in which a product is produced could impose a charge for the governmental goods and services benefiting the producer, while the country in which the consumer consumes the product could impose a charge for the governmental goods and services benefiting the consumer."). *See also* Musgrave & Musgrave, *supra* note 131, at 70.

137. In a situation where the residence country provides the usual foreign tax credits or exemptions to ameliorate double taxation, the source country's tax on income diminishes the tax take of the residence country. The tax gain to the source country is a loss to the treasury of the residence country. Nonetheless, the concept of inter-nation equity prefers the entitlement of the source country to that of the residence country because residence entitlement extends to worldwide income and does not detract from the entitlement of the source country to realize a national gain from business profits derived within its border. *See* Musgrave & Musgrave, *supra* note 131, at 68–71.

138. Kaufman, *supra* note 61, at 154 (claiming that "fairness exists in the international tax system only when states distribute among themselves the competence to tax in a way that conforms to prevailing view of justice internationally—internation equity"). Economic globalization has demonstrated the need for multinational enterprises to actively participate in international

less, some contemporary tax writers blatantly dismiss the fairness doctrine and the theory of inter-nation equity as "irrelevant" considerations in the formulation of international tax rules and policies.[139]

### 3. Harmonization and Administrative Simplicity

The complexities of the international tax aspects of individual nation's tax codes give rise to both awe and concern.[140] Cross-border transactions create the need for special tax considerations because international tax provisions must also resolve jurisdictional claims. The need to address both revenue and global economic competitiveness objectives contributes to the complexity of international tax rules.[141] Nevertheless, it is a well-accepted principle of international tax policy that even necessarily complex tax laws should strive as much as possible to minimize compliance costs for taxpayers and administrative costs for tax authorities.[142]

The harmonization of the tax treatment accorded "clicks" and "mortar" income represents a priority for effective tax administration in the Twenty-First Century.[143] The commercial potential of the

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efforts to ameliorate the impact on developing countries and to improve the redistributive nature of benefits from world trade. *See* UNITED NATIONS, THE GLOBAL COMPACT: CORPORATE LEADERSHIP IN THE WORLD ECONOMY (1999).

139. Graetz, *supra* note 116, at 1372–73 (noting that the objective of inter-nation equity is "irrelevant" in so far as it involves redistribution of tax revenues because such redistribution on an international level may not be possible or justifiable). Kaufman, *supra* note 130, at 1465 (observing that issues of fairness often play "second fiddle" to other policy objectives in contemporary tax literature). Avi-Yonah, *supra* note 1, at 1650 (arguing "that the concept of inter-nation equity can be given practical meaning in the design of international tax rules if it is interpreted as embodying explicit redistributive goals" but that some national governments are not prepared to enter into discussions on such terms).

140. Avi-Yonah, *supra* note 126, at 1301, 1304, refers to the current international tax regime as a "flawed miracle." Because the international tax regime is based on an internationally acceptable consensus involving the majority of the world's taxing jurisdictions, it "can be regarded as one of the major achievements of twentieth-century international law." The "miracle is flawed" due, in part, to the rise of integrated multinational enterprises, which has rendered the rules and principles "agreed upon in the 1920s and 1930s obsolete."

141. HOFFMAN, *supra* note 86, at 9-2 (noting that "from a U.S. perspective, international tax laws should promote the global competitiveness of U.S. enterprises and at the same time protect the tax revenue base of the United States. These two objectives sometimes conflict."). This tension between rules that address national revenue concerns and those that pursue international efficiency norms is replicated in most of the world's countries.

142. *See* OECD Framework, *supra* note 4 (noting that although the international tax regime involves numerous special considerations, such as the interaction of legal systems, currencies, and enforcement problems, it is important that international tax rules adhere to international tax policy principles and promote an administratively feasible system for the collection of tax revenues from global business transactions).

143. Harmonization through simplification was one of the pursuits of a recent study in the United States. JOINT COMMITTEE ON TAXATION, STUDY OF THE OVERALL STATE OF THE FEDERAL TAX SYSTEM AND RECOMMENDATIONS FOR SIMPLIFICATION, PURSUANT TO

Internet and other emerging technologies presents a number of unique challenges to the current international tax regime. From an administrative perspective, it is important that tax rules applying to e-commerce profits are similar to the rules dealing with income from more traditional business activities. A unified approach to the treatment of various forms of multinational business income would ease many administrative concerns.[144] Without international cooperation, it is likely that the existing tax collection mechanisms used by many international tax authorities would lead to traditional business activities being taxed differently from e-commerce activities.[145]

Proposals for reform or improvement of the existing system of international taxation must address practical and administrative considerations. The inclination to establish special administrative practices for e-commerce and other digital transactions must be avoided. Many nations do not possess the administrative resources or expertise to enforce distinct tax rules for e-commerce.[146] Efforts at reform must consider technologically-based solutions that are acceptable to international tax authorities as well as to multinational businesses that need to be able to reasonably anticipate the tax costs of their transactions.[147] One well-respected contemporary reform proposal that promotes administrative simplicity in international tax collection involves international acceptance of the unfettered primacy of source country taxation of active business income.[148]

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SECTION 8022(3)(B) OF THE INTERNAL REVENUE CODE OF 1986 (Joint Comm. Print 2001) *available at* http://house.gov/jct/s-3-01vol2.pdf.

144. *See* Canada E-Commerce Report, *supra* note 3, at 2.4.3.3 (noting that "to ensure a harmonious global tax regime, international cooperation is strongly encouraged").

145. The use of computer networks for tax administration and increased information exchanges of digital information can reduce taxpayer compliance costs and facilitate tax collection of income from international trade. *See* INFORMATION TECHNOLOGY AND INNOVATION IN TAX ADMINISTRATION 3, 9–11 (Glenn P. Jenkins ed., The Hague, Kluwer Law Int'l 1996).

146. In the absence of any supranational administrative body for tax matters, multilateral organizations such as the OECD have come to be relied upon for the development of customary practices and norms in respect of many international tax issues. *See* ARNOLD & MCINTYRE, *supra* note 53, at 3. While the OECD is often restricted to processing the input and positions of its member states, the organization has made efforts in recent years to derive input from non-members in matters such as harmful tax competition. *See generally*, OECD Harmful Practices Report, *supra* note 19.

147. Cockfield, *supra* note 10, at 1263 (recognizing that the implementation of reform proposals may require a level of cooperation and resource deployment among national tax authorities that has never occurred).

148. Avi-Yonah, *supra* note 126, at 1350–51 (claiming that an international consensus could be attained on the basis of source taxation of active income and residence taxation of passive income because both developed and developing countries have much to gain and little to lose from reaching agreement on such a simplified international tax structure).

### C. International Tax Treaties

Tax treaties are typically bilateral agreements between two sovereign nations that provide rules for the tax treatment of various forms of income. These bilateral tax agreements do not impose taxes, but they provide a mechanism for resolving tax claims between the treaty partners. The following section describes how tax treaties significantly define and limit the scope of a nation's jurisdiction to tax extraterritorial business profits. The treaty limitation involving the concept of permanent establishment is then explored including its historical roots, its entrenchment in influential model tax conventions, and recent efforts to adapt the permanent establishment definition to encompass electronic commerce.

#### 1. Significance of Bilateral Tax Treaties

Bilateral tax treaties, or double taxation conventions as they are often called, attempt to resolve issues such as overlapping tax claims, discriminatory tax treatment of foreign enterprises and the promotion of information exchanges between tax authorities. The relief from double taxation in global trade and investment is often cited as the primary motivating force towards bilateral and multilateral cooperation in the field of international taxation.[149] The reality of international taxation, however, is that the foreign tax credit rules or exemption systems found in the domestic laws of most developed countries effectively alleviate the incidence of double taxation of multinational business income.[150] Given that countries have unilaterally taken steps to protect their residents from double taxation of foreign source income, what is the primary force that drives the conclusion of tax treaties?

Rather than concern over the plight of the taxpayer, the primary driving force behind bilateral tax treaties is the fiscal demands of tax-

149. Alvin C. Warren, Jr., *Income Tax Discrimination Against International Commerce*, 54 TAX L. REV. 131 (2001) (explaining why many bilateral tax treaties are invariably referred to as conventions to prevent double taxation).

150. For instance, both the United States and Canada provide relief from double taxation to resident taxpayers through a unilateral foreign tax credit mechanism that permits the taxpayer to offset the amount of foreign taxes paid against the domestic taxes that would have otherwise been payable on the foreign source income. The United States introduced foreign tax credit rules in 1918, seventeen years before it concluded its first comprehensive tax treaty. *See* Michael J. Graetz & Michael M. O'Hear, *The "Original Intent" of U.S. International Taxation*, 46 DUKE L. J. 1021, 1026 (1997). For discussion of U.S. foreign tax credit rules, see *supra* text accompanying notes 94–97. For discussion of Canada's foreign tax credit rules, see *supra* text accompanying note 112.

ing nations.[151] Tax treaties do not levy any new taxes, but provide rules by which nations can accommodate competing tax claims. A nation's tax treatment of the multinational income of its residents is modified by the rules and principles established by its bilateral tax treaties.[152] Where income is derived by a resident of one country from sources in a foreign country, and if both countries assert a legitimate claim to tax that income, then either country may view an agreement to grant the other the primary right to tax that income as a loss of tax revenue.[153] The assignment of primary tax jurisdiction to one country will result in the loss of tax revenue to the other treaty country.[154] In effect, the allocation of tax jurisdiction in a bilateral treaty constitutes a fiscal transfer mechanism between nations.

Tax treaties alter the status quo created by domestic tax rules by restricting the incidence of taxation of business profits in the source or market country. In the United States and Canada, domestic source rules allow relatively unfettered taxation of enterprises carrying on business within the country.[155] In contrast, most bilateral tax treaties restrict the taxation of multijurisdictional business income in the source country to income attributable to a "permanent establishment" in the host country.[156] If an enterprise is a resident of a country that has a bilateral tax treaty with the country where the buyer of the enterprise's product resides, then bilateral tax treaties invariably provide that the non-resident business must have a "fixed base" or other physical presence in the country where the buyer resides before that country can tax the income derived from such sales.[157]

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151. "International treaty negotiation is, to some extent, a zero-sum game: one country's gain in revenue is another's loss." Avi-Yonah, *supra* note 126, at 1301.

152. ARNOLD & MCINTYRE, *supra* note 53, at 3 (noting that tax treaties create rights and obligations for the contracting states and that such agreements do not have any effects on taxpayers until the treaty provisions are incorporated into a country's domestic laws through enacting legislation).

153. The division of the total tax take on global income based on national theories of entitlement theory is at the core of the theory of inter-nation equity debate. *See* Musgrave & Musgrave, *supra* note 131; Peggy Musgrave, *supra* note 131.

154. Kaufman, *supra* note 61, at 189 (claiming that whether the residence or home country experiences a loss or revenue depends on the approach it takes to relieve double taxation).

155. Domestic U.S. law requires foreign enterprises to pay U.S. federal income tax if the enterprise carries on a trade or business in the United States even in the absence of any physical presence in the country. *See supra* text accompanying notes 57–73; for Canada, *see supra* text accompanying notes 98–100.

156. The term "permanent establishment" is defined in considerable detail in most bilateral tax treaties and the evolution of this pertinent treaty definition will be explored and described in the following section of this Article. In principle, the permanent establishment concept is based on the need to demonstrate the physical presence of the taxpayer within the country as grounds for that country's right to tax the business income derived by the taxpayer.

157. The term "fixed base," which is also found in most tax treaties, is applied to limit source taxation of income from the performance of professional and other independent services.

The business contact requirement established under a country's domestic tax laws cedes priority to bilateral tax conventions that restrict source country taxation of business profits in the absence of a permanent establishment or fixed base. The treaty requirement that the foreign business must be an enduring physical presence within the market country in order to entitle the market country to tax the income of the foreign taxpayer within that country serves to allocate taxing jurisdiction (and revenues) away from the treasury of the source country in favor of the country where the enterprise is resident. By entering into a bilateral tax treaty, a nation effectively agrees to forego its taxing authority over nonresident enterprises that do not maintain a permanent establishment within the country. The tax treaty effectively shifts the threshold for taxing global business profits away from source taxation.[158]

### 2. Development of the Treaty Concept of Permanent Establishment

#### *a. Definition and Effect*

The basic definition of permanent establishment found in most bilateral tax treaties refers to "a fixed place of business through which the business of an enterprise is wholly or partly carried on."[159] The permanent establishment definition also typically includes a place of management, a branch, an office, a factory, a workshop and other examples of physical presence in the jurisdiction, such as a mine, oil or gas well, a quarry, and building or construction site.[160] Some fixed places of business may be excluded from the standard treaty definition of permanent establishment. For instance, facilities used solely for the purpose of storage, display, or delivery of goods or merchandise are not considered a permanent establishment for tax purposes.[161] Foreign

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Unlike the concept of permanent establishment, the term "fixed base" is usually not defined in most treaties but it is acknowledged that the term is closely linked to the existence of physical presence in the same manner as "permanent establishment." *See* OECD Model, *supra* note 37, at Commentary on Article 14, paragraph 4.

158. *See* Jacques Sasseville, *The Future of the Treaty Rules for Taxing Business Profits*, *in* 2000 WORLD TAX CONFERENCE REPORT 5:1, 5:2 (Canadian Tax Foundation 2001).

159. OECD Model, *supra* note 37, art. 5(1).

160. *Id.* at Commentary to Art. 5.

161. *Id.* at art. 5 and Commentary. It should be noted that the greater the number of exceptions to the definition of permanent establishment, the narrower the scope of source taxation. The conceptual framework for delineating excepted activities is to generally avoid activities of a preparatory or auxiliary nature. Most of the following activities are also excluded from the OECD Model definition of permanent establishment: maintaining stock of goods solely for the purpose of storage, display, or delivery; maintaining a fixed place of business solely for the purpose of purchasing goods or merchandise or for the collection of information; maintaining a fixed place of business solely for the purpose of advertising or supplying information; or maintaining a

enterprises engaged strictly in electronic commerce and other Internet activities are not encompassed by the traditional treaty definition of permanent establishment.

If a permanent establishment does not exist within the source country, then the business profits will either escape taxation or be taxed only by the residence country.[162] If the foreign business has a permanent establishment within a country, it is necessary to allocate the profits generated by the enterprise to the permanent establishment in order to determine the business's income tax liability to the host country.[163] While tax conventions typically provide a basic arm's length standard to determine attribution of business income and expenses to the activities of multinational enterprises with a permanent establishment in a source country, the legal quandary that arises in circumstances where the treaty standard conflicts with domestic transfer pricing rules is beyond the scope of this Article.[164]

*b. Historical Development of the Permanent Establishment Concept*

A physical nexus requirement for the taxation of global business profits was introduced in the world's first bilateral tax treaty concluded in 1899.[165] Although very few countries were concluding tax treaties in the early 1900s, there was a multilateral movement towards the adoption of a set of international tax norms to deal with global

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fixed place of business to engage in activities that have a preparatory or auxiliary character on behalf of the enterprise.

162. It is important to note that if the entity is incorporated in the source country, then it is considered a resident taxpayer of that country. So the tax treaty provisions establishing the taxation of business profits by a source country are generally only applied to active business income when a permanent establishment of an unincorporated company or other foreign entity exists within its borders. It should be noted, though, that multinational enterprises do not necessarily have to carry on business in the jurisdiction of incorporation or registration.

163. The allocation and attribution of business profits for multinational enterprises often involve complex comparability and "arm's length transfer" factors. The OECD has developed a detailed set of guidelines to assist tax authorities and multinational enterprises in their efforts to apportion global business profits among those nations where the taxpayer has a permanent establishment or other nexus for taxation. *See* OECD, COMMITTEE ON FISCAL AFFAIRS, TRANSFER PRICING GUIDELINES FOR MULTINATIONAL ENTERPRISES AND TAX ADMINISTRATIONS 25–41 (1994).

164. The calculation of business profits is greatly influenced by the accepted accounting practices of each taxing jurisdiction. The OECD recognized the limitations inherent in providing that only business income attributed or connected to a "permanent establishment" may be taxed in the source country by expressly stating that the calculation of the enterprise's tax liability should be determined in accordance with the source country's domestic income tax laws. *See* OECD Model, *supra* note 37, at art. 7(2). The application of the appropriate accounting standards to the calculation of business profits for tax purposes raises a series of complex issues and considerations that are beyond the scope of this Article.

165. The bilateral tax treaty between Austria-Hungary and Prussia was signed in 1899. *See* SKAAR, *supra* note 38, at 75.

commerce.[166] In 1928, a group of experts convened by the League of Nations proposed the adoption of the first model tax convention.[167] The consensus at that time was that as long as the foreign business did not have a substantial physical presence in the host country, the residence country alone should be permitted to tax the worldwide business profits of its resident taxpayer.[168] The 1928 Model was the first significant model convention to establish physical presence as the nexus requirement for source taxation of multinational business profits as a core international tax norm.[169]

Many developing nations opposed the use of the permanent establishment rule for the taxation of multinational business profits almost from its inception.[170] In a 1943 meeting in Mexico City, a subcommittee of the League of Nations presented a model bilateral tax treaty that granted source countries the authority to tax all income from industrial, commercial or agricultural business activities taking place within the borders of the country without requiring the existence of a permanent establishment.[171] The Mexico Model, as it was referred to, did not require the existence of a permanent establishment as a prerequisite to taxation by the source country.[172] Due to the

166. In the 1920s, when groups of international tax experts were meeting to formulate a model convention to deal with the problem of double taxation and the division of tax revenues between countries, most of the European governments at that time were imposing "*impot reals*," which were basically levies on different types of income, such as a source tax on business profits. Few countries were entering into tax treaties at that time because only the United States, Canada, Japan and a few European countries had a comprehensive version of the modern income tax system during that period. *See* John F. Avery Jones, *The David R. Tillinghast Lecture: Are Tax Treaties Necessary?*, 53 TAX L. REV. 1, 12 (1999).

167. The General Meeting of Government Experts on Double Taxation and Tax Evasion, a group of tax officials from nine European countries, the United States, Japan, Argentina and Venezuela, adopted in October 1928 the first model treaty, known as the "Bilateral Convention for the Prevention of Double Taxation in the Special Matter of Direct Taxes" [hereinafter 1928 Model]. *See* UNITED NATIONS, MANUAL FOR THE NEGOTIATION OF BILATERAL TAX TREATIES BETWEEN DEVELOPED AND DEVELOPING COUNTRIES, ST/ESA/94 17 [hereinafter U.N. Manual].

168. The literature refers to "the 1920's compromise" as routinely allocating taxation of business income to the country of source and the taxation of portfolio or passive income to the country of the capital supplier's residence. *See* Graetz, *supra* note 116, at 262.

169. The 1928 Model, *supra* note 167, recommended the adoption of rules that would restrict a source country from taxing profits derived from a foreign business, unless the foreign business had a "permanent establishment" within the source country. For a historical overview of the early developments of the permanent establishment definition, see SKAAR, *supra* note 38, at 82–85.

170. *See* Zapata, *supra* note 5, at 252–53.

171. LEAGUE OF NATIONS, FISCAL COMMITTEE, MODEL BILATERAL CONVENTIONS FOR THE PREVENTION OF INTERNATIONAL DOUBLE TAXATION AND FISCAL EVASION, (League of Nations Document, C.2.M.2.1945.II.A., Geneva 1945) [hereinafter Mexico Model].

172. Many of the nations represented at the Mexico conference felt that the permanent establishment definition did not fully encompass the principle of exclusive source taxation for

model convention's embodiment of the principle of exclusive source country taxation of multinational business profits, the Mexico Model is noteworthy as "the first attempt by the developing countries to write a model treaty reflecting their particular problems."[173]

The permanent establishment threshold for source country taxation of international business profits was reintroduced in 1946 when the Fiscal Committee of the League of Nations endorsed a new model bilateral tax convention.[174] In contrast to the Mexico Model, the so-called "London Model" was used as the main reference text for the Organization for Economic Cooperation and Development (OECD), which was an association of the most industrialized countries of the post-war period.[175] The permanent establishment concept espoused in the London Model was reproduced and enhanced in the OECD Model that was originally published in 1963.[176]

The OECD Model's adoption of the permanent establishment definition in connection with the multinational taxation of business profits effectively became the blueprint for future bilateral tax treaties. The OECD Model gained incredible prominence in the ensuing decades after its first release in 1963.[177] The success of the OECD Model can be attributed to a variety of factors. The number of treaties concluded between OECD members increased rapidly following the introduction of the OECD Model. Since OECD member countries accounted for the bulk of international trade, the impact of the OECD Model extended far beyond the membership of the organization. Moreover, the commentaries on the provisions of the OECD Model gradually gained widespread recognition as useful interpretive guidelines for the application of relatively complex tax provisions.[178] The popularity of the OECD Model also contributed to its rigidity and re-

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business income that was at the root of the 1920s compromise. *See* U.N. Manual, *supra* note 167, at 17, 20.

173. U.N. Manual, *supra* note 167, at 17.

174. COMMITTEE OF LEAGUE OF NATIONS, THE MODEL BILATERAL CONVENTION FOR THE PREVENTION OF THE DOUBLE TAXATION OF INCOME AND PROPERTY, (1946) [hereinafter London Model]. The text and commentary of both the Mexico Model, *supra* note 171, and the London Model are reprinted in UNITED NATIONS, UNITED NATIONS MODEL DOUBLE TAXATION CONVENTION BETWEEN DEVELOPED AND DEVELOPING COUNTRIES (UN, ST/ESA/102, 1980) [hereinafter U.N. Model].

175. Work on the draft model bilateral tax convention started in 1956 under the predecessor entity to the OECD, namely the Organisation for European Economic Co-operation. *See* OECD Model, *supra* note 37, at 7–8. The current composition of the OECD and some of its most pertinent international tax reports are set out *supra* note 4.

176. The text and commentary of the first OECD Model was first published in 1963. The OECD Model was subsequently revised in 1967, 1977 and 1992, at which time it was converted to loose-leaf format to allow more frequent revisions. *See* OECD Model, *supra* note 37.

177. *See* ARNOLD & MCINTYRE, *supra* note 53, at 96.

178. *See* OECD Model, *supra* note 37, at 10.

sistance to change.[179] As the OECD Model became the established precedent for numerous bilateral tax treaties, revisions to the model convention would entail renegotiation of virtually all of a nation's existing treaties.[180]

The United Nations introduced a model tax convention in 1980 that purported to address the perceived greatest shortcoming of the OECD Model, namely that limits on source taxation would only have a nominal impact on the distribution of tax claims as long as international trade and investment flows were somewhat balanced between the two treaty partners.[181] The Group of Experts working under the auspices of the United Nations sought to promote the completion of tax agreements between developed and developing countries by encouraging greater levels of source country taxation in the UN Model.[182] Accordingly, the U.N. Model proposes a moderately more expansive definition of permanent establishment relative to the OECD Model.[183] The problem with the U.N. Model may be that it

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179. The inflexibility of the OECD Model was demonstrated when, in the context of developing rules for the taxation of electronic commerce, the OECD attempted to add a computer server as an element of the treaty definition of permanent establishment. *See* OECD Server Proposal, *supra* note 35 (where the recommendations of the OECD Technical Advisory Group led to the expansion of the Commentary to Article 5, but no change in the text of the OECD Model). While the intention of the OECD may have been commendable, the changes in the Commentary do not even go through the pretext of establishing a functional legal definition of permanent establishment that could be extended to electronic commerce. Basically, the OECD Server Proposal suggests that the permanent establishment definition could be reasonably amended to include computer servers in certain circumstances, ISPs in other limited circumstances, and web sites in certain rare circumstances.

180. *See* LI, *supra* note 54 (explaining why the basic structure of the OECD Model has remained the same since 1963 with most of the changes to the model being introduced through changes to the Commentaries).

181. The U.N. Model, *supra* note 174, was drafted by the *Ad Hoc* Group of Experts on Tax Treaties Between Developed and Developing Countries and was adopted by the Economic and Social Council of the United Nations in 1980 with a view to encouraging the increased participation of developing countries in the negotiation of bilateral tax treaties.

182. The OECD Model may work reasonably well when trade and investment flows between nations are relatively reciprocal. However, developing countries are often not in a reciprocal trade position to developed countries, so the treatment of multinational business profits promoted by the OECD Model represented potential loss of tax revenues for less developed countries. *See* U.N. Model, *supra* note 174, introduction.

183. For instance, the U.N. Model, *supra* note 174, reduces the time period under which a construction site may be considered permanent from twelve months under the OECD Model to typically six months, and it adds a clause stating that the furnishing of services by an enterprise for a period of more than six months within any year should constitute a permanent establishment. The most important contribution of the U.N. Model, at least in the context of the possible taxation of e-commerce activities, involves the addition of the use of facilities for the purpose of delivery of goods belonging to the enterprise as sufficient to constitute a permanent establishment. So it is possible for an online vendor of tangible goods, such as Amazon.com, that maintains a warehouse in a foreign country for the delivery of merchandise to buyers in that country

used the OECD Model as the starting point for drafting its own model treaty. The U.N. Model simply transplanted the physical presence criterion of the OECD Model when it sought to determine the appropriate nexus for source country jurisdiction with respect to the taxation of multinational business profits, thereby ensuring the perpetuation of physical presence as a cornerstone of modern bilateral tax treaties.[184]

### *D. The Need for International Tax Reform*

The prevailing system of treaty rules for the taxation of global business income is under siege on several fronts. The surging popularity of e-commerce exposes the theoretical and practical failings of the permanent establishment concept.[185] A comprehensive study of the permanent establishment principle conducted before the emergence of e-commerce concluded that modern commercial practices had already largely eroded the effectiveness of the permanent establishment requirement.[186] The international tax treatment of cross-border business income has failed to evolve in any progressive or rationale manner with the fundamental tenets of international taxation remaining the same since the 1920s.[187] The adoption of the permanent establishment definition as an international norm can be mostly explained as the power of precedent rather than any other persuasive economic or tax policy rationale.[188]

The concept of permanent establishment does not contemplate the existence of a nexus between intangible business activities and foreign markets. The use of physical criteria to determine tax jurisdiction in a digital environment inadequately responds to modern tax evasion and arbitrage strategies that are expected to dramatically increase as e-

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to be treated as having a permanent establishment under the U.N. Model, but not under the OECD Model.

184. India E-Commerce Report, *supra* note 5, at 11–12 (noting that there is no possible liberal interpretation of the existing provisions of Article 5 of both the OECD Model and the UN Model that addresses the special challenges of e-commerce and recommending that the United Nations or the OECD find an alternative to the concept of permanent establishment).

185. *Id.* at 10–11 (observing that "with e-commerce, the need for physical presence virtually ceases" so the application of the permanent establishment principle "does not ensure certainty of tax burden and maintenance of the existing equilibrium in sharing of tax revenues between countries of residence and source).

186. *See* SKAAR, *supra* note 38, at 573–74.

187. The permanent establishment threshold introduced in the 1928 Model, *supra* note 167, and developed as part of the 1920's compromise continues to be the prevailing standard for determination of tax jurisdiction for international business income, notwithstanding its shortcomings. *See* Graetz & O'Hear, *supra* note 150, at 1074–89.

188. *See* Sasseville, *supra* note 158, at 5.2.

commerce grows to its full potential.[189] The solution to this prospective tax crisis is to modify or abandon historical international tax norms, such as the treaty definition of permanent establishment, that fail to adequately correlate tax rules to digital transactions. E-commerce may prove to be the proverbial nail in the coffin of the permanent establishment principle.

The implementation of much-needed tax reforms appeared imminent in 1998 when the OECD Committee on Fiscal Affairs endorsed a report that established the framework for developing tax rules to deal with e-commerce.[190] Recognizing the challenges posed by e-commerce, the OECD subsequently released several reports addressing some of the perceived shortcomings of its model tax convention.[191] However, true progress in resolving many of the complex tax issues resulting from e-commerce has yet to occur, largely because the commitment of OECD member countries to the permanent establishment threshold for the taxation of multinational business income.[192] As long as the OECD continues to be the lead organization in developing a global strategy to address emerging tax issues, it is possible that the necessary structural tax reforms will be pushed aside in favor of *ad hoc* amendments to current international tax norms.[193]

189. The treasuries of many nations—including the United States and Canada—will likely incur significant revenue losses as multinational enterprises exploit the shortcomings of existing international tax rules and as significant numbers of taxpayers proceed to use the Internet and other technologies to evade static tax laws. *See* Jinyan Li, *E-Commerce Tax Policy in Australia, Canada and the United States*, 6 UNIV. NEW SOUTH WALES L. J. FORUM 40–48 (2000). *See also* DOERNBERG, *supra* note 18, at 388–92.

190. The Committee report, ELECTRONIC COMMERCE REPORT: TAXATION FRAMEWORK CONDITIONS, constitutes the basis of the OECD Framework, *supra* note 4.

191. In 2001, OECD technical advisory groups released the following three progress reports that built upon the OECD Framework established at the 1998 Ministerial Conference held in Ottawa, Canada, namely: OECD PE Report, *supra* note 35; OECD Characterization Report, *supra* note 50; and OECD Harmful Practices Report, *supra* note 19.

192. Michael J. McIntyre, *U.S. Taxation of Foreign Corporations in the Digital Age*, 55 BULL. FOR INT'L FISCAL DOCUMENTATION 498, 505 (2001), *available at* http://www.law.wayne.edu/mcintyre/text/For_Corp_Digital.pdf (concluding that "in speculating about the intent of the parties negotiating a permanent establishment clause before the development of electronic commerce . . . . The only plausible assumption is that no sane negotiators acting in the best interests of their respective countries and without pressure from entrenched special interests would intentionally negotiate away that right.").

193. The OECD approach to electronic commerce taxation has failed to produce any internationally accepted approach for determining the source of income earned through a website or any mechanism for determining ownership of income-producing digital assets, to name just two common practical deficiencies of existing e-commerce tax norms. The ineffectiveness of the OECD approach has significant implications on international tax authorities. Since many developing countries lack the resources and information to effectively research and analyze the impact of e-commerce on their tax administrations, the OECD reports are often relied upon by tax authorities around the world. *See* Luciana Cussi, Deputy Secretary, Secretariat of Federal Revenues—Brazil, *An Overview of the Tax Policy, Tax Administration and International Issues Raised*

The Government of India recently endorsed an extensive report on e-commerce taxation supporting the proposition that e-commerce income be taxed in the same manner as traditional commerce.[194] The report recommended the abandonment of the permanent establishment concept because it relied on an outdated physical presence standard that leads to considerable uncertainty and revenue losses when extended to e-commerce.[195] The Indian E-Commerce Report considered several alternatives to the prevailing permanent establishment norm and, although the Committee favored further study of available trade date, the report concluded that any approach adopted by the government must ensure that tax reforms are applied to all commerce and not just e-commerce.[196]

International tax treaty reforms are clearly required to address the emergence of digital commerce. The domestic tax rules of most nations, including the United States and Canada, generally provide that any foreign enterprise carrying on business within the country will be subject to taxation on any income derived from those business operations.[197] Tax treaties effectively replace the national common law threshold of regular and continuous business activities with the permanent establishment definition. International efforts to improve or reform the application of international tax rules to electronic commerce must focus on the shift in the allocation of tax jurisdiction that occurs when a bilateral tax treaty applies.

The tax convention treatment of multinational business income is increasingly under siege because treaty provisions expand the scope of residence-country tax jurisdiction over global commerce without theoretical justification.[198] The permanent establishment concept was historically supported on the basis that physical presence was necessary for carrying on significant business activities within the foreign

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*by Electronic Commerce* (paper presented on June 4, 2001 at TAX ADMINISTRATIONS AND ELECTRONIC COMMERCE CONFERENCE held in Montreal, Canada from June 4–6, 2001).

194. *See* India E-Commerce Report, *supra* note 5.

195. *Id.* at 10–12. As the second most populous country in the world with a large and technologically savvy English-speaking population, India's declaration in favor of the abandonment of the permanent establishment concept eschewed by the OECD Model could influence the path of international tax reform in the Twenty-First Century.

196. *Id.* at 12–16 (indicating that the only viable long-term solution for the problems of taxing e-commerce involves making direct taxation identical for all forms of income).

197. For an analysis of the application of the domestic tax rules of the United States and Canada to e-commerce, *see supra* text accompanying notes 63–114.

198. ELECTRONIC COMMERCE PROJECT TEAM, AUSTRALIAN TAX OFFICE, TAX AND THE INTERNET, at para. 5.3.6.1. (1999) (concluding that the application of the OECD Model's definition of permanent establishment to e-commerce would lead to an "unacceptable shift in the traditional balance between source and resident country taxing rights") [hereinafter Australian Tax Office].

market.[199] However, multinational enterprises are now capable of carrying on business activities in multiple jurisdictions without having to establish a fixed base in any particular jurisdiction and are, therefore, able to exploit traditional treaty definitions that place great importance on the location of a permanent establishment.[200] As more international business income is earned by increasingly stateless entities, it will become increasingly difficult for tax authorities to effectively apply residence-based tax rules to these multinational enterprises.[201]

Reforms to the prevailing system of international tax rules and practices must be completed in a neutral, equitable, and harmonious manner.[202] The principle of inter-nation equity recognizes that both residence and source countries should share in the tax revenues derived from cross-border commercial transactions. Current international tax rules are arguably inequitable in the apportionment of tax jurisdiction. Treaties often dictate that source countries must forego their legitimate claim to tax revenues in favor of the residence country's claim. Since wealthy countries are invariably home to many multinational enterprises while poor countries are chronic importers of capital and technology, the current network of bilateral tax treaties gives rise to the anomaly of reverse foreign aid. The treasuries of poor countries are granting tax revenues to the treasuries of the wealthiest nations! The concurrent loss of potential tax revenues affects the ability of developing nations to invest in telecommunications infrastructure, which in turn could exacerbate the global technological divide and the loss of economic opportunities for the less developed countries.

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199. The Commentary to the OECD Model, *supra* note 37, states that it "has come to be accepted in international fiscal matters that until an enterprise of one State sets up a permanent establishment in another State it should not properly be regarded as participating in the economic life of that other State to such an extent that it comes within the jurisdiction of that other State's taxing rights."

200. *See* Avi-Yonah, *supra* note 126, at 1315–16 (noting that the role of multinational enterprises, although still growing in absolute terms, is diminishing relative to the growth of portfolio investment, in part, because these integrated businesses have the ability to achieve effective export neutrality through debt financing and transfer-pricing manipulation).

201. Graetz, *supra* note 116, at 320 (arguing that attempts to determine the residence of modern global commercial enterprises are "largely an effort to put flesh into fiction, to find economic and political substance in a world occupied by legal niceties").

202. "There is no quick fix that leaves these irrational systems essentially intact and reforms only the tax treatment of electronic commerce. The appropriate response is radical reform of the current system." McLure, *supra* note 121, at 313.

## III. ALTERNATIVES FOR TAXATION OF MULTINATIONAL BUSINESS INCOME

Existing tax rules and norms dealing with global commerce need to be reformed in a manner that promotes accepted international tax policy objectives of neutrality, inter-nation equity, fairness, and administrative simplicity. The following discussion reviews the pros and cons of maintaining the status quo, as well as potential reforms to the taxation of business profits with particular emphasis given to income generated by e-commerce transactions.

### A. *Status Quo*

Even though governments and international organizations appear concerned about the potential challenges posed by e-commerce and its digital appurtenances, many industrialized nations feel that existing taxation principles can be extended to include e-commerce transactions.[203] Supporters of the status quo argue that there is no compelling reason to subject e-commerce to source-country taxation.[204] The maintenance of the status quo in a digital environment may prove an incredibly challenging endeavor. In order to bring e-commerce within the scope of prevailing tax rules and norms, tax authorities have to invoke inadequate definitions and inappropriate analogies. The United States Treasury claims that e-commerce transactions could be analogized to mail-order transactions and other traditional forms of commerce to justify the application of existing tax rules to e-commerce.[205] Further, the OECD openly recommends the use of tax treaty fictions that treat web servers in the same manner as a permanent establishment.[206]

Adherence to the status quo in an increasingly digital environment will gradually deteriorate the effectiveness of the international

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203. "The taxation framework for electronic commerce should be guided by the same taxation principles that guide governments in relation to conventional commerce." OECD, Framework, *supra* note 4, at 4. *See also* Canada E-Commerce Report, *supra* note 3, at 2.4.3.3 (recommending that "tax authorities continue to tax electronic commercial transactions in accordance with existing tax legislation . . . existing rules can be adapted to collect tax revenues").

204. *See* Michael P. Boyle et al., *The Emerging International Tax Environment for Electronic Commerce*, 28 TAX MGM'T. INT'L J. 357, 367 (1999) (arguing that as long as electronic commerce is increasing economic wealth, "there is no justification—other than a protectionist one—for a country of source to demand a fixed percentage of global wealth if the increment is not being created locally").

205. *See* James D. Cigler & Susan E. Stinnett, *Treasury Seeks Cybertax Answers With Electronic Commerce Discussion Paper*, 8 J. INT'L TAX'N 56, 63 (1997) (claiming that most Internet and other digital transactions are comparable to more traditional business methods, but acknowledging that e-commerce possesses several unique features that defy easy categorization).

206. *See* OECD PE Report, *supra* note 35.

system of taxation with a profound impact upon the treasuries of both developed and developing nations.[207] Technological developments have advanced to the point where companies can engage in significant commercial trade electronically without establishing a physical presence within the country where it completes its sales.[208] Aggressive corporate tax planning will lead to further exploitation of the deficiencies in current rules in order to minimize overall tax liability. Revenue losses could be compounded by the fact that many national tax authorities may simply be unaware that certain enterprises are generating business profits within their borders.[209]

The anticipated growth of e-commerce will likely exacerbate the problems of tax evasion and international over- and under- taxation, contributing to the unfair allocation of revenues between nations. In order to avoid the loss of potentially significant revenues, national tax authorities may unilaterally move to assert tax jurisdiction over the profits generated by e-commerce.[210] Unilateral action may increasingly lead to double taxation as two or more countries impose tax on

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207. India E-Commerce Report, *supra* note 5, at 11 (concluding that the continued application of the permanent establishment threshold in an increasingly digital business environment would adversely affect administrative certainty of tax collection). Australian Tax Office, *supra* note 198, at para. 5.3.6.1 (indicating that the application of existing international tax rules to e-commerce would cause an "unacceptable shift in the traditional balance between source and resident country taxing rights").

208. Some writers argue that any concept predicated on physical presence is incompatible with the reality of electronic commerce. *See* Charles I. Kingson, *The David Tillinghast Lecture: Taxing the Future*, 51 TAX L. REV. 641, 661 (1996) (explaining that "the search for a physical presence such as permanent establishment takes on a touch of the quixotic" when applied to electronic commerce).

209. The key to fighting non-compliance in cross-border transactions may involve increased exchanges of information among international tax authorities. Current international tax collection practices are unlikely to overcome the numerous barriers that prevent the effective exchange of digital and other useful tax information. *See* Vito Tanzi, *The Nature and Effects of Globalization on International Tax Policy: Globalization, Technological Developments, and the Work of Fiscal Termites*, 26 BROOK. J. INT'L L. 1261, 1281 (2001) (noting that the presence of substantial technical, legal, linguistic, administrative, and political limitations create impediments to the exchange of information between tax authorities and these concerns cannot be overcome in the near future).

210. If the international experience with mobile flows of capital is any indication, the more likely scenario is that source countries will engage in injurious tax competition. When the United States decided in 1984 to exempt portfolio interest from their withholding tax, it initiated a classic race to the bottom where, one after the other, all the major economies abolished their withholding tax on interest for fear of losing mobile capital flows to the United States. *See* Reuven Avi-Yonah, *Memo to Congress: It's time to Repeal the U.S. Portfolio Interest Exemption*, TAX NOTES INT'L, Dec. 7, 1998, at 1817 (noting that the American led competition of interest income taxation had adverse implications for the U.S. Treasury and eroded the pre-eminence of source taxation around the world). Electronic commerce payments could easily become subject to the same harmful tax competition if source countries determine that the application of current tax rules to digital transactions do not provide an adequate source of revenues to offset the perceived spin-off benefits of providing a targeted tax exemption.

the same business activity. If governments are unable to effectively tax the domestic income derived by e-commerce activities, multinational enterprises will continue to shift income-producing operations to low-tax or no-tax jurisdictions. Therefore, the current international tax regime is not a viable refuge from the vagaries of a dynamic economic environment.

### *B. Residence-Based Taxation*

The debate surrounding the desirability of residence-based taxation as opposed to source-based taxation continues in a digital age with some proponents arguing for greater residence-country jurisdiction to tax e-commerce business profits.[211] Advocates of residence-country taxation believe that electronic transactions may escape taxation altogether unless the resident vendor is taxed on its net income.[212] Two primary reasons have been advanced to justify exclusive residence country taxation of global business profits of resident individuals and businesses. First, exclusive jurisdiction would allow the home country to more easily tax business income on a net basis in accordance with the ability-to-pay principle.[213] Second, residence country taxation would discourage multinational enterprises from shifting their profit-making activities to lower tax jurisdictions because the firm's country of residence will continue to tax those profits even after such a shift.[214]

The digital age of global commerce challenges the proposition that residence-based taxation will lead to the collection of greater tax revenues for some countries. In fact, it is more likely that the strict application of residence rules would lead to greater tax avoidance and evasion due to the increasingly malleable nature of corporate residency.[215] Under a pure residence-based system of taxation, multina-

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211. "The best guarantee in order to avoid double taxation issues would in any case be to abandon the [permanent establishment] concept in favor of exclusive residence-based taxation." Ine Lejeune et al., *Does Cyber-Commerce Necessitate a Revision of International Tax Concepts?*, 38 EUR. TAX'N 50, 58 (1998).

212. *See* U.S. E-Commerce Report, *supra* note 3, at § 7.1.5, 18–19 (noting that "source based taxation could lose its rationale and be rendered obsolete by electronic commerce. By contrast, almost all taxpayers are resident somewhere.").

213. Kaufman, *supra* note 61, at 158 (noting that although this ability-to-pay theory has become associated with social welfare views of distributive justice, the theory does not necessarily apply to multinational enterprises).

214. Effective resident country taxation will require substantive tax reforms that establish rules for the net taxation of the whole commercial enterprise. In so far as residence taxation is predicated on equity and ability-to-pay principles, it is important for the resident's tax base to be globally inclusive. *See* McIntyre, *supra* note 129.

215. It is unlikely that the necessary tax reforms could ever be adopted because tax authorities already experience great difficulty in determining the business profits of multinational enter-

tional enterprises will have considerable financial incentive to incorporate separate and distinct legal entities in tax havens and low-tax jurisdictions.[216] For instance, because U.S. tax law classifies a company as domestic or foreign based on its formal place of incorporation, it is possible for multinational enterprises to shift income-producing activities to an entity incorporated in a tax haven country and avoid having to pay current income tax to the U.S. Treasury.[217]

A residence-based approach to global taxation of business income would be particularly inadequate in its treatment of e-commerce businesses. The contemporary economic reality is that e-commerce presents a lucrative and mobile business model for global enterprises to shelter significant profits. Once the value of an electronic or information good or service has been established, the marginal cost for marketing, producing and transmitting the online product approaches zero, thereby, providing the opportunity for the e-commerce vendor to realize significant gains upon the sale of intangible products without the need for establishing a residence in the market country.[218] Existing companies will be driven to relocate their e-commerce and other profitable operations through isolated corporate entities.[219] Start-up technology companies will be encouraged to establish the income-producing aspects of their operations within tax havens in order to avoid paying taxes.[220]

A move towards residence-based taxation of all business income would entail radical shifts in the international distribution of tax revenues. Based on current economic trading patterns, the move to greater

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prises. *See* Bird & Wilkie, *supra* note 59, at 82 (noting that tax administrators tend "to favour the source principle for pragmatic reasons, reflecting the considerable practical difficulties of extending the residence principle beyond national borders without hard-to-secure cooperation from foreign tax authorities").

216. For a discussion of how Walmart and other large companies have established and isolated legally distinct entities to take advantage of sales tax loopholes and opportunities within the United States, see Cockfield, *supra* note 19.

217. The Internal Revenue Code provides that "domestic corporations" must pay income tax based on the company's worldwide business profits. *See* I.R.C. § 61 (2002). A "domestic corporation" is defined as an entity that was "created or organized in the United States or under the laws of the United States or of any State." *See* I.R.C. § 7701(a)(4) (2002) and text accompanying *supra* note 67. *See* Avi-Yonah, *supra* note 126, at 1314, 1317 (noting that multinational enterprises do not vote and are not residents of a single society and that these entities only have a territorial connection to the United States on the basis of source of income).

218. *See* Arthur J. Cockfield, *Information Economics and Digital Taxation: Challenges to Traditional Tax Laws and Principles*, 11 (2002) (unpublished manuscript on file with author). Since Internet and technology companies are relatively mobile, it is possible for such enterprises to shift income-producing e-commerce activities to preferential tax jurisdictions.

219. *See* Swain, *supra* note 19; Cockfield, *supra* note 19.

220. Cockfield, *supra* note 2, at 172 (suggesting that many multinational enterprises will likely be able to avoid having to pay any tax whatsoever on their e-commerce profits under a pure residence-based approach).

residence-based taxation of cross-border business profits would dramatically increase the flows of tax revenues from the treasuries of developing countries to the coffers of developed countries.[221] Any further shift in the tenuous equilibrium of inter-nation revenue distribution in favor of the treasuries of the wealthy nations would have profound international economic consequences.[222] Developing nations are particularly vulnerable to the development of rules that would permit e-commerce producing nations to exclusively tax global business profits.[223] Since the adoption of a pure residence-based system of taxation for e-commerce or traditional commerce transactions would exacerbate distributive disparities among nations, it is unlikely that such a proposal would obtain the requisite international support.[224]

### *C. Global Profit Formula*

An alternative form of international taxation of global business profits requires the apportionment of income among related companies based on a stipulated formula.[225] Nations would divide the taxpayer's global income according to an internationally accepted formula. The formula for income allocation could include typical factors, such as sales, payroll costs, and assets within the jurisdiction, or could

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221. *See* Charles E. McLure, Jr., *Source-Based Taxation and Alternatives to the Concept of Permanent Establishment*, *in* 2000 WORLD TAX CONFERENCE REPORT 6:1 (Canadian Tax Foundation 2001) (noting that the possibility of any move by the U.S. to adopt residence country taxation of multinational business profits would be "technically naïve as well as self-serving and politically unrealistic"). Due to the position of the United States as the world leader in the production and export of e-commerce goods and services, it is believed that any move to expand residence country jurisdiction would be motivated by fiscal self-interest.

222. The precarious imbalance in tax revenue allocation that would ensue as a result of greater residence country taxation would likely be unsustainable. *See generally*, DOERNBERG, *supra* note 18.

223. Cockfield, *supra* note 10, at 1182 (noting that governments throughout the world—especially developing countries—are concerned that they will not receive their fair share of the revenues associated with taxing e-commerce profits).

224. Although it may appear that the U.S. could increase its revenues under a residence-based regime for the taxation of business profits, pragmatists argue that such a shift in tax policy would have a revolutionary and, perhaps, opposite effect. *See* David L. Forst, *The Continuing Vitality of Source-Based Taxation in the Electronic Age*, *in* TAX NOTES INT'L, Nov. 3, 1997, at 1455 (claiming that "in the electronic age the traditional method of dividing taxing rights continues to be robust, and the adoption of a new method, such as exclusive taxation of persons by their countries of residence, is neither warranted from a conceptual perspective nor likely to be agreed to by the world's nations").

225. *See* Jinyan Li, *Global Profit Split: An Evolutionary Approach to International Income Allocation*, 50 CAN. TAX J. 823 (2002) (arguing that the concept of formulary apportionment is a natural development in the evolution of international tax reform and consistent with the development of the globally integrated business mode). Professor Li proposes a global profit split method for allocating international income whereby the allocation formula would reflect the economic factors that contribute to profit making.

conceivably be extended to include other factors, such as research and development expenditures.[226] The formula apportionment process resembles the system already used in federal countries, such as the United States and Canada, to divide income tax revenues among their internal jurisdictions.[227]

The conceptual legitimacy of the formulary approach for income taxation is widely acknowledged as providing benefits that complement international trade.[228] The global profit split method would allow better matching of profits derived from international commerce with the jurisdiction that contributed the economic resources to produce the profits. The formulary approach to global income taxation would effectively replace the need for aggressive transfer pricing rules. Businesses with operations in more than one country would be treated as a single taxable entity for global profit allocation purposes. Many of the hurdles associated with applying the current transfer pricing rules to integrated and intangible e-commerce goods and services would be alleviated under the formulary approach.[229]

Sharing tax revenues among nations according to an accepted formula may present an equitable solution to the alternative of exclusive residence-based or source-based taxation.[230] Nonetheless, any move towards formulary apportionment of multinational business profits would undermine the present international consensus regarding the proper allocation of taxable income among jurisdictions.[231] Furthermore, the global profit split method would have to overcome a variety of seemingly insurmountable practical and administrative diffi-

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226. *See* Graetz, *supra* note 116, at 318–19.

227. Provincial income tax systems in Canada tend to be more unified with the federal income tax system than the U.S. state income tax systems are with the U.S. federal income tax system because most Canadian provinces have adopted the federal government's income tax base and jurisdictional apportionment formulas. *See* Forgione, *supra* note 13, at 16.20.

228. The European Union is considering the recent recommendations for the use of formulary allocation proposed by the Commission of the European Communities in its Communication from the Commission to the Council, the European Parliament and the Economic and Social Committee, TOWARDS AN INTERNAL MARKET WITHOUT TAX OBSTACLES: A STRATEGY FOR PROVIDING COMPANIES WITH A CONSOLIDATED CORPORATE TAX BASE FOR THEIR EU-WIDE ACTIVITIES (October 23, 2001). Formulary taxation was also considered as a viable option within North America in a study by Paul R. McDaniel, *Formulary Taxation in the North America Free Trade Zone*, 49 TAX L. REV. 691 (1994).

229. *See* Reuven S. Avi-Yonah, *The Rise and Fall of Arm's Length: A Study in the Evolution of U.S. International Taxation*, 15 VA. TAX REV. 89, 158–59 (1995).

230. The global profit split method effectively allows the taxpayer's country of residence to tax part of the entity's business income while also allowing the source country to tax part of the profits. *See, generally*, Li, *supra* note 225.

231. *See* Avi-Yonah, *supra* note 126, at 1306 (noting that the present international consensus is that business income should be taxed in the country in which it originates and that any move away from source country taxation of active income would go against the ultimate goal of the international tax regime).

culties, such as requiring uniform definitions of tax factors and allocation formulas.[232] Although formulary apportionment represents an intriguing potential solution to transfer pricing difficulties, this approach to international taxation of multijurisdictional business income has a long list of detractors.[233] A report to the Canadian Minister of National Revenue stated that the formulary approach would not necessarily eliminate the risk of double taxation, would be difficult to administer, and would "lead to an unfair allocation of taxes on profits among countries."[234] The U.S. experience with limited formulary apportionment on a subnational level does not bode well for the multilateral development of a global profit split tax model.[235]

### *D. Expansion of Source Country Tax Base*

Expansion of taxation within the source country is predicated on the international consensus that a nation should have the primary claim to tax business income derived within the borders of the country.[236] The current network of international tax treaties provide a mechanism by which tax claims can be apportioned between residence and source country. Tax treaties invariably establish a compromise by granting the source country the right to tax business income earned

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232. The need for tax base uniformity under a formulary apportionment regime has been cited as an unrealistic objective as it would represent an overwhelming restriction on a nation's fiscal sovereignty. The fiscal sovereignty of nations has led to the establishment of diverse and disparate tax bases around the world, which would have to be dismantled if countries are to adopt the formulary apportionment model. *See* OECD E-Commerce Report, *supra* note 4, at 66 (noting that formulary taxation creates "administrative complexity and requires a level of international cooperation that is unrealistic to expect in the field of international taxation").

233. Formulary apportionment was first considered and rejected by the League of Nations in 1927 and 1928. In recent years, the OECD and the U.S. Treasury Department have come out against global formulary apportionment. *See* Cockfield, *supra* note 2, at 173–74.

234. Canada E-Commerce Report, *supra* note 3, at 4.1.3.2 (indicating that the adoption of a global formulary apportionment tax system would not adequately address issues raised by e-commerce insofar as e-commerce profits were treated differently than traditional business income).

235. There are numerous complexities that surround the application of apportionment factors and allocation formulas under the different tax rules adopted by U.S. states. *See* Graetz, *supra* note 116, at 320 (observing that the formulas used by many states weigh the factors differently, typically to the advantage of the local treasury, with the result that some income is taxed more than once in multiple jurisdictions while other income appears to escape taxation altogether).

236. The international model tax treaty negotiations that culminated in what came to be known as "the 1920s compromise" provided for business income to be taxed by the source country. *See* Warren, *supra* note 149, at 132 (summarizing the 1920s compromise as settling that "the source country is given primary (or exclusive) jurisdiction to tax corporate business income, while the residence country is given primary (or exclusive) jurisdiction to tax investment income"). *See also* Avi-Yonah, *supra* note 126, at 1305 (noting that "the international consensus allocates active business income to the jurisdiction from which it derives (the source jurisdiction) and passive income to the jurisdiction in which the investor resides (the residence jurisdiction)").

within its borders, but only if the income is attributable to a permanent establishment in the source country.[237] It is possible to increase the level of effective taxation of business income in the source-country without materially reforming prevailing international tax norms through modifications to conventional tax rules and expansion of the permanent establishment definition.[238] These reforms could be pursued on an international level or, simply, by modernizing domestic tax rules and definitions to address electronic commerce.[239]

### 1. Restricted Force of Attraction Principle

In an effort to expand the taxing jurisdiction of the source country, the United Nations model tax convention adopted a restricted force of attraction rule for the taxation of active business profits.[240] The principle allows tax authorities to attribute income from several sources to a foreign entity that has a permanent establishment within the host country. The profits of an e-commerce division of a traditional business enterprise could theoretically be taxed under force-of-attraction rules by the country where the sales are completed, as long as the entity that carries on the e-commerce activities maintains a physical presence in the market country.[241] The restricted force of attraction principle could be implemented without the need for substantial tax reform. Bilateral tax treaty rules could be modified by adding clauses to permit a country to tax business activities within its borders that are similar to activities conducted by an existing permanent establishment of the related taxpayer within the country.[242]

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237. *See* Arnold, Sasseville, and Zolt, *supra* note 22 at 1987–89 (nothing that even though the source country is clearly entitled to tax any income that is derived within the boundaries of the country, the permanent establishment restriction is supposed to alleviate the compliance burden on taxpayers and the administrative duties of tax officials in the source country).

238. Source-country taxation of business profits can be expanded simply by modifying existing attribution and transfer pricing rules, by clarifying standards applied in respect of the characterization of income, or by expanding the treaty definition of permanent establishment. *See generally*, OECD PE Report, *supra* note 35.

239. International and domestic tax rules can be broadened to include website and integrated software agents where appropriate. *See* McIntyre, *supra* note 192, at 506 (arguing that to "maintain some coherence to the U.S. tax rules, therefore, it is necessary for the United States to treat a virtual office created through the use of a web site on the Internet as an office for tax purposes").

240. *See* U.N. Model, *supra* note 174, art. 7(1) and related Commentary to Article 7.

241. *See* Cockfield, *supra* note 2, at 205–16 (arguing in favor of the application of the restricted force of attraction principle for the taxation of e-commerce).

242. There is currently no international consensus on how to attribute profits to the activities of a permanent establishment. E-commerce underscores the need to introduce clear and effective attribution rules whether it is along the lines of the restricted force of attraction principle, or in accordance with some variation of the prevailing arm's length principle. *See* OECD PE Report, *supra* note 35.

The major problem with the force of attraction rule is its close attachment to the concept of permanent establishment. Under a force of attraction principle, it is still possible for multinational firms to transfer income-producing business activities that would traditionally be carried on from a permanent establishment to separate web-based operations situate outside of the market country. Taxpayers can structure operations in a manner that could attribute income derived from auxiliary e-commerce transactions to or away from the enterprise's permanent establishment.[243] The profits of many e-commerce businesses may never be subject to taxation by the country where the supply is concluded because the taxpayer may not possess a fixed place of business within that country.[244] The force of attraction principle shares many of the same deficiencies of the permanent establishment concept in its approach to e-commerce and the globalization of trade of intangible goods and services.

### 2. Withholding Tax on Commercial Transactions

Another method for expanding the taxation base for source countries would be to impose a withholding tax on certain business sales. Basically, this proposal requires a specified percentage of the amount paid for a commercial good or service to be withheld in the jurisdiction where the sale is completed and remitted to the tax authority of that jurisdiction. Nations can establish a monetary threshold that would preclude the source country from imposing a withholding tax on the e-commerce income until the taxpayer earns the threshold amount within the source state.[245] The application of a withholding tax regime often permits income to be taxed in both the source country and the residence country.[246] The market country collects withholding tax

243. Global enterprises could easily implement entity isolation strategies that bypass the application of permanent establishment attribution rules. *See* McLure, *supra* note 121, at 403.

244. Cockfield, *supra* note 19 (observing that the world's largest retailer has incorporated a separate entity for its e-commerce operations with the choice of incorporating jurisdiction for the entity apparently motivated by state sales and use tax avoidance strategies). The isolated entity principle can be extended on an international level to minimize the U.S. federal and state income tax liability of the e-commerce enterprise.

245. Reuven S. Avi-Yonah, *International Taxation of E-Commerce*, 52 TAX L. REV. 507, 536 (1997) (indicating support for withholding from the gross e-commerce sale within a jurisdiction in excess of a stipulated monetary threshold).

246. The taxpayer's country of residence retains the right to tax the worldwide business income of the taxpayer after providing a tax credit for the amount of any withholding tax paid to the foreign treasury. The application of a low withholding tax rate by the source state would result in additional tax room for the taxpayer's country of residence. Whether there would be a transfer of revenues from the source state to the residence state depends on the tax base and rates for the withholding tax as negotiated between treaty partners.

revenue regardless of whether the taxpayer has a permanent establishment in the country.

The infeasibility of implementing a withholding tax on all business transactions would probably lead to the withholding tax proposal being limited to selected business activities, such as e-commerce transactions. However, the notion of imposing withholding tax obligations only on e-commerce transactions violates several important tax policy principles. Tax neutrality promotes worldwide economic efficiency by ensuring that tax biases are removed from business investment decision-making.[247] A withholding tax regime also gives rise to administrative complexities when it relies on identification and compliance by consumers.[248] In order to mitigate administrative concerns, the source country could impose a withholding tax only on selected taxpayers, such as foreign businesses operating within the country without using a permanent establishment.[249] Such an approach, though, may be inequitable to the taxpayer.[250] Where a source-based withholding tax is imposed on the gross amount of the payment to the foreign company, it is unlikely that the tax rate will correspond to the economic profit earned by the vendor on the transaction across all market sectors.[251]

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247. The neutrality principle requires that all business income whether arising out of e-commerce transactions or through more traditional means be taxed in an harmonious and similar manner. *See supra* text accompanying notes 117–129.

248. Compliance by withholding tax obligants could easily become an administrative nightmare. Private sector developments in communications technology already make it difficult for tax authorities to identify where buyers and sellers of e-commerce goods and services are located. The collection of a withholding tax would be particularly difficult to monitor where goods and services are delivered in digital form directly to the consumer's computer. Many e-commerce consumers may unintentionally and unknowingly fail to report the taxable transaction. *See* Canada E-Commerce Report, *supra* note 3, at 4.2.1.2 (identifying concerns of unintentional non-reporting by e-commerce participants due to "the purchaser's lack of knowledge of the tax implications of payments to non-residents and related procedures," such as the need to withhold and remit a percentage of the purchase price to local tax authorities).

249. It is possible to retain the current framework of bilateral tax treaties and add withholding tax rules that apply only to e-commerce transactions. In such cases, e-commerce profits would be accorded special treatment under the treaty in the same manner as other select forms of income, such as income earned by athletes and entertainers under the OECD Model, *supra* note 37, at Art. 17.

250. The use of withholding taxes may contribute to an increase in the overall level of taxation to the multinational taxpayer. Although the taxpayer would theoretically be indifferent as long as the overall level of tax would be unchanged, the withholding tax regime creates possibilities of over-taxation in the source country due to non-recognition of underlying business expenses as well as incomplete relief from double taxation by the residence country due to the basket limitations of the foreign tax credit rules.

251. In order to alleviate the seemingly inequitable treatment of foreign businesses, proponents of the withholding tax concept suggest that the taxpayer should be permitted to elect to file as a net-basis taxpayer in the source state. The foreign taxpayer would receive a tax refund or

## *E. Adoption of Domestic Source Nexus*

The tax sovereignty of each country has led to the adoption of a domestic nexus standard that is applied to all businesses that do not fall within the scope of a tax treaty. The act of carrying on a trade or business within the market country would be sufficient for tax authorities to assert jurisdiction to tax all income arising from the trade or business activities of the taxpayer in the market country.[252] The default domestic standard clearly establishes a lower threshold for source-country taxation than the treaty standard of permanent establishment, but it is unclear whether the current domestic business nexus would encompass e-commerce.[253]

Reversion to domestic tax rules complements the notion of national tax sovereignty. A country that is allowed to exercise its taxing jurisdiction over income generated by the purchasing activities of its nationals has the corresponding right to delineate the appropriate scope of its tax jurisdiction. A nation is legitimately entitled to apply its domestic tax laws to business profits earned on sales made within the country.[254] Market-based income taxation involves the allocation of tax jurisdiction to the nation where the consumption occurs. The multinational taxpayer would be indifferent as to which country collects the revenues as long as its total tax bill remains unchanged.[255]

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credit for any withholding tax paid in excess of the domestic income tax burden that would otherwise be payable to the source country. *See* Avi-Yonah, *supra* note 245, at 532, 541.

252. The jurisdictional threshold established by U.S. domestic tax law for taxation of non-resident businesses is whether the foreigner's activities constituted a "United States trade or business." Under Canadian tax law, the jurisdictional threshold is whether the non-resident was "carrying on business in Canada." *See supra* text accompanying notes 69–79 and 104–107.

253. For a foreign person to be carrying on a U.S. trade or business, the business activities of the non-resident must be "considerable, continuous, and regular." *See, e.g.*, Pinchot v. Commissioner, 113 F.2d 718 (2d Cir. 1940). Although this common law standard for U.S. taxation has not been applied to Internet technology, it was held in a case involving radio transmission that "broadcasting through the ether" did not constitute carrying on a U.S. trade or business. Piedras Negras Broadcasting Co. v. Commissioner, 43 B.T.A. 297, 311 (1941), *aff'd* 127 F.2d 260 (5th Cir. 1942). Based on the case law, it seems that the domestic nexus standard in the U.S. requires either human action or the presence of a tangible business asset in the United States. *See* McIntyre, *supra* note 192; David R. Tillinghast, *Taxation of Electronic Commerce: Federal Income Tax Issues in the Establishment of a Software Operation in a Tax Haven*, 4 FLA. TAX REV. 339 (1999).

254. "One can argue that entitlement to corporate tax revenue exists any time a firm avails itself of the productive resources or the market of a nation—that is, if it has an economic presence in the nation." Charles McLure, Jr., *Source-Based Taxation and Alternatives to the Concept of Permanent Establishment*, *in* 2000 WORLD TAX CONFERENCE REPORT 6:1, 6:4 (Canadian Tax Foundation 2001).

255. Since the taxpayer's country of residence would typically provide unilateral relief from double taxation by granting a tax credit for foreign taxes or by exempting foreign source income from the residence tax base, the foreign business should be indifferent as to the allocation of the tax burden between the two nations.

The domestic tax standard provides administrative convenience to tax authorities because it can be applied uniformly to all foreign businesses.[256] Nonetheless, while the domestic nexus for business taxation offers benefits, the tax rules of most nations need to be modernized if e-commerce vendors are to be subject to the same threshold as other commercial enterprises.[257]

### *F. Reviewing the Tax Reform Alternatives*

The previous sections explored the various alternatives for the international taxation of business profits, in general, and the treatment of income from electronic commerce, in particular. Having noted in the earlier part of this Article that prevailing international treaty norms contribute to the anomalous flow of tax revenues from the treasuries of poor countries to the treasuries of wealthy nations, the argument for economic justice naturally points away from the status quo towards international tax rules that promote greater taxation of multinational business profits in the source or market jurisdiction. The final part of this Article explores the objectives and policies that should guide the implementation of reforms to expand source country taxation of global commerce.

## IV. TECHNOLOGY AND THE PURSUIT OF GLOBAL ECONOMIC JUSTICE

The digital revolution refers to the use of information technologies in a manner that creates new and substantial markets. Electronic commerce provides a mechanism for moving economic activity closer to the ideals of perfect competition.[258] The structure and capabilities

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256. Tax authorities can apply the same standard to all non-resident businesses if bilateral tax treaties adopt the reciprocal domestic nexus for taxation. In addition to alleviating the importance of residency determinations, the domestic nexus approach avoids considerations of whether the foreign enterprise has a permanent establishment in the market country.

257. The ability of Internet users to prevent identification of their e-commerce transactions may continue to present challenges for tax authorities and lead to separate domestic tax rules for e-commerce. Furthermore, it may be necessary to adopt some form of withholding tax rules in order to protect the interests of the domestic treasury against foreign resident taxpayers with nominal assets in the market country. In reviewing how existing domestic tax rules in the United States would be applied to e-commerce, the U.S. Treasury, *supra* note 3, at 7.2.3 declared: "U.S. based individuals engaged in providing marketing and support services for a foreign-based provider of computerized research may create a U.S. trade or business for the foreign person even if the computer servers and other activities are located outside the United States." *See also id.* at 7.2.5 (concluding that "it may be necessary to further clarify the applicable principles in this area and seek to create an international consensus on this issue").

258. *See* J. Barrett Willingham, *Electronic Commerce and the Free Trade Area of the Americas*, *in* NAFTA: LAW AND BUSINESS REVIEW OF THE AMERICAS 483, 487 (The Hague, Kluwer Law Int'l 2000) (indicating how e-commerce, with its low transaction costs, reduced barriers

of the Internet and e-commerce transcend the traditional market limitations of time, geography, and information.[259] The Internet allows instant market responses. The global nature of e-commerce reduces the economic importance of the geographical location of suppliers and consumers. Businesses can now access remote global markets with relative ease. The greater availability and transmission of information facilitates price revelation, improves product development, and allows for tailored customer service. In short, the digital age offers the real prospect of economic efficiencies and valuable new global markets for e-commerce businesses.[260]

The current system of taxation for global business income is in dire need of reform. While e-commerce successfully eliminates time and distance as barriers to global trade, it creates new problems for international tax authorities. International income tax rules developed out of an historical compromise that allocated jurisdictional tax claims over multinational business profits based on physical presence. Bilateral tax treaties provide that a host country may tax active business income only if it can be attributed to a permanent establishment within the country. The global nature of the Internet poses significant challenges to traditional notions of jurisdiction and sovereignty. The digital economy permits multinational enterprises to engage in trading on a virtually global scale, twenty-four hours a day, seven days a week. It is now possible for commercial enterprises to engage in significant business activity in a foreign jurisdiction without establishing a physical presence in the jurisdiction.

Maintenance of the status quo is not sustainable for administrative and policy reasons. Internet tax freedom has led to tremendous concern in the United States about the dichotomous treatment between e-commerce and its tangible equivalents.[261] On an international

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to entry and improved consumer access to information complements the ideal of perfect competition that underlies the move towards liberalized trade regimes).

259. Catherine L. Mann, *Balancing Issues and Overlapping Jurisdictions in the Global Electronic Marketplace: The UCITA Example*, 8 WASH. U.J.L. & POL'Y 215, 223 (2002) (exploring how the Uniform Computer Information Transactions Act balances the tensions of policymaking in an increasingly global information-based marketplace).

260. "These efficiencies that minimize time and geography constraints, combined with the information and network characteristics of the Internet marketplace, allow for more ways for business to create value." *Id.*

261. The ITFA, *supra* note 84, which was amended by the *Internet Tax Nondiscrimination Act of 2001*, *supra* note 85, is scheduled to expire on November 1, 2003. This author believes that it is very unlikely that the Bush Administration will be able to garner a further extension of the existing moratorium. In response to the reality that e-commerce products are not subject to the same sales and use tax treatment accorded to physical goods and services, tax authorities from about forty states recently entered into the Streamlined Sales and Use Tax Agreement (SSUTA), which generally seeks to extend the indirect taxation laws of the U.S. states to electronic sales.

level, the United States government has indicated that it is committed to developing a coherent strategy to deal with the tax and trade implications of the Internet and electronic commerce.[262] The continuing inability of international trade negotiations to resolve basic conceptual notions about e-commerce demonstrates the inadequacy of the current approach to global commerce.[263] International tax authorities are responding to escalating administrative concerns by resorting to the outdated "competent authorities" provisions in tax treaties to procure information on the identity of taxpayers situate in foreign jurisdictions.[264]

### *A. Abandon Treaty Concept of Permanent Establishment*

Reforms must involve reconsideration of the existing nexus threshold for business income taxation found in most bilateral tax

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As of June 5, 2003, South Dakota, Kentucky, Utah, Arkansas, Indiana, Kansas, Minnesota, Nebraska, North Dakota, Vermont, Washington, and West Virginia had amended their tax laws to comply with the SSUTA. Texas has passed legislation to bring its sales tax laws in partial compliance with SSUTA. California, which a recent study estimated lost $1.75 billion in sales taxes on purchases by Californians from out-of-state vendors, is taking steps to formulate new Internet tax policies in anticipation of the demise of the federal restriction. *See* STATE TAX TODAY, 30-6 (Feb. 13, 2003), 31-3 (Feb. 14, 2003), 60-9 (Mar. 28, 2003), 60-10 (Mar. 28, 2003), 94-40 (May 15, 2003), 96-31 (May 19, 2003), and 108-33 (June 5, 2003). *See also* David E. Hardesty, *Streamlined Sales Tax Nears Adoption Threshold* (June 5, 2003), *available at* http://www.ecommercetax.com/doc/ 060503.htm.

262. *See* Ambassador Charlene Barshefsky, United States Trade Representative, Testimony before the House Appropriations Committee on Commerce, Justice, State and Judiciary (F.D.C.H. April 5, 2000), *available at* 2000 WL 365138 ("We also have begun a longer-term work program, whose goals include ensuring that our trading partners avoid measures that unduly restrict development of electronic commerce; ensuring that WTO rules do not discriminate against new technologies and methods of trade. . .[and] take maximum advantage of electronic commerce.").

263. Trade agreements must overcome the challenges inherent in classifying an electronic sale as a transaction involving either a "good" or a "service." The General Agreement on Trade and Tariffs (GATT), which deals with the cross-border trading of goods, subjects "goods" to national treatment and most-favoured-nation treatment in a manner not found in the General Agreement on Trade in Services ("GATS"), which deals primarily with "services." *See generally*, JOHN H. JACKSON, THE WORLD TRADING SYSTEM: LAW AND POLICY OF INTERNATIONAL ECONOMIC RELATIONS (2d ed., MIT Press 1997); and Richard N. Snape & Malcolm Bosworth, *Advancing Services Negotiations*, *in* THE WORLD TRADING SYSTEM: CHALLENGES AHEAD 185 (Jeffrey J. Schott ed., Institute for International Economics 1996). The distinction between "goods" and "services" has taken on even greater importance in the negotiation of international trade agreements due to the growth of e-commerce. *See* Mann, *supra* note 259, at 226–27 (arguing that e-commerce embodies a "complex nature of bundled transactions [that] will create huge problems in classifying these transactions as goods or services and within services, by which delivery mode").

264. Many tax treaties have provisions providing for exchange of information between different national tax authorities, but the practical consequence of the current system of international information exchange is that treaty partners "end up exchanging very little or no information." McCracken, *supra* note 16, at 1883.

treaties. Domestic tax laws invariably allow the source country to assert primary tax jurisdiction over income arising from business operations within the country, unless a bilateral tax convention provides otherwise. Tax treaties change the nexus standard set out in a nation's laws for taxation of the business income of foreign residents. The problem is that bilateral tax treaties limit source country taxation of multinational business profits through the use of the permanent establishment definition and other restrictive rules that focus on physical presence.

The permanent establishment definition must be abandoned because it fails to respond to the intangible nature and other challenges of e-commerce.[265] As long as the permanent establishment concept remains the core requirement for taxation of international business income, the market country will be precluded from asserting tax jurisdiction over e-commerce income. As the digital economy gains momentum, the continued application of the permanent establishment concept will result in increasingly greater losses of tax revenue for source countries and more opportunities for tax avoidance by integrated multinational enterprises.

### B. *Market Country Taxation of Multinational Business Profits*

The abandonment of the treaty concept of permanent establishment should be accompanied by a move towards greater taxation of international business income in the source or market country. Expansion of the source country tax base resolves jurisdictional tax claims while promoting inter-nation equity. Fairness exists in the international tax system only insofar as tax jurisdiction and revenues are allocated among nations in a manner that conforms to prevailing views of international justice and equity.[266]

Source country taxation finds legitimacy in the benefits theory of taxation, which provides that a nation has an equitable claim to tax income derived from market activities fostered by the nation and its residents. Under the benefits theory, tax revenues are perceived as contributions for the provision of market opportunities and services. Education, infrastructure, police, laws, and accumulations of wealth are only a few of the national resources that benefit market partici-

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265. The Government of India recommended the abandonment of the permanent establishment concept in 2001 based on several important theoretical and practical shortcomings of the existing treaty definition of permanent establishment. *See* India E-Commerce Report, *supra* note 5.

266. *See* Kaufman, *supra* note 61, at 153–54 (the principle of inter-nation equity is presented as the primary consideration for a tax system predicated on international justice).

pants.[267] Even if one does not totally embrace the benefit theory of taxation, the concept of neutrality provides further support for the legitimacy of a host country to tax business income arising out of market transactions completed within its borders.[268]

The promotion of source-based taxation of global business profits should not in itself be perceived as the panacea for all problems plaguing the current regime of international taxation. Transfer pricing issues among related multinational enterprises, global disintermediation, and the difficulties in categorization of income will continue to require the attention of international tax authorities. Some of these challenges may be alleviated by the proposal to expand market country taxation of multinational business profits, but it will nonetheless be necessary for tax authorities to modernize their domestic tax codes to address many of the special challenges presented by digital technologies. Income characterization issues are particularly important in the area of electronic commerce because the prevailing system of tax treaty rules imposes substantially different levels of taxation depending on the categories of income without following any legitimate rationale.[269]

Tax authorities must act quickly to utilize new technologies that facilitate the administration and remittance of income tax on international business transactions.[270] E-commerce importing countries would have to develop appropriate collection and enforcement mechanisms in order to enjoy a portion of the increasing revenues associated with business profits derived by e-commerce sales to resident consumers.[271] Governments need to assert their authority over the evolution of an Internet architecture to ensure that the nation's revenue interests

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267. "The claim of source countries to tax income produced within their borders is analogous to a nation's long-recognized claim of sovereignty over natural resources within its boundaries." Graetz, *supra* note 116, at 298.

268. The jurisdictional claim of a country to tax revenues from market activities within its borders is supported by economic principles of worldwide economic efficiency and capital import neutrality. The principle of tax neutrality also requires that all business income, whether arising out of e-commerce transactions or through more traditional means, be taxed in a similar manner. *See supra* text accompanying notes 117–129.

269. Digital transactions could be reasonably treated, depending on the circumstances, as generating either business profits or royalties. *See* Avi-Yonah, *supra* note 126, at 1308–310.

270. Cussi, *supra* note 193, refers to Internet-based start-ups, such as "mycustoms.com" and "tariffic.com" that already offer online forms and other services to ensure that transactions in a foreign country comply with the excise tax requirements of the local tax authorities.

271. Tax authorities need to implement technologically advanced collection, monitoring, and enforcement mechanisms that can apply to e-commerce. Some countries may take unilateral action by introducing administrative and collection rules that provide for the withholding and remittance of tax payments due by foreign e-commerce companies if there is reason to believe that the foreign supplier may not remit the tax liability to the source country.

are satisfied according to domestic tax laws.[272] Smart governments will regulate, not by direct regulation of e-commerce buyers and sellers, but by introducing regulations that encourage e-commerce businesses to develop computer codes to assist with the collection and reporting of income tax at source.[273] Since the e-commerce business-to-business market represents about eighty percent of the total e-commerce market at this time, it has been suggested that the imposition of regulatory requirements that promote tax laws could be implemented without too much difficulty in the business-to-business sector.[274]

Tax authorities interested in developing market country tax rules for multinational business profits should consider the information and experience gained in other taxation areas. The rules and mechanisms underlying existing consumption taxes, such as value-added taxes, may provide considerable guidance for governments needing to develop income tax guidelines on the basis of a market nexus.[275] It is important to recognize the link between income and consumption taxes and related claims of inter-nation equity that have, for the most part, been left unanalyzed.[276] The European Union's (EU) recent enactment of new regulations are particularly relevant in that the new rules ensure that most global e-commerce businesses would be required to collect value-added tax (VAT) on sales made to EU consumers.[277] International tax authorities could reasonably follow the EU experience and adopt similar rules for income tax purposes so that businesses aiming to sell e-commerce products to residents of a par-

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272. *See* Cockfield, *supra* note 10, at 1236–237 (arguing that "Internet technologies also represent opportunities that could resolve a number of the vexing problems that plague international tax.").

273. This argument borrows largely from Professor Lawrence Lessig's theory that "code is law" as set out in Lawrence Lessig, *The Limits in Open Code: Regulatory Standards and the Future of the Net*, 14 BERKELEY TECH. L.J. 759, 763 (1999) ("Smart governments will regulate, but not by directly regulating the behavior of people in cyberspace. Smart governments will instead regulate by regulating the code that regulates the behavior of people in cyberspace."). *See also* LAWRENCE LESSIG, CODE AND OTHER LAWS OF CYBERSPACE 5–8 (Basic Books 1999).

274. *See* OECD E-Commerce Report, *supra* note 4, at 34–36.

275. All of the OECD member states, except the United States, have implemented some form of value-added sales tax. In most countries, destination-based VATs exempt exported goods and services while imports are subject to the tax. *See* Cockfield *supra* note 10, at 1259.

276. Warren, *supra* note 149. *See also* Graetz, *supra* note 116, at 299 (observing that credit-method value-added taxes are a common form of consumption taxes).

277. The EU directives, which take effect in July, 2003, subject electronic commerce sales to VAT in roughly the same manner as sales of tangible services. As a result of the new rules, foreign companies that make e-commerce sales to EU consumers or businesses must register with an EU jurisdiction. EU tax authorities argue that the new VAT directive will ensure that the collection and remittance of taxes on e-commerce sales and other digital products will be more uniform with traditional business procedures. For further information on the regulations and legal provisions adopted by the European Union enacted in May, 2002, see Directive 2002/38/EC and Reg. No. 792/2002, which amended the Sixth VAT Directive 77/388/EEC.

ticular country would have to register with or notify the appropriate tax authority before completing e-commerce sales to the foreign consumer.

### *C. Bridging the Global Digital Divide*

The Internet and electronic commerce have the potential to promote economic development throughout the world. Globalization offers developing countries the prospect of collecting tax revenues from increased business activities within their jurisdiction, which can be used to promote telecommunications infrastructure and other technological improvements in these poor countries. These countries would, in turn, be more capable of participating in international trade and investment, which in turn would lead to further tax revenues being invested in telecommunications infrastructure and digital technology, ultimately leading to greater market opportunities for nations that export e-commerce goods and services.[278] However, many poor countries fear that this productivity cycle is being thwarted by international tax rules that prevent the market country from receiving their full share of multinational business profits.[279] Developing countries have been reluctant to enter into bilateral tax treaties that required them to forego their jurisdiction to tax foreign enterprises conducting business within their boundaries. Nations that refuse to conclude bilateral tax treaties with industrialized countries remain on the periphery of global trade and investment flows.

In order to realize the promise of the digital age, governments must adopt tax provisions that enable market countries to tax global e-commerce companies. The "global digital divide" between nations will ultimately deprive multinational businesses of the loss of future markets.[280] Unless the existing system of international taxation is reformed in a neutral and equitable manner, the poorest countries of the

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278. If developing countries are permitted to tax the income generated by the e-commerce purchases of its citizens, then it would encourage government investment in telecommunications infrastructure leading to improved markets for developed countries. *See generally*, Arthur J. Cockfield, *Electronic Commerce, Developing Countries and Declining Tax Revenues*, *in* UNESCO ENCYCLOPEDIA OF LIFE SUPPORT SYSTEMS (2002) (unpublished manuscript on file with author).

279. *See* Cockfield, *supra* note 2, at 1182 ("Developing countries are particularly vulnerable to the development of rules that permit e-commerce producing nations to exclusively tax cross-border e-commerce transactions.").

280. The "global digital divide" refers to the disparity or gap between countries and individuals that have access to information technologies, such as the Internet and e-commerce, and those countries and individuals that do not have such access. *See* J.M. Spectar, *Bridging the Global Digital Divide: Frameworks for Access and the World Wireless Web*, 26 N.C. J. INT'L L. & COM. REG. 57 (2000).

world could easily spiral into a cycle of declining tax revenues and depleted infrastructures. International tax rules must be improved to bolster source-country gains in order to maintain a fair division of tax revenues.[281]

The United States recognizes the need to adopt equitable and neutral rules for the taxation of e-commerce in order to prevent revenue losses that could further the "digital divide" between nations.[282] The substantial disparity in Internet use and e-commerce between the United States and many developing countries does not benefit any nation.[283] The United States has been proactive in introducing e-commerce into regional trade negotiations, but due to the continuing prevalence of technological disparities throughout the world, the U.S. proposals have been met with suspicion, disapproval, or outright rejection.[284] Due to concerns of tax neutrality, the United States has argued for the harmonized tax treatment of digital products downloaded over the Internet and their tangible equivalents.[285] United States dominance of electronic commerce will, at least in the short run, increase the importance of fair and equitable rules in international trade agreements.[286] Over the long term, it would be mutually advantageous for the disparate tax regimes of the world to unify their trade

281. Graetz, *supra* note 116, at 328.

282. The United States is committed to the amelioration of the digital divide. *See* THE WHITE HOUSE, THE CLINTON-GORE ADMINISTRATION: FROM DIGITAL DIVIDE TO DIGITAL OPPORTUNITY (Feb. 2, 2000), *available at* http://www.digitaldivide.gov/2000-02-02.html.

283. *See* FTAA JOINT GOVERNMENT-PRIVATE SECTOR COMMITTEE OF EXPERTS ON ELECTRONIC COMMERCE, REPORT WITH RECOMMENDATIONS TO MINISTERS, *available at* http://www.ftaa-alca.org. Former Mexican President Ernesto Zedillo eloquently noted that "the biggest betrayal of those poorest people would be to try to tell them that you don't need electronic commerce, or suggest to them one way of getting something out of the WTO is to block electronic commerce." *WTO Chief, Mexican President: Free Trade Failure Only Hurts Poor*, DOW JONES INT'L NEWS SERV., Jan. 28, 2000.

284. "Major trading nations, led by the United States, have systematically exercised a sort of neomercantilist strategy by introducing electronic commerce into global trading arrangements to enhance their own wealth, power and market access at the expense of others." Wiwit Wirsatyo, *E-Commerce at Global Negotiation*, JAKARTA POST, March 31, 1999 (claiming that developing countries are worried that their relative lack of technological capacity will casue them to become e-commerce consumers rather than producers, leading to the erosion of local and national languages and cultures). The U.S. and developed European Union countries have alienated developing countries by demanding international consensus on Internet regulation. *See* Steven M. Hanley, *International Internet Regulation: A Multinational Approach*, 16 J. MARSHALL J. COMPUTER & INFO. L 997 (1998).

285. The Gilmore Commission, which dealt with the interaction of selected U.S. trade, tax and e-commerce issues, opined that software, books and music should be treated in the same manner whether delivered in digital or tangible format, effectively requiring that governments "harmonize down" the tax treatment of the tangible equivalent of the tax-free e-commerce product. *See* Mann, *supra* note 259, at 230.

286. *See* Willingham, *supra* note 258, at 500.

and tax policies to respond to the challenges presented by increasingly global business enterprises.[287]

If the necessary political will can be drawn into action, then we may be able to avert the prospect of escalating economic disparity among the world's nations. Governments and tax authorities from industrialized countries must demonstrate the willingness to negotiate tax treaties that address the equitable concerns of developing countries. The expansion of source-based taxation would provide opportunities for developing nations to exercise their legitimate claim to tax revenues arising out of the commercial purchase activities of their nationals. In order to appease the interests of prospective tax treaty partners, a country may agree to reduce its rate of source income tax on foreign business income so as to allow the country of residence to levy some tax on the net business income of its resident taxpayers. By balancing the revenue interests of all countries, we may be able to forge a path towards worldwide consensus on the need for international tax reform.

287. *See* Amelia H. Boss, *Electronic Commerce and the Symbiotic Relationship Between International and Domestic Law Reform*, 72 TUL. L. REV. 1931 (1998) (arguing that e-commerce requires a symbiotic relationship between domestic and international legal reforms of disparate legal systems).