

REFORMING THE PERMANENT ESTABLISHMENT PRINCIPLE THROUGH A QUANTITATIVE ECONOMIC PRESENCE TEST

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SUMMARY

The permanent establishment principle has shown remarkable resiliency, forming an accepted international income tax law principle since its inception roughly 100 years ago. The basic idea is that countries agree through their tax treaties that they will not tax profits associated with a nonresident's cross-border transaction unless those profits are attributable to a fixed place of business within their borders. Recent developments, including the acceptance by the OECD member states of the Ottawa Taxation Framework Conditions/¹/ along with the new server/PE category, suggest that tax authorities and multinational businesses continue to be wedded to the PE concept.

The PE's success is surely related to the flexibility of the concept. In fact, the physical presence requirement under the PE has undergone significant dilution over the past several decades. This paper argues for further evolution of the PE principle to take into account modern commercial practices, such as e-commerce, that permit nonresident firms to generate significant revenue in foreign markets without the need for a physical presence. The OECD model tax treaty/²/ and the U.N. model tax treaty/³/ should possibly incorporate a new PE fiction -- a quantitative economic presence test -- that enables source countries to tax above-threshold sales (for example, gross revenues in excess of US \$ 1 million) despite the absence of any physical presence.

Part I of this article briefly reviews the historical development of the PE principle as well as its success in eliminating international double taxation and promoting a relatively balanced sharing of tax revenue. Part II discusses how the PE principle has evolved to dilute the physical presence test. Particular attention is paid to the recent OECD initiative that introduces a new PE category: computer servers. Part III argues that the development of a quantitative economic presence PE would be consistent with the historical rationale for PEs and could restore a balanced sharing of tax revenue among countries without imposing overly burdensome compliance costs on multinational firms.

I. A BRIEF HISTORY OF THE PERMANENT ESTABLISHMENT PRINCIPLE

A. WHERE DOES THE RULE COME FROM?

An early version of the PE principle has been traced to the late 1800s, when European nations negotiated bilateral tax treaties to govern the tax treatment of cross-border economic activity.^{/4/} The modern version of the rule arose after World War I when nations became concerned that international double taxation was inhibiting international trade and investment. After the war, for example, Canadian tax authorities attempted to tax incoming mail-order sales of a U.S. firm even though the firm advertised its goods only in Canada.^{/5/} The Americans maintained that the United States should have the exclusive right to tax those earnings, creating potential double taxation of the same business activities.

Because of growing concern, the League of Nations commissioned a group of tax specialists to come up with a mechanism to ensure that double taxation would be avoided. The group arrived at a consensus and developed the PE concept that became enshrined in a 1927 model tax convention and later adopted in the 1963 OECD model tax treaty (as well as subsequent revisions of this model treaty in 1977 and 1992).

Under the traditional PE principle, the country in which a nonresident business conducts its business (the source country) agrees that it will not tax cross-border profits resulting from a nonresident's activities unless the nonresident maintains a PE within the borders of the source country and profits can be attributed to the activities of that PE. The country where a business is based (the residence country) typically agrees to grant a tax credit for the amount of taxes paid to the source country to avoid international double taxation. Alternatively, the residence country can exempt from taxation any income earned by a PE located in a source country (as Canada does for types of active business income earned within tax treaty partner countries).

The PE is a defined term in each bilateral tax treaty and generally consists of "a fixed place of business through which the business of an enterprise is wholly or partly carried on."^{/6/} Tax treaties offer examples of PEs, including stores, offices, branches, and factories. Also, tax treaties typically exclude from the definition of a PE activities related to a physical presence within a source country that are merely preparatory or auxiliary in nature, such as the maintenance of a warehouse to store goods.^{/7/} In essence, the historical PE is supposed to represent a fixed physical presence within the source country that lasts for a significant period of time and performs integral aspects of a cross-border transaction.

B. CAN THE RULE BE JUSTIFIED?

Contemporary international tax policy analysis often uses guiding principles to evaluate a legal rule, such as the PE principle. On the equity side, entitlement theories, such as the benefit principle, economic allegiance, or international equity are used to justify a tax policy choice. On the efficiency side, commentators typically trot out goals, such as promoting capital export neutrality, capital import neutrality, the need for low compliance and tax administration costs, and so on. In truth, there is little agreement on the appropriate set of guiding principles for

international tax policy, and an honest view might suggest that current justifications suffer from arbitrariness.

The arbitrariness can be partly explained by the absence of any world tax authority to unify the disparate theories. In contrast, tax systems at the national level can at least theoretically be brought into concordance with accepted guiding principles through political measures, as electorates can toss out legislators who impose politically unacceptable taxes. Because of the absence of any world tax organization, developments in international tax policy result less from the application of accepted guiding principles. Instead they take form from a combination of the exercise of economic power and the need to promote cross-border economic activity to enhance domestic welfare through international trade and investment. In other words, countries strive to collect as much tax revenue as possible from international trade and investment without upsetting the apple cart by provoking retaliations from major trade partners.^{8/}

For example, there is no sacred reason why a physical presence requirement should be used to determine nexus for international income tax purposes. Commenters have noted that the exertion of tax jurisdiction over significant sales into a source country can be justified simply on the basis that the source country market presented opportunities for the profits to be generated in the first place. For example, Klaus Vogel suggests, "[i]t cannot convincingly be denied that providing a market contributes to the sales income at least to some extent as providing the goods does. There is no valid objection, therefore, against a claim of the sales State to tax part of the sales income."^{9/} Other potential justifications for taxation despite an absence of a physical presence include the fact that the source country government provided the means to access the market by building roads and other infrastructure.^{10/} Finally, permitting capital importing countries (especially developing countries) to enjoy revenue from taxing cross-border transactions offers those countries an incentive to subsidize telecommunications facilities and networks, which in turn expands market opportunities for capital-exporting nations.^{11/}

Having noted the arbitrariness of existing rationales, it is still possible to argue that the PE principle has well served the international community, or at least the developed nations that implemented and supported it.^{12/} The principle can be justified from an efficiency perspective as it offers a relatively straightforward compliance guide to businesses and tax authorities. A multinational firm understands that it will not have to hire a foreign accountant, register as a taxpayer, maintain records under foreign tax laws, file a tax return, and so forth in a foreign jurisdiction unless it sets up shop in the source country. Similarly, the physical presence requirement permitted the foreign tax authority to audit and, if necessary, seize property to satisfy an outstanding tax liability.

The PE principle can also be supported from an equity perspective. Historically, most multinational companies would typically not set up a store or branch office unless they intended to conduct significant business activity within the source country. In an age when international trade most often contemplated cross-border sales of manufactured goods, a physical presence within foreign markets was often necessary to engage in significant operations. Hence, source countries were permitted to tax only significant and recurring cross-border activity taking place within their borders. As long as that assumption holds, the PE rule enabled a relatively balanced sharing of tax revenue from cross-border activities; capital-exporting countries enjoyed the

revenues associated with taxing production, while capital-importing nations derived revenue from taxing sales functions.

In any event, the proof, as they say, is in the pudding, and the PE principle appears to have promoted or at least not inhibited cross-border trade and investment, enhancing national and international welfare. The success of the principle, however, is almost certainly related to the flexibility of the concept, which has adapted to changing commercial practices.

II. EVOLUTION OF THE PERMANENT ESTABLISHMENT PRINCIPLE

A. DILUTION OF THE PHYSICAL PRESENCE REQUIREMENT

In a remarkable book titled *Permanent Establishment: Erosion of a Tax Treaty Principle*, Arvid Skaar traces the evolution of the PE principle from its inception to the late 1980s.^{13/} In his study of the application of the principle by national tax authorities, Skaar notes that the principle has undergone a significant dilution during the past half-century to take into account emerging commercial practices. Enhanced global trade, the rise of the service sector, increased mobility of capital, and other factors of production all contributed to a perceived need to modify the physical presence requirement of the traditional PE.

Consider the definition of a permanent establishment within the current OECD model tax treaty. The PE definition was broadened to include dependent agents that habitually conclude contracts in source countries.^{14/} Further, construction projects lasting more than 12 months constitute a PE (often reduced to 6 months in tax treaties).^{15/} Also, PE fictions were developed to circumvent the requirement of geographic and temporal permanence. The fictions ensured that temporary and mobile activities fall within the definition of permanent establishment. For example, income above a stipulated threshold earned by entertainers within source countries can be taxed by this state despite the absence of any real fixed place of business.^{16/} Under the OECD model tax treaty, particularly mobile industries such as shipping or air transport are taxed where the place of effective management is located.^{17/}

Skaar also notes that some treaty provisions negotiated between countries further dilute the PE principle beyond the developments within model tax treaties. For example, the tax treaty between Norway and the United Kingdom includes provisions to ensure pure source state taxation of offshore petroleum-related activities, which "implies that several of the traditional conditions for PEs under the basic rule are completely abandoned."^{18/}

Finally, the U.N. model tax treaty has broadened the definition of PE to strengthen source state taxation, which is typically in the interest of developing nations. For example, a PE within that model tax treaty is defined to include independent agents in some circumstances, as well as the performance of services that last longer than six months.^{19/} A "restricted force of attraction" rule additionally expands source state taxation by permitting states where nonresidents maintain traditional PEs to tax other income that is attracted to the PE, even though that income is not directly related to the PE.^{20/} Other multilateral tax treaties, such as the Andean Pact, moved to exclusive source-based taxation, downplaying physical presence tests.

Increased economic integration along with information technology developments such as the Internet represent a renewed threat to the usefulness of the PE concept. In 1991 Skaar concluded his study by suggesting "the future is likely to prove that the PE principle has lost its force for new and mobile industries, whether tax treaties are renegotiated for this purpose or not."^{21/}

B. RECENT DEVELOPMENTS: THE SERVER/PERMANENT ESTABLISHMENT

In recent years, the PE principle has attracted renewed attention as a result of the advent of Internet and e-commerce.^{22/} The Internet, essentially a network of networks linked by a common communication protocol, enables and facilitates remote economic activity. At times, the Internet removes the necessity for traditional intermediaries (for example, foreign branches) that were used to enable cross-border transactions. Instead of a traditional store or depot, computer servers (that is, computers that are networked to the Internet) can perform functions similar to these traditional PEs, as the software within the server can display a Web page on the Internet, take a customer's order, accept payment, and transmit digital goods and services.

Other information technology developments encourage source state tax erosion under traditional principles by promoting: (1) the consolidation of foreign operations; (2) the replacement of physical establishments with Web sites to transfer transaction costs to customers; (3) a reduction of source country offices for customer support and after-sales services; (4) the replacement of agents with remote contracting; and (5) the enhanced provision of remote services.^{23/} Governments and commenters are concerned that those new commercial developments would further dilute source country tax jurisdiction and revenues,^{24/} accelerating an already worrisome trend.^{25/}

In November 1996 the U.S. Treasury was the first national tax authority to issue a report on the international tax policy implications of e-commerce.^{26/} The discussion draft, which did not represent official U.S. policy, was meant to frame the policy challenges presented by e-commerce. However, a concern arose with the report's view that the nature of the Internet and an increase in remote economic activity likely meant residence-based taxation would take on greater importance.^{27/} That was a worrisome suggestion to many non-American tax authorities as, then and now, the United States produced and exported the lion's share of international e-commerce.^{28/} Further, the report suggested that servers would not likely constitute PEs under U.S. tax policy.^{29/}

In contrast, most other national tax authorities took a more cautious approach to the server/PE issue. For example, in 1998 Revenue Canada (as it was then) refused to take a position when a U.S. company asked about the tax implications of storing proprietary information on a Canadian-based server.^{30/} Two Canadian government reports published in 1998 suggested that a server might constitute a PE under some circumstances.^{31/} Other tax authorities, including the Australian Tax Office, also suggested that a server might constitute a PE.^{32/}

Against that background, the OECD began to play an active role in trying to help its member states reach consensus on many international e-commerce issues, including cross-border income and consumption tax issues. In October 1998 the then-29 OECD member states reached consensus at the Ministerial Meeting on Global E-Commerce in Ottawa on the principles that

should guide the development of international tax rules for e-commerce. The OECD member states adopted the so-called Ottawa Taxation Framework Conditions, which asserted that traditional tax rules and principles should generally be applied to e-commerce.^{/33/} Further, [t]he approach does not preclude new administrative or legislative measures, or changes to existing measures, relating to electronic commerce, provided that those measures are intended to assist with the application of the existing taxation principles. [A]ny adaptation of existing international taxation principles should be structured to maintain the fiscal sovereignty of countries, to achieve a fair sharing of the tax base . . . and to avoid double taxation and unintentional nontaxation.^{/34/}

Other guiding principles included the need for: (1) maintaining neutral tax treatment between e-commerce and traditional commerce; (2) low compliance costs for taxpayers and low administrative costs for tax authorities; (3) clear and simple tax rules to promote business certainty; (4) reducing the risk of tax evasion and tax avoidance; and (5) flexibility to keep pace with technological and commercial developments. Businesses and governments also signed on to nearly identical guiding principles in the Joint Declaration of Business and Government Representatives.^{/35/} It was clear that governments and businesses would not tolerate radical changes to the international income tax regime or new rules for e-commerce alone.

The OECD then appointed a working group to study PEs. After a two-year period of issuing drafts and soliciting feedback, the group presented its recommendations in December 2000. The OECD adopted them into the commentaries to the OECD model tax treaty in February 2001.^{/36/} The commentaries essentially create a new PE category for computer servers. At the same time, the view that Web sites should constitute PEs was rejected. Servers now constitute a PE under the OECD model tax treaty if the server performs integral aspects of a cross-border function and the nonresident firm owns or leases the server within the source country.

No human intermediary is required to program or service the foreign-based server. The commentaries offer an example of a retail server/PE that displays a Web page, takes a customer's order, processes payment, and transmits a digital good or service to the end consumer. Under those circumstances, the server constitutes a PE entitling the source country to tax profits attributable to the server. Profit attribution is likely a source of controversy in this area, and the OECD has issued yet another draft report on the topic of server profit attribution as part of its efforts to reach consensus on the application of profit attribution in the context of transfer prices.^{/37/}

In other works I have argued that servers should never constitute PEs, mainly because the location of a server need not have any geographic connection to activities that add value and create income.^{/38/} Servers and the software functions within a server form part of the hardware and software infrastructure of the Internet. Those can be shifted outside the country where an e-commerce firm is based or where software products are developed, and outside the source country where e-commerce goods and services are purchased. Two main deficiencies of the new rule have been identified. First, server/PEs will not effectively allocate taxing jurisdiction and revenue to source countries. Second, server/PEs offer tax-planning opportunities for multinational firms to shift income outside residence countries.

Under the guise of promoting traditional tax principles, I have argued that the OECD has almost completely warped the original intent of the PE concept into an economic presence test of sorts.^{39/} Consider the following example. Canco is a Canadian resident e-commerce company that sells digital goods and services. Canco can lease servers in a low corporate income tax jurisdiction, such as Ireland. Software within the Irish servers can be designed to data mine consumers (through the use of, say, cookies) to create marketing profiles of the individuals that surf its Web site. This compiled information creates a marketing intangible that is "owned" by the Irish server/PE and that can be later "sold" under traditional transfer pricing principles to Canco, creating a deductible expense in Canada and generating revenue and potential profits for the Irish server/PE. As discussed in part IV. 2(b) of this article, those sorts of situations may lead tax authorities to focus less on the physical presence of a server and more on the activities performed by the server to determine the extent that source countries can exert their tax jurisdiction over e-commerce activities.

By attempting to develop cyberspace analogs to the traditional PE concept, OECD member states have subverted the traditional physical presence requirement to a significant extent. It remains unclear whether this new rule will be successfully implemented by the OECD member states. England, Germany, and Switzerland have suggested that they will not follow the new rule because, in their view, servers should not be used to create a nexus. On the other hand, Spain and Portugal dissented from the OECD view on the grounds that Web sites should be treated as PEs, presumably in the hope that more revenue would be allocated to these net e-commerce importing nations through a broader view of nexus for e-commerce purposes.

The United States, which initially came out in the Treasury report against server/PEs, ultimately signed on to the new server/PE rule. According to a former senior Treasury official, "The [new server/PE] rules present a reasonable compromise, but also confirm both the prescience of the 1996 Treasury Report, a generation ago in the IT [information technology] age, and the inexorable move, there predicted, toward the demise of source-based taxation in this area."^{40/} Treasury apparently believed the new rule would not expand source-based taxation, hence effectively promoting residence-based taxation of e-commerce, which placed the United States back in the position it advocated in the Treasury report.

C. REFORM PROPOSALS: GETTING RID OF PES

The Committee is of the view that applying the existing principles and rules to e-commerce does not ensure certainty of tax burden and maintenance of the existing equilibrium in sharing of tax revenues between countries of residence and source. The Committee is also firmly of the view that there is no possible liberal interpretation of the existing rules, which can take care of these issues, as suggested by some countries. The Committee, therefore, supports the view that the concept of PE should be abandoned and a serious attempt should be made within OECD or the UN to find an alternative to the concept of PE.^{41/}

Tax authorities in India have made it clear that maintaining the status quo is not in their interest. To restore a balanced sharing of revenue, observers have proposed several mechanisms that seek to move away from the PE requirement in many ways.

Richard Doernberg has suggested that a low rate withholding tax imposed by source countries on business-to-business e-commerce sales may be appropriate (while maintaining the traditional PE principle for other cross-border profits).^{42/} The gross tax should be creditable in the country of residence to avoid international double taxation. Further, the residence-based taxpayer should have the option to file a return in the source country and pay a net income tax instead of the gross withholding tax (largely to remove tax liability when the firm's ventures are not profitable).

The Indian Ministry of Finance has seemed to approve that approach, although it was indicated that the withholding tax should be applied to all cross-border transactions (that is, e-commerce and traditional commerce) that erode source state revenue. Further, the withholding tax should represent the firm's final tax liability and, hence, the taxpayer should not have the option to file as a net payer.^{43/} Also, India's tax authorities have been aggressive in characterizing cross-border e-commerce payments as resulting in royalty income to impose royalty withholding taxes under its tax treaties.^{44/}

In a previous work, I suggested that e-commerce developments could be addressed by: (1) making it clear that a computer server will never constitute a PE; (2) permitting countries to negotiate a low rate withholding tax for all e-commerce payments as long as a multinational enjoys above-threshold sales within source countries; (3) expanding the use of the restricted force of attraction rule; and (4) resorting to a greater use of the residual profit split method for difficult transfer pricing matters involving unique intangibles.^{45/}

A potentially more ambitious approach suggests a greater use of withholding taxes along with global formulary apportionment, as discussed by Jinyan Li.^{46/} Formulary taxation would replace the current transactional arm's-length approach to transfer pricing. Under the formulary taxation approach, the income of multinational firms would be divided among countries under a stipulated formula. Much like the system used by provinces in Canada and states in the United States for corporate income taxes, a ratio of factors, such as payroll, property, or sales, would be taken into consideration to determine the appropriate division of revenue. By taking into account sales within a source state, tax jurisdiction and accompanying revenue would be allocated to that state even in the absence of a physical presence.

All of those suggested approaches are at least theoretically defensible. However, none has attracted international support from tax authorities, apart perhaps from sympathetic views from the developing world, such as the Indian tax authorities. The main argument against the use of withholding taxes is that those taxes are often placed on unprofitable activities, thus punishing or distorting cross-border trade and investment. Further, the OECD has led a worldwide trend toward a reduction in withholding taxes to stimulate more international investment and trade. These views have been at least partly supported by many national tax authorities, including Canada's.^{47/} Others suggest that, theoretical concerns aside, withholding taxes work well in practice and represents the best way for tax authorities with few resources to protect their tax base from the erosion that results from remote cross-border transactions.

Formulary taxation is often touted as the most realistic alternative to the transactional arm's-length regime, which, it is argued, does not fit well into the world of increased economic trade and investment where multinational firm activity is highly integrated. The current transfer

pricing regime arguably fails to address that reality by attempting to fictitiously separate integrated elements of a firm's activities into discrete components. Despite its potential merits, formulary taxation is likely politically infeasible, as many governments and international organizations have come out against formulary taxation in recent years, including the European Union's Ruling Committee, the OECD, the CCRA, and the U.S. Treasury. Those views largely spring from fiscal sovereignty concerns, as countries would be bound to formulae determined at the supranational level. Others attack formulary taxation on technical grounds that the proposed system will be inefficient, increase enforcement and compliance costs, and continue to permit income-shifting strategies.

At any rate, developments such as the Ottawa Taxation Framework Conditions and the server/PE rule demonstrate that the OECD member states are unwilling to depart in any significant way from the PE principle and traditional arm's-length approach to transfer pricing. However, the gradual dilution of the physical presence requirements, the increasing usage of profit-split formulae, and advanced pricing agreements have, as commenters have recognized, shown an acceptance by the OECD member states that the PE principle should continue to evolve and adapt to modern commercial practices.^{48/}

III. TOWARD AN ECONOMIC PRESENCE PERMANENT ESTABLISHMENT

I suggest that national tax authorities should consider adopting a PE fiction within model tax treaties called a quantitative economic presence PE that would permit source countries to tax significant cross-border economic activity.^{49/} A quantitative threshold, such as gross sales of US \$ 1 million, will ensure that source countries can subject nonresident companies to their tax jurisdiction only if those nonresidents conduct significant business activities within their borders. The rule is designed as a backstop to protect source country income tax base erosion and could promote greater business certainty surrounding the taxation of many cross-border transactions.

A. QUANTITATIVE VS. QUALITATIVE TESTS

The suggested approach is similar to previous reform proposals. For example, a League of Nations subcommittee in 1940 investigated whether changes were necessary to the PE principle.^{50/} The subcommittee drafted a model draft treaty (the so-called Mexico Draft) that maintained the fixed place of business requirement for a PE, but also permitted source state taxation when significant sales took place within the source country despite an absence of a fixed place of business. Paragraph 2 of art. IV of the Mexico Draft stated, "If an enterprise or an individual in one of the contracting States extend their activities to the other State, through isolated or occasional transactions, without possessing in that State a permanent establishment, the income derived from these activities shall be taxable only in the first State." According to Skaar, "[t]he criterion under this model is the regularity or location of the activities of the business operations, rather than the significance or location of the activities of the enterprise."^{51/}

Because of the advent of World War II, most of the subcommittee consisted of representatives from Latin American countries. The representatives sought to strengthen source state taxation.

The Mexico Draft was never adopted by the League of Nations, and a later draft (the so-called London Draft) returned to the earlier definition of a PE that focused largely on the need for a fixed presence within a source country.

Similarly, Luc Hinnekens has discussed the potential creation of a "virtual PE" in model tax treaties, under which source countries would be permitted to tax cross-border profits as long as the nonresident company conducted continuous and commercially significant business activity within the source country.^{/52/} Hinnekens suggests that to determine whether source state nexus is met, a facts and circumstances test could be developed, similar to the one used by U.S. courts in the context of state and local sales and use taxes. This test would use qualitative criteria (for example, presence of computer servers or use of trademarks) and quantitative criteria, because "[e]ven significant volumes of sales may not be sufficient to prove a nexus-constitutive level of focused and purposeful penetration and performance of core activities in the market of" the source country.

The qualitative approach to economic presence tests arguably suffers from many deficiencies. The experience of subfederal sales taxes in the United States is instructive. Forty-five states and over 7,000 local governments have developed their own sales and use tax systems. Subfederal governments often pass legislation (so-called long-arm statutes) to try to force out-of-state businesses to charge and remit sales taxes on purchases by residents of the taxing state. The dormant commerce clause of the U.S. Constitution, however, prevents state and local governments from passing laws that unduly interfere with interstate commerce.

The U.S. Supreme Court developed an earlier facts and circumstances test to determine whether subfederal laws passed constitutional muster. In the context of the sales and use taxes, the Supreme Court later indicated that that test created unacceptable uncertainty, as firms with interstate commerce could never be certain whether a state or local government would be able to exert its tax jurisdiction over out-of-state firms. As a result, the Supreme Court ultimately developed a bright-line test that prevents subfederal governments from imposing sales tax collection obligations on out-of-state firms unless those firms maintain a physical presence within the taxing state (similar in many ways to the traditional PE principle).^{/53/}

As a result of their inability to tax most remote consumer sales, state and local governments are estimated to be losing up to \$ 12 billion a year in revenue losses.^{/54/} Further, the physical presence test has led to a tax-planning strategy called entity isolation in which retailers incorporate a separate subsidiary for remote sales to insulate those sales from sales tax obligations.^{/55/} Because of the problems surrounding remote sales, state tax authorities are working toward radical unification and simplification of the disparate state and local sales tax systems through the efforts of the Streamlined Sales Tax Project (SSTP). Under the SSTP all state and local governments will adopt the same sales tax base, and filing requirements will be greatly simplified. As of 2 October 2003, 38 states have introduced or passed legislation approving the SSTP model or similar models that would permit states to impose collection obligations on remote retailers despite the absence of any physical presence within the taxing state.

There is concern over the increasing use of qualitative economic presence tests in the context of U.S. state income tax laws. It is unclear whether the bright-line physical presence test enunciated by the U.S. Supreme Court applies to subfederal income taxes or only to sales taxes. Some state courts have taken the former position and permitted state tax authorities to assert income tax jurisdiction over out-of-state firms despite the absence of any physical presence by those firms. For example, state courts have permitted state tax authorities to assert income tax jurisdiction over an out-of-state company if the company licenses trademarks or other intellectual property rights to an affiliate in the taxing state.^{56/} Critics have suggested that those qualitative economic presence tests lead to business uncertainty and onerous compliance obligations for firms that can never be certain whether they have filing obligations in jurisdictions where they maintain no physical presence.^{57/}

Despite those apparent deficiencies, qualitative economic presence tests in the federal context make at least theoretical sense because the highest court in the land can ultimately resolve compliance uncertainty (although there continues to be significant litigation over these issues within the United States). In the international context, these tests make less sense, because there is no world tax authority or world tax court. As a result, tax authorities and courts throughout the world will develop their own interpretation of the factors that meet the requirements for source state taxation. Capital-importing nations will tend to interpret the factors broadly to permit their tax authorities to exert jurisdiction over nonresident firms, while capital-exporting nations will tend to construe the test more narrowly. Different interpretations might lead to greater business uncertainty, an increase in assessments and litigation, and international double taxation.

On the other hand, a quantitative test might be relatively easy to administer and enforce. A firm without a traditional PE in a source state would not have to incur compliance costs and file a tax return in the source state unless the firm surpassed the stipulated threshold. The proposal would catch only large multinational firms with significant global sales and the resources to comply with foreign income tax obligations in countries where they have no physical presence. Reuven Avi-Yonah has proposed a gross withholding tax for above-threshold sales in the context of cross-border e-commerce sales and has discussed the feasibility of quantitative threshold tests that focus on gross sales.^{58/} The quantitative economic presence PE is reviewed in more detail below.

B. EVALUATION

This section provides an initial evaluation of the quantitative economic presence test, although it is recognized that more consideration and analysis would be necessary before serious consideration of this approach. For example, empirical analysis is required to estimate how an economic presence test would alter the existing allocation of tax revenue among different nations.

1. Upholds Historical Rationale for PE

The proposed economic presence PE would uphold the traditional rationales of the PE principle. First, it would ensure that source countries enjoy tax revenue from significant cross-border activity that takes place within their borders. As such, it would encourage a balanced sharing of revenue between capital-exporting and capital-importing nations. That sharing would

discourage aggressive practices by capital importing nations that are losing revenue through changing commercial practices. The economic presence test would discourage international double taxation, the main purpose of tax treaties. Further, the adoption of that test might forestall the growing use of withholding taxes by net e-commerce importing nations. An economic presence PE would permit the OECD to argue for a continued reduction in withholding taxes that, in the view of many OECD countries, undermine cross-border trade and investment efforts.

Second, the economic presence PE is simple in conception and practice. The rule is pragmatic in the sense that it encourages business certainty, because multinational firms would foresee whether they would be subject to source country income tax jurisdiction, similar to the notion that a physical presence signaled likely filing obligations. Further, the proposed approach would catch only the "big fish" with significant international trade; smaller firms (especially start-up e-commerce firms) would be let off the hook, which makes sense because they have fewer resources to comply with foreign income tax laws.

2. Traditional International Tax Principles

An economic presence PE arguably represents a significant departure from traditional international tax principles, because a physical presence within a source state is no longer required to enable the source state to tax active business profits. Alternatively, an economic presence PE can be portrayed as just another step in the evolution of the PE principle, as physical presence requirements have already undergone dilution through the developments noted previously.

In fact, the economic presence PE represents a more incremental step in the evolution of the PE principle than the recently adopted server/PE. I have argued elsewhere that the server/PE really represents a form of qualitative economic presence test because maintaining a server/PE in a source country is now elective, and tax authorities will focus more on what type of economic activity is occurring within each country where a server/PE is located.⁵⁹ Because there are millions of servers throughout the world that form an important component of the infrastructure of the Internet, the server/PE rule discourages tax authorities from asking what sort of a taxable presence exists within each country.

Tax authorities may instead focus on the profit attribution aspects of a cross-border e-commerce transaction by questioning: (1) what types of sales are being generated by the server; (2) how did the server acquire rights to intangible assets; (3) what functions does the server perform; and (4) what risks does it assume? Unlike the proposed quantitative economic presence PE, the server/PE does not uphold the traditional rationale for the PE because it leads to business uncertainty and will not effectively share tax revenue between residence and source countries. The proposed economic presence test can be portrayed as a small evolutionary step from the economic presence test created by the new server PE rule.

The proposed economic presence PE is designed to permit source countries to tax active business profits similarly, as those profits are taxed when an entertainer or artist generates them through a short presence within the source country. The proposal permits countries to maintain worldwide taxation schemes whereby they can choose to "top up" any difference between the foreign tax liability (for which a foreign tax credit is given) and domestic liability for the earnings in

question. Hence, the proposal supports the tax policy concern that taxpayers should be taxed by the residence state on their ability to pay, or "faculty."

3. Neutral Tax Treatment

The economic presence PE would generally offer neutral tax treatment between e-commerce and traditional commerce. Both forms of commerce would be subject to the same rule. No new or special taxes are directed at e-commerce in concordance with the views of the OECD.

One of the issues surrounding the taxation of international e-commerce is that cross-border transfers of e-commerce goods often blur the lines among different types of income (that is, active business income, services income, or royalty income). The problem is that international tax rules and treaty principles seek to categorize different types of income to determine the appropriate tax treatment. A possible deficiency of the gross sales threshold is that multinational firms may argue that all their sales should result in royalty income and are already subject to gross withholding taxes under tax treaties. (Taxpayers, of course, will raise that argument only if no withholding taxes are applied to royalty income as suggested by the OECD model tax treaty.)

There will also be market distortions because below-threshold remote transactions will be subject only to residence-based taxation (assuming an absence of a traditional PE), while above-threshold transactions will attract source state taxation. More analysis and empirical work is necessary to determine the potential magnitude of those distortions.

4. Fiscal Sovereignty Implications

As Richard Bird has noted, incremental change in international tax policy is likely the only feasible approach partly because of sovereignty concerns.⁶⁰ The economic presence test will not dilute fiscal sovereignty much. National tax authorities will not have to harmonize any of their tax rules for the economic presence test to be workable, as would occur, for example, under global formulary apportionment.

The main sovereignty implications would appear to surround a heightened need to share information between national tax authorities to ensure the threshold test would work. Greater information sharing raises administrative and privacy concerns. As discussed elsewhere, information technology developments, such as the use of extranets (that is, a part of the Internet that links select partners in a secured manner) among tax authorities, could assist with information sharing.⁶¹

Also, source countries may require limited power to audit nonresident companies despite a lack of physical presence within their territories. That raises practical concerns surrounding enforcement because of the inability to seize property for unpaid tax liability, serving notices of assessment, and so forth. Companies that surpass the stipulated gross revenue threshold late in the fiscal year may have to retroactively amend and file returns in source and residence countries. But tax authorities are already presented with that challenge when they exert jurisdiction over companies because of the temporary appearance of agents, artists, or server/PEs.

5. Transfer Pricing, Compliance, and Enforcement Costs

An economic presence PE within source countries would require multinational firms to designate appropriate transfer prices between the head office and the economic presence PE so that the appropriate profits could be attributed to that PE. Transfer pricing and profit attribution to the economic presence PE appear to raise several concerns. Existing practices could be applied to ensure that source countries could tax only an appropriate portion of the profits attributable to the economic presence PE. In the easiest cases, the economic presence PE could be analogized with a traditional retail outlet within the source country, and transfer prices would be set with comparable businesses on a case-by-case basis. More problematic cases would likely require more sophisticated approaches, such as profit splits (or the residual profit-split method for unique intangibles) and the negotiation of bilateral or multilateral advanced pricing agreements. Transfer pricing issues would arguably increase the compliance burden for large multinational firms that might be subject to the proposed rule.

An economic presence PE may also be difficult for many tax authorities to enforce. Many authorities lack the resources to audit the worldwide income of a multinational firm -- hence the preference for the use of withholding taxes by some countries. An audit of business-to-business transfers to determine whether the requisite gross sales threshold is met might be feasible by looking to the invoices of the source country-based recipient business, which must maintain records to justify the deduction of business expenses for tax purposes (or, alternatively, to support inclusion in a cost-of-goods-sold account).

Cross-border business-to-consumer e-commerce transfers are much more problematic because of the inability of both the source and residence country to determine the geographic location of consumers for many cyberspace transactions and because consumers typically have no recordkeeping obligations. On the other hand, multinational firms and tax authorities often compile records for cross-border value added tax purposes (all OECD countries with the exception of the United States have national VATs or goods and services tax), and that information could be used to enforce the economic presence test. Also, the European Union has implemented economic presence tests in the context of cross-border digital transactions and the imposition of EU VATs.^{62/} If those efforts prove successful, firms will need to develop accounting systems to track sales into foreign jurisdictions, and that tracking could be used to help enforce the economic presence tests for income tax purposes.

C. HARMFUL TAX COMPETITION AND TAX AVOIDANCE STRATEGIES

Beginning in 1997, international bodies such as the European Union and the OECD have focused efforts on reducing "harmful" tax competition.^{63/} Harmful tax competition is said to be the sort that reduces national and international welfare by distorting cross-border investment location decisions or promoting income shifting as a result of tax reasons and not out of real economic rationales. In contrast, "good" tax competition occurs when countries legislate innovative tax rules that do not unduly inhibit economic growth, lessen compliance costs, or tame the so-called Leviathan tendencies of mature industrialized nations to bloat.

The dilution of source-based taxation as a result of e-commerce and other developments in turn promotes the use of tax havens as production intermediaries because the state where large

consumer markets are located is not permitted to tax cross-border transactions due to absence of a traditional PE. Avi-Yonah and others have noted that permitting source states to tax significant cross-border profits would discourage the use of tax havens and inhibit harmful tax competition.⁶⁴

Further, the economic presence PE would inhibit tax avoidance strategies. For example, there has always been a concern that multinational firms that maintain a PE within a source state, but argue that cross-border profits are not attributable to the PE, abuse the PE rule. The OECD has acknowledged that "[i]t is no doubt true that evasion of tax could be practiced by undisclosed channeling profits away from a permanent establishment and that this may sometimes need to be watched."⁶⁵ The restricted force of attraction rule within the U.N. model tax treaty discourages that planning because sales of similar products are "attracted" to the existing PE, entitling the source country to tax the relevant cross-border profits.

The advent of the Internet and the ease of conducting remote economic activity suggests that, assuming they have not already done so, multinational firms may take steps to consolidate their operations so that existing PEs are pulled out of source countries or profits are ostensibly shifted away from existing PEs to the head office, adding to source country base erosion. An economic presence test that focuses on sales taking place in the source country would continue to entitle that country to exert its tax jurisdiction over those sales despite an absence of a PE within the source country.

IV. CONCLUSION

Modern commercial developments, such as the movement toward service-oriented economies, a reduction in barriers to global capital flows and, most recently, the rise of e-commerce, have contributed to the dilution of source country income tax jurisdiction. That has resulted in revenue losses and increased risk of international double taxation as capital-importing countries struggle to regain a fair share of the tax pie. This paper has argued that the PE principle should continue to evolve by adding a new form of PE called an economic presence PE, a fiction that creates a PE in source countries where nonresident firms generate significant cross-border revenues (that is, gross revenue in excess of US \$ 1 million).

The economic presence PE would generally impose neutral tax treatment between e-commerce and traditional commerce and encourage a balanced sharing of revenue between residence and source countries as originally envisioned by the PE principle. Multinational firms would likely resist movement toward any system that creates potential income tax liability in countries where they maintain no physical presence. However, international trade and investment would arguably be promoted by an economic presence test that attempts to address modern commercial developments without unduly destabilizing international tax norms.

/1/ See OECD Committee on Fiscal Affairs, *Electronic Commerce: Taxation Framework Conditions* (Paris, OECD, 1998).

/2/ See OECD, *Model Tax Convention on Income and on Capital* (Paris, OECD, 2000) (hereafter OECD model tax treaty).

/3/ See United Nations *Model Double Taxation Convention Between Developed and Developing Countries* (New York, United Nations, 1980) (hereafter United Nations model tax treaty).

/4/ The requirement for a fixed place of business within source countries is typically traced back to the tax treaty between Austria-Hungary and Prussia in 1899. For background, see Arvid A. Skaar, *Permanent Establishment: Erosion of a Tax Treaty Principle* (Boston, Deventer, 1991) at pp. 65-101.

/5/ See Michael J. Graetz and Michael M. O'Hear, "The 'Original Intent' of U.S. International Taxation" (1997), 46 *Duke L. J.* 1021 at p. 1088 (arguing that the original intent of U.S. international income tax policy favored source-based taxation).

/6/ See OECD model tax treaty, *supra*, note 2, at article 5(1).

/7/ *Id.*, at article 5(4).

/8/ The desire to maintain fiscal sovereignty appears to similarly influence the direction of international tax policy. For discussion, see Arthur J. Cockfield, "Tax Integration Under NAFTA: Resolving the Conflict Between Economic and Sovereignty Interests" (1998), 34 *Stan. J. Int'l L.* 39.

/9/ See Klaus Vogel, "Worldwide vs. Source Taxation of Income -- A Review and Reevaluation of Arguments" (1998), 11 *INTERTAX* 393 at p. 400.

/10/ See Charles E. McLure Jr., *Alternatives to the Concept of Permanent Establishment*, Report of the Proceedings of the World Tax Conference: Taxes Without Borders 61-15 (Toronto, CTF, 2000).

/11/ See Arthur J. Cockfield, *The Real Digital Divide: Electronic Commerce, Developing Countries and Declining Tax Revenues*, UNESCO Encyclopedia of Life Support Systems, 6.31.3.6 (forthcoming 2002).

/12/ In contrast, many developing nations have opposed the PE concept since its inception under the view that the PE principle represents only the interests of capital-exporting nations. See, for example, Sonia Zapata, "The Latin American Approach to the Concept of Permanent Establishment in Tax Treaties With Developed Countries" (1998), 52 *Bulletin for International Fiscal Documentation* 252.

/13/ Skaar, *supra*, note 4.

/14/ OECD model tax treaty, *supra*, note 2, article 5(5).

/15/ *Id.*, article 5(3).

/16/ *Id.*, article 17.

/17/ *Id.*, at article 8.

/18/ Skaar, *supra*, note 4, at p. 433.

/19/ United Nations model tax treaty, *supra*, note 3, article 5.

/20/ *Id.*, article 7.

/21/ Skaar, *supra*, note 4, at p. 573.

/22/ For background, see Arthur J. Cockfield, "Balancing National Interests in the Taxation of Electronic Commerce Business Profit" (1999), 74 *Tulane L. Rev.* 133 (hereafter "Balancing National Interests").

/23/ *Id.*, at pp. 157-59.

/24/ For an early discussion of this view, see David R. Tillinghast, "The Impact of the Internet on the Taxation of International Transactions" (1996), 50 *Bulletin for International Fiscal Documentation* 524 (indicating that Internet commercial developments "threaten fundamentally to alter [the] division of revenue by shifting the balance of taxing jurisdiction, and revenue, decisively in favour of the country of residence").

/25/ For discussion on the erosion of source state tax jurisdiction, see Richard M. Bird, "Shaping a New International Tax Order" (1988), 43 *Bulletin for International Fiscal Documentation* 292 (arguing that mechanisms need to be developed to enhance source state tax jurisdiction).

/26/ See Office of Tax Policy, U.S. Department of the Treasury, *Selected Tax Policy Implications of Global Electronic Commerce* (Washington, D.C., Dept. of Treasury, 1996) (hereafter Treasury report).

/27/ *Id.*, at pp. 18-19 (saying that "source based taxation could lose its rationale and be rendered obsolete by electronic commerce").

/28/ According to one estimate, the United States accounted for roughly 80 percent of the global total of e-commerce in 1998. See OECD, *The Economic and Social Impacts of Electronic Commerce: Preliminary Findings and Research Agenda* 29 (Paris, OECD, 1999).

/29/ Treasury report, *supra*, note 26, at p. 22.

/30/ See Revenue Canada, Internal Memo 981646 (31 Aug. 1998).

/31/ See Electronic Commerce and Canada's Tax: A Report to the Minister of National Revenue Administration From the Minister's Advisory Committee on Electronic Commerce (April 1998); Electronic Commerce and Canada's Tax Administration: A Response to the Advisory Committee's Report on Electronic Commerce by the Minister of National Revenue 21 (September 1998).

/32/ See Australian Tax Office, Tax and the Internet: Discussion Report of the Australian Tax Office Electronic Commerce Project par. 7.2.15. (Canberra, Australian Government Publishing Service, 1997).

/33/ Supra, note 1.

/34/ Id., at p. 3.

/35/ See Joint Declaration of Business and Government Representatives: Government/Business Dialogue on Taxation and Electronic Commerce (Ottawa, OECD, 1998).

/36/ OECD model tax treaty, supra, note 2, commentary on article 5.

/37/ For discussion, see Arthur J. Cockfield, "Through the Looking Glass: Computer Servers and E-Commerce Profit Attribution," Tax Notes Int'l, 21 Jan. 2002, p. 269.

/38/ See Arthur J. Cockfield, "Transforming the Internet Into a Taxable Forum: A Case Study in E-Commerce Taxation" (2001), 85 Minn. L. Rev. 1171; Arthur J. Cockfield, "Should We Really Tax Profits From Computer Servers? A Case Study in E-Commerce Taxation," Tax Notes Int'l, 20 Nov. 2000, p. 2407.

/39/ But see Arvid A. Skaar, "Erosion of the Concept of Permanent Establishment: Electronic Commerce," in Gustaf Lindencrona, Sven-Olaf Lodin, and Bertil Wiman, editors, International Studies in Taxation: Law and Economics (The Hague, Kluwer, 1999) at p. 307 (concluding that servers and Web sites can constitute PEs under traditional interpretation). Skaar notes that the PE concept does nevertheless not seem to be relevant for purposes of taxing electronic commerce. Id. at p. 320.

/40/ Discussion between the author and Joseph Guttentag, former deputy assistant secretary for international tax affairs, U.S. Department of the Treasury. Reprinted with permission of Mr. Guttentag.

/41/ See Ministry of Finance, Indian, Report of the High Powered Committee on E-Commerce and Taxation 11-12 (2001) (hereafter Indian report).

/42/ See Richard Doernberg, "Electronic Commerce and International Tax Sharing," Tax Notes Int'l, 30 Mar. 1998, p. 1013.

/43/ See Indian report, supra, note 41, at p. 13.

/44/ *Id.*, at p. 228. See also "Indian AAR Issues Landmark Ruling on E-Commerce Under U.S.-India Tax Treaty," *Tax Notes Int'l*, 5 July 1999, p. 11.

/45/ See Cockfield, "Balancing National Interests," *supra*, note 22, at pp. 185-216.

/46/ Jinyan Li, *International Taxation in the Age of Electronic Commerce* (Canadian Tax Foundation, 2003).

/47/ See, for example, Technical Committee on Business Taxation, *Report of the Technical Committee on Business Taxation 6.25* (Ottawa, Dep't of Finance, 1997).

/48/ See, for example, Reuven S. Avi-Yonah, "The Rise and Fall of Arm's Length: A Study in the Evolution of U.S. International Taxation" (1995), 15 *Va. Tax Rev.* 89.

/49/ I addressed this approach in an earlier work without delving into the issue. See Cockfield, "Balancing National Interests," *supra*, note 22, at pp. 175-76.

/50/ See Skaar, *supra*, note 1, at pp. 88-95.

/51/ *Id.*, at p. 90.

/52/ See Luc Hinnekens, "Looking for an Appropriate Jurisdictional Framework for Source-State Taxation of International Electronic Commerce in the Twenty-First Century" (1998), 26 *Intertax* 192 at p. 197. See also Richard L. Doernberg et al., *Electronic Commerce and Multijurisdictional Taxation* (The Hague, Kluwer, 2001) at pp. 349-54.

/53/ *National Bellas Hess Inc. v. Dept. of Revenue*, 386 U.S. 753 at p. 758 (1967); *Quill Corp. v. North Dakota*, 504 U.S. 298 at p. 315 (1992).

/54/ See General Accounting Office, *Sales Taxes: Electronic Commerce Growth Presents Challenges: Revenue Losses Are Uncertain 20-21* (Washington, D.C., GAO, 2000); Donald Bruce and William Fox, *State and Local Revenue Losses From E-commerce: Updated Estimates 1* (Knoxville, Center for Business and Economic Research, 2001) (estimating losses of \$ 13.1 billion for 2001).

/55/ See Arthur J. Cockfield, "Walmart.com: A Case Study in Entity Isolation," *State Tax Notes*, 26 Aug. 2002, p. 633.

/56/ The U.S. Supreme Court denied certiorari in a case that supports qualitative economic presence tests for determining nexus for income tax purposes. See *Geoffrey Inc. v. Tax Comm.*, 437 S.E. 2d 13 at p. 16 (S. Ct. So. Car. 1993), cert. denied, 510 U.S. 992 (1993).

/57/ See, for example, Scott D. Smith and Sharlene Amitay, "Economic Nexus: An Unworkable Standard for Jurisdiction," *State Tax Notes*, 9 Sept. 2002, p. 174-2.

/58/ See Reuven S. Avi-Yonah, "International Taxation of Electronic Commerce" (1997), 52 Tax L. Rev. 507.

/59/ Arthur J. Cockfield, "Designing Tax Policy for the Digital Biosphere: How the Internet Is Changing Tax Laws" (2002), 34 Conn. L. Rev. 333 at pp. 390-96.

/60/ See Richard M. Bird, "Commentary, A View From the North" (1994), 49 Tax L. Rev. 745.

/61/ See Cockfield, "Transforming the Internet," *supra*, note 38, at pp. 1235-63.

/62/ As of July 2003, non-European Union suppliers must assess, collect, and remit VAT on sales of digital goods and services to European Union consumers. See European Council, Council Regulation 792/2002 amending temporarily Regulation (EEC) 218/92 on administrative cooperation in the field of indirect taxation (VAT) concerning additional measures regarding electronic commerce (7 May 2002); European Council, directive amending Directive 77/338/EEC regarding the value added tax arrangements applicable to electronically supplied services and radio and television broadcasting services (12 Feb. 2002).

/63/ See, for example, OECD, Harmful Tax Competition: An Emerging Global Issue (Paris, OECD, 1998); Alex Easson, "Tax Competition and Investment Incentives" (1997), 2 EC Tax J. 63.

/64/ See Avi-Yonah, "International Taxation of Electronic Commerce," *supra*, note 58.

/65/ See OECD model tax treaty, *supra*, note 2, commentary to article 7, at para. 9.