BALANCING NATIONAL INTERESTS IN THE TAXATION OF ELECTRONIC COMMERCE BUSINESS PROFITS

Arthur J. Cockfield [FNa1]

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SUMMARY

This Article begins by exploring the issues surrounding the taxation of electronic commerce (e-commerce) business profits. The United States Treasury Department and other national tax authorities are struggling to find mechanisms to collect the anticipated significant revenues derived from taxing e-commerce profits. Legal reform is likely required because the existing regime was set up to handle transfers of physical goods across borders. This Article discusses possible reform efforts to confront the challenges posed by cyberspace transactions that defy traditional conceptions of cross-border trade. The Treasury Department and most other national tax authorities insist on using traditional international tax principles. Since it is clear that any reform will require significant international cooperation, this Article proposes a framework for the taxation of e-commerce profits that incorporates traditional international tax principles. Under the proposals, the country where the e-commerce good or service is produced should be able to tax most related business profits. This Article also proposes that e-commerce importing nations should enjoy a part of the revenues derived from sales within their borders. The proposals hence represent a balanced compromise between the interests of countries that are either net exporters or net importers of e-commerce goods and services.

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I. INTRODUCTION

As the nations of the world emerged from the ashes of World War I, they were confronted with renewed enthusiasm for international trade and investment. But the potential for international double taxation threatened to undermine this renewal: both the country where a business was established (the residence country) and the foreign country where this business conducted its trade or investment (the source country) might try to tax the profits associated with the same business activity. [FN1] Since international double taxation would greatly increase the cost of doing business in foreign markets, it became crucial to find a way to divide international tax revenues between the residence and source countries.

After a number of efforts, it was decided in 1928 that source countries should tax the profits derived from foreign businesses, but only if the profits came from "permanent establishments" (e.g., a branch, factory, sales office, or depot) operated by the foreign businesses within the

source countries. [FN2] If no permanent establishment [p. 136] existed within the source country, the residence countries alone could tax the profits. [FN3] The use of the permanent establishment concept as the demarcation point for source-country taxation was probably sensible at a time when a physical presence was required in foreign markets to conduct significant business operations. Hence, the permanent establishment concept arguably provided a reasonable compromise between the interests of countries that exported goods, services, and capital and countries that tended to import goods, services, and capital because both of these countries shared tax revenues derived from international trade. [FN4]

The emergence of electronic commerce (e-commerce), however, threatens this compromise since this new commercial medium does not require any physical presence within the source country. For example, the United States Treasury Department has observed: Electronic commerce . . . may be conducted without regard to national boundaries and may dissolve the link between an income-producing activity and a specific location. From a certain perspective, electronic commerce doesn't seem to occur in any physical location but instead takes place in the nebulous world of cyberspace. Persons engaged in [p. 137] electronic commerce could be located anywhere in the world and their customers will be ignorant of, or indifferent to, their location. [FN5]

As e-commerce accelerates, the division of tax revenues between nations will be upset as long as a requirement of some type of geographic permanency (i.e., a permanent establishment) exists before a source country can tax foreign businesses: countries that import e-commerce goods and services will not be entitled to tax any of the related profits. Further, a danger exists that many e-commerce transactions will escape residence-country taxation entirely as highly mobile e-commerce businesses shift their operations to tax havens. As a result of these concerns, governments and international organizations are struggling to develop solutions to the challenges presented by e-commerce. These governments and international organizations invariably indicate a preference for the use of traditional international tax principles (e.g., maintaining the permanent establishment concept) to confront the challenges, [FN6] despite the fact that these principles seem [p. 138] particularly unsuitable to the taxation of e-commerce. [FN7] Nevertheless, this preference is understandable since the existing principles are well known, have been in place for decades, and have been remarkably successful in promoting international trade and investment. [FN8]

Accordingly, this Article proposes rules to tax international e-commerce business profits that are based on traditional international income tax principles. [FN9] The proposals are meant to serve as a potential [p. 139] framework for countries trying to negotiate a compromise between their potentially different and competing national interests that have arisen as a result of the new environment created by e-commerce. The proposed changes could be used to modify the three most influential model tax treaties--the Organisation for Economic Co-operation and Development (OECD) Model Treaty, the United States Model Treaty, and the United Nations Model Treaty--if sufficient international consensus develops. [FN10] As a result of tax avoidance concerns, residence countries should be granted primary authority to tax e-commerce business profits. Residence-based taxation (i.e., taxing a resident company's business profits everywhere in the world) will discourage companies from shifting their profit-making activities to lower tax jurisdictions since the residence country will continue to tax these profits.

However, concessions must be offered to bolster source-country tax revenues in order to maintain a fair division of tax revenues. As a result, source countries should be able to impose a withholding tax where foreign consumers will withhold a specified percentage of the payment price on the e-commerce good or service and remit it to the foreign tax authority. For example, a consumer in Japan who downloads a software product from a company based in San Francisco would withhold, for instance, five percent of her twenty dollar purchase price and pay it over to the Japanese treasury. In order to simplify tax administration, this withholding obligation should only arise if the resident company is conducting significant business, perhaps one million dollars in gross sales, within the source country. As a further concession, the source countries should be permitted, if they wish, to negotiate a "restricted force of attraction" principle within their tax treaty networks. A restricted force of attraction provision increases source-country tax revenues by permitting the source country to tax any business activities within its borders that are similar to ones conducted by an existing permanent establishment within the source country. This principle-- that has historic and current precedents in U.S. income tax treaties as well as the United [p. 140] Nations Model Treaty--will expand the source-country's tax base, allocate e-commerce profits to source states in certain circumstances, and inhibit tax avoidance opportunities created by recent information technology developments. [FN11]

The Article is organized as follows. Part II briefly reviews the current international tax regime that governs the taxation of cross-border business activity and explores the tax issues and challenges presented by e-commerce. It ends with a discussion regarding the international tax policy principles that should guide proposals to tax e-commerce business profits. Part III reviews and evaluates several possible alternatives to taxing these profits, including a "do nothing" approach, movement toward residence-based taxation, the use of tax treaty "fictions," the adoption of global formulary apportionment, and the use of destination-based income taxes for e-commerce transactions. Part IV proposes several changes to existing tax treaty policy, touched on above, as the most appropriate course to accommodate the challenges presented by the emergence of e-commerce. The Article concludes with Part V, which argues that these proposals are designed to attract the requisite amount of international cooperation, but that more radical alternatives may be necessary as the continued development of information technologies and the growing interdependence of the global business community place further strain on the existing international tax regime.

II. CHALLENGES TO THE CURRENT REGIME

This Part begins by briefly discussing the rules that are relevant to the income taxation of international e-commerce transactions. Subpart B reviews a number of challenges to this regime as a result of the emergence of e-commerce. Subpart C contains a discussion of the principles that should guide proposals to resolve some or all of these challenges.

A. THE TAXATION OF INTERNATIONAL BUSINESS PROFITS

International tax treaties and tax rules that govern cross-border profits are very complex, and the discussion herein does not profess to give a detailed description of these rules. Rather, the attempt is to highlight the international tax provisions that are relevant to the discussion that takes place in Parts III and IV of this Article.

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1. National Taxation

Many countries throughout the world tax their residents (individuals and business entities) on their worldwide profits (i.e., any profits realized in any country). The United States is one such country. [FN12] Situations often arise where two or more countries both try to tax the worldwide profits of resident multinational firms, which gives rise to the potential for double taxation of the same economic activity during the same period. In order to avoid this circumstance, countries often grant foreign tax credits, which permit the resident to offset the foreign taxes paid against the domestic taxes that would otherwise be payable. [FN13] Most countries limit the foreign tax credit so that it cannot exceed the amount of domestic taxes that would be paid on the business activity in question; [FN14] this ensures that the treasury of the residence country does not subsidize the higher tax rates of foreign countries.

Countries that tax worldwide income on the basis of residency, however, generally do not tax profits in source countries unless and until they are repatriated to the residence country. This permits resident companies to defer residence-country taxation until profits are brought back to the home (or residence) country. This deferral opportunity, however, is often restricted by "controlled foreign corporation" rules that permit the residence country to tax certain profits (typically passive investment activity profits such as interest or royalties) on an accrual basis (i.e., whether or not the profits are actually distributed back to the home country). [FN15] Controlled foreign corporation rules are becoming more prevalent throughout the world as countries strive to curtail excessive tax avoidance and tax evasion; sixteen OECD countries had adopted controlled foreign corporation rules by 1997. [FN16]

[p. 142] Other countries, such as France, do not tax their residents on a worldwide basis. [FN17] Rather, these countries simply exempt most foreign income from domestic tax. This approach is often called an exemption or territorial system. Still other countries have adopted some form of hybrid approach in which active business income in foreign countries is exempt from taxation while passive investment income is often taxed on an accrual basis. [FN18] Nations have also enacted tax rules to determine whether a nonresident's business activity has a sufficient nexus to bring it within the country's tax jurisdiction. Under U.S. law, income that is "effectively connected" [FN19] with a nonresident's conduct of a "trade or business" [FN20] in the United States is subject to federal income tax. Case law indicates that the threshold for business activities to constitute a U.S. trade or business is generally low. [FN21] For example, the sale of inventory on a regular basis is considered a trade or business in the United States. [FN22] Whether or not e-commerce transactions meet this threshold is unclear. [FN23] Other countries employ their own tests to determine whether a sufficient nexus exists between the foreign business activity in their country and their tax law to impose the income tax. [FN24] These tests may [p. 143] be weaker than the one employed in the United States; some countries may thus

argue that any e-commerce transactions that deal with customers or vendors located within their countries are subject to tax on the business profits derived from these transactions.

2. Tax Treaties

a. General Scheme

A nation's international tax rules are often modified by way of bilateral tax treaties. [FN25] The most important and influential model tax treaties are the OECD Model Treaty, the United States Model Treaty and the United Nations Model Treaty. [FN26] The provisions within these tax treaties reflect a compromise among different nations and help to resolve a number of issues such as the elimination of discriminatory tax treatment, the prevention of tax evasion through the promotion of information exchanges between administrative authorities, and the fair allocation of tax revenues. [FN27] The tax treaties also strive to eliminate international double taxation by trying to ensure that the taxpayer is taxed only once on its activities. [FN28] However, the tax treaty rules impose different tax treatment on different types of income. The general pattern is reflected in the three model tax treaties. [FN29] Passive investment income (e.g., portfolio interest and portfolio dividends) and some types of business income (e.g., rents and royalties) are not subject to source-country taxation. [FN30] Rather, the source country imposes a withholding tax on the gross amount of any income once it is distributed back to [p. 144] the home country. [FN31] Resident taxpayers are generally granted foreign tax credits for the withholding tax. [FN32] The withholding tax rates agreed upon in tax treaties are often significantly lower than the rates imposed by national law. [FN33] On the other hand, active business income is subject to full taxation by a source-country's income tax system, as long as a "permanent establishment" exists within the source country and business is conducted through this permanent establishment. [FN34] Prior to discussing the permanent establishment concept, it is important to note that the classification of e-commerce income as either falling within the passive category or active category is crucial in determining its ultimate tax treatment. If the e-commerce transaction is classified as generating, for example, royalty income, it will escape source-country taxation other than withholding tax rates negotiated via the tax treaty, which are generally low or nil. These income classification issues will be discussed subsequently. [FN35]

b. Permanent Establishment

As indicated above, source-country income taxes are generally only applied to active business income when a permanent establishment (that must be an unincorporated company and thus not a legal entity) exists within its borders. [FN36] If no permanent establishment exists within the source country, the business profits will thus either escape taxation or, as is typically the case, will be taxed by the residence country. [FN37] A permanent establishment is defined within each [p. 145] model treaty. Article 5 of the U.S. Model Treaty defines a permanent establishment as "a fixed place of business through which the business of an enterprise is wholly or partly carried on." [FN38] The article goes on to give examples of permanent establishments, including "a) a place of management; b) a branch; c) an office; d) a factory; e) a workshop; and f) a mine, an oil or gas well, a quarry, or any other place of extraction of natural resources." [FN39] A later provision excludes from the definition of a permanent establishment a number of auxiliary activities, including "the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise" and "the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise, or of collecting information,

for the enterprise." [FN40] These exclusions would seem to cover many of the activities that computer servers or websites perform. [FN41]

The OECD Model Treaty has similar definitions of a permanent establishment while the United Nations Model Treaty has put in place an expanded definition of the permanent establishment concept. [FN42] Additional descriptions of permanent establishments along with clarifying examples can be found in the commentary accompanying the OECD Model Treaty. [FN43] According to the model tax treaties, permanent establishments must generally consist of some type of facility, construction site, or possibly an agency relationship in certain circumstances (e.g., for dependent agents that habitually conclude contracts within the source country). [FN44] Taken together, the definitions within the model treaties suggest that the nonresident's activities must have a degree of permanence sufficient to consist of a regular economic presence in the source country. One commentator indicates that this presence must be fixed in both a locational and temporal aspect. [FN45] In other words, the business activity must be able to be linked to a specified geographical area and the activity cannot be a purely temporary venture. [FN46] [p. 146] There are, however, a number of "fictions" set out in provisions of the model tax treaties that attempt to circumvent the requirement of geographical and temporal "permanence." These fictions ensure that certain temporary and mobile activities are caught by the definition of permanent establishment. For example, there are provisions to ensure that the income generated by entertainers can be taxed in the source state despite the absence of any real fixed place of business. [FN47] Attempts to analogize these fictions to e-commerce transactions will be discussed at a later point. [FN48]

c. Rationale Behind the Permanent Establishment Concept

From a historical perspective, the permanent establishment concept represented a practical way to ensure that foreign income taxes would only be applied to substantial recurring business within foreign countries. [FN49] A permanent establishment was thought to represent evidence of these significant business activities since, at the time, a physical presence within foreign markets was necessary to engage in such significant operations. The commentary to the OECD Model Treaty indicates: [I]t 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. [FN50]

A more cynical view might suggest that the permanent establishment concept arose from the economic dominance of industrialized nations who favored residence-based taxation since they were generally capital exporters when the rules were initiated. [FN51] In fact, many developing nations have opposed the permanent establishment principle almost since its inception. [FN52] In 1940, a [p. 147] subcommittee of the League of Nations was charged with reviewing the model bilateral tax treaty that was initially put in place in 1928. [FN53] Interestingly, the majority of these sub-committee members were from Latin America and other developing countries as a result of the advent of the Second World War. [FN54] They drafted source-based provisions that were favorable to the interests of their countries, which were generally net-capital importers at the time. For example, source countries were permitted to tax business profits within their borders as long as the transactions that gave rise to these profits were not isolated. [FN55]

The existence of a permanent establishment was not required. [FN56] The draft treaty came to be known as the Mexico Draft. [FN57]

The Mexico Draft was never adopted and a subsequent draft in 1946 (the London Draft) required that a foreign business entity have a permanent establishment in the source country before its profits would be subject to any income taxes imposed by the source country. [FN58] As a result of the perception that the London Draft and subsequent drafts by the OECD [FN59] favored the interests of developed nations, many developing nations--especially Latin American countries--refused to enter into bilateral tax treaties with other countries until recent years. [FN60] A commentator has offered the following criticism of the permanent establishment concept that seems particularly telling in the age of e-commerce: "[T]he future is likely to prove that the [permanent establishment] principle has lost its force for new and mobile industries, whether tax treaties are renegotiated for this purpose or not. An enterprise's connection to the soil, its [permanent establishment], is no longer a reliable evidence of economic allegiance." [FN61] Nevertheless, the permanent establishment concept has arguably served the global community well for the past seven decades because it provided an eminently practical way to determine when a residence [p. 148] nation should yield its taxing jurisdiction. It is at least partly for this reason that many countries are unwilling to replace the permanent establishment concept with a new one despite the seeming inapplicability of the concept to e-commerce, which does not require any physical presence within the source country.

d. Permanent Establishments and Transfer Pricing

The concept of permanent establishment plays an additional important role in determining how the corporate income tax base is allocated among nations. Corporations with related parties in more than one country transfer goods, services, or capital among these related parties. Transfer prices are the prices set by these taxpayers on the resources exchanged among the related parties. The transfer price received or charged for goods, services, or financing will be included in the income of the supplier and the corresponding cost or payment will be deducted from the profits of the related party. Tax authorities must try to ensure that these non-arm's length transactions are measured on an objective basis; otherwise, a multinational firm can manipulate its transfer prices in such a way as to shift profits to the relatively lower-taxed jurisdictions. To avoid this result, the model tax treaties indicate that profits must be allocated among the related parties as if they were operating in an arm's length fashion. [FN62] Related parties include both separate legal entities (e.g., a corporation) and permanent establishments (e.g., a branch that is owned by a corporation residing in a foreign country). Accordingly, it is often again necessary to identify whether a permanent establishment exists for transfer pricing purposes. This is an important point because the lion's share of e-commerce transactions currently takes place among businesses, including related business entities. [FN63] Cross-border transfer pricing is a significant [p. 149] revenue issue to the treasuries of most nations due to the amount of international related party transactions that are taking place. [FN64] As a result, the determination of appropriate tax treatment for related party transactions involving e-commerce is an increasingly important issue.

In order to ensure that a related party transaction is evaluated on an objective basis, transfer pricing rules have been developed to permit the tax authorities of a country to adjust the taxable income of a resident or nonresident company that does not correspond to the arm's length test.

The OECD provides a lengthy guide to help determine what actually corresponds to a non-arm's length valuation. [FN65] Most OECD countries follow this guide, although some, like the United States, have implemented their own distinct rules that differ in some circumstances. [FN66] The OECD guidelines and the United States transfer pricing rules generally suggest that tax authorities should look to taxpayers in comparable circumstances that are engaged in comparable transactions in order to determine what the related party price should be. [FN67] United States treasury regulations indicate that comparable transactions can be established by looking at factors such as functions, risk, contractual terms, economic conditions, and the nature of the property or services. [FN68] There are currently a number of options available to both taxpayers and the IRS to assist with the determination of the appropriate transfer prices. [FN69] As will be discussed, most of these [p. 150] approaches are not very helpful in determining the appropriate tax treatment for transactions that involve the transfer of related party e-commerce goods, services, and capital.

B. ISSUES SURROUNDING THE INCOME TAX TREATMENT OF E-COMMERCE

The previous subpart set out some of the important aspects of international tax law that relate to the taxation of e-commerce business profits. The emergence of new information technologies, the Internet, and their accompanying commercial potential present a number of unique challenges to this regime. This subpart briefly describes e-commerce transactions and its challenges. [FN70]

1. Types of E-Commerce

The Office of Tax Policy of the U.S. Treasury Department has issued a report on the policy implications of global e-commerce. [FN71] The Treasury Report defines e-commerce as "the ability to perform transactions involving the exchange of goods or services between two or more parties using electronic tools and techniques." [FN72] This expansive definition, however, seems to include more "traditional" forms of e-commerce such as telemarketing, mail order sales using 1-800 telephone numbers, and television sales. Perhaps a more appropriate definition would focus exclusively on market transactions that involve the Internet. For example, one such definition would limit e-commerce to "the use of computer networks to facilitate transactions involving the production, distribution, sale, and delivery of goods and services in the marketplace." [FN73]

[p. 151] The "goods and services" mentioned in the latter definition can have either a tangible or physical presence (similar to existing goods and services) or they can be purely intangible or "digital" in that they never manifest themselves in a form outside of a computer. [FN74] The first type--that is, tangible products and services--can be purchased by individuals and businesses by logging onto an Internet Service Provider (ISP) or an On-Line Service Provider (OSP) and accessing the relevant information via the World Wide Web. [FN75] The consumer will be connected to the vendor's webpage (which is connected to the retailer's Internet server). [FN76] Books, computer products, flowers, and apparel are some of the most popular merchandise offered via the Internet. Often, consumers can complete their transactions without dealing directly with any humans; the computer program will generally be capable of offering sufficient guidance to overcome any purchasing obstacles. These types of transactions are sometimes called "indirect electronic commerce" since, after the initial electronic ordering, the goods and

services are generally physically delivered using traditional channels such as postal services or commercial couriers. [FN77] In other words, this type of e-commerce devises new ways of selling old products. In addition to the tangible products, e-commerce also offers intangible products, including video games, computer software, music, pornography, and digital versions of existing printed matter. Further, intangible services are offered, including on-line gambling, travel services, stock brokerage, and banking. "The distinguishing feature of this type of commerce is that all communication--advertising, selecting, purchasing (including payment), and especially delivery of the product--occurs (or can occur) on-line, perhaps in real time." [FN78] This can be considered "direct electronic commerce" since the intangible goods and services (often called "content") are delivered [p. 152] directly via the Internet. In other words, this represents new ways to sell new products.

The market for these tangible and intangible consumer products is currently small and totals approximately $26 billion. [FN79] It is anticipated, however, that this market will grow at an exponential rate in the coming years. [FN80] Further, it is anticipated that business-to-business transactions, which currently account for 80% of all e-commerce activity, will dominate e-commerce transactions at least in the short term. [FN81] Businesses use the Internet to enhance productivity, increase product quality, and reduce transaction costs; e-commerce can be used to achieve these results along all points of the value-added chain from a supplier of raw materials to the final consumer. In addition to creating electronic links among different businesses (i.e., electronic data interchange (EDI)), businesses are also taking advantages of "intranets" (i.e., secure internal networks) as well as "extranets" which extend the intranet to select business partners. [FN82]

Twelve separate studies forecast total e-commerce revenues at a range of $23 billion to $1.5 trillion by 2002. [FN83] As indicated by the differing forecasts in these studies, predictions concerning this growth rate are inherently difficult (although the high stock price/earnings ratios of many Silicon Valley software firms signal that the market has significant "faith" in this new form of commerce). [FN84] The current growth rate of information technologies [FN85] and the Internet, [FN86] however, can only be described as astounding. [p. 153] A number of technological constraints need to be overcome before this market can obtain its potential, especially with respect to business-to-consumer e-commerce. These constraints include a lack of bandwidth, slow modem speeds, lack of access to computer products among some segments of the population, privacy concerns, and payment security problems. [FN87] The road to the electronic superhighway may be paved by the most recent round of mergers between cable and telecommunications companies. For example, Cox Communications in San Diego, California and Rogers Communications in North York, Ontario currently offer television cable services as well as high-speed Internet access via their cable lines for an additional monthly charge. Once a number of technological hurdles are overcome and home and business networking becomes more widespread, a next generation of e-commerce goods and services will likely emerge. [FN88] The exact nature of these new products of course is only open to speculation at this point. The fact, however, that this fluid and dynamic market may move in unanticipated directions suggests that any e-commerce international income tax proposals should be sufficiently flexible to deal with these changes.

2. Emerging Issues

This subpart briefly reviews the e-commerce issues that present new challenges to the current regime for taxing international business income. [FN89]

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a. Permanent Establishment Issues

As indicated previously, a crucial aspect in determining when a source country can apply its income tax to a cross-border transaction lies in determining whether a permanent establishment exists within that source country. [FN90]

(i) Web Servers and Websites

Does the existence of a company's Internet server [FN91] or website [FN92] create a permanent establishment? The Treasury Department states: Computer servers can be located anywhere in the world and their users are indifferent to their location. It is possible that such a server, or similar equipment, is not a sufficiently significant element in the creation of certain types of income to be taken into account for purposes of determining whether a U.S. trade or business exists. It is also possible that if the existence of a U.S.-based server is taken into account for this purpose, foreign persons will simply utilize servers located outside the United States since the server's location is irrelevant. [FN93] The OECD also notes that a server could be located in a building where the enterprise has no other presence; a website can automatically transfer itself electronically at fixed intervals to new servers in different buildings, cities or countries; and mirror sites can be set up to direct customers to different servers depending on the level of traffic at any given time. [FN94] A report on e-commerce issued by the Australian Taxation Office also notes the elusive nature of taxing income that does not necessarily have a physical nexus to the market where e-commerce goods and services are purchased. [FN95] [p. 155] Commentators have discussed the problematic nature of attaching the permanent establishment concept to servers. [FN96] The OECD Model Treaty specifically excludes from the definition of permanent establishment any facilities maintained "solely for the purpose of storage, display or delivery of goods or merchandise." [FN97] A server or website that acts as a "warehouse" by simply advertising and selling tangible and intangible goods may thus not fall within the definition of permanent establishment. But what if the server's program performs additional functions such as executing orders, arranging for shipping, and performing after-sale service functions? The case for concluding that a permanent establishment exists seems to grow stronger as computer programs perform functions that cannot be considered as simply auxiliary. [FN98] This point is discussed further in the next subpart.

(ii) Agent Relationship

A permanent establishment may exist if a company uses a dependent agent located somewhere in the source country as long the agent habitually exercises authority to conclude contracts. [FN99] An independent agent can also qualify as a permanent establishment in some cases under the United Nations Model Treaty. [FN100] An e-commerce transaction that involves a consumer ordering a product by simply "clicking" on a specified link would seem only to involve the customer and the company offering the product. [FN101] But "intelligent" [p. 156] computer programs can perform functions that are similar to agents, including the conclusion of contracts or even the negotiation of the price of the product. [FN102] The point here is that software programs perform many of the functions that are traditionally associated with the activities of

agents or employees. Should the activities of the computer programs (which could be located on a server virtually anywhere in the world) be considered the actions of a dependent agent and thus qualify as a permanent establishment? The commentary to the OECD Model Treaty may provide assistance in this area as it indicates a permanent establishment may exist if the business of the enterprise is carried on mainly through automatic equipment, the activities of the personnel [i.e., dependent agents or employees] being restricted to setting up, operating, controlling and maintaining such equipment. Whether or not gaming and vending machines and the like set up by an enterprise of a State in the other State constitute a permanent establishment thus depends on whether or not the enterprise carries on a business activity besides the initial setting up of the machines. [FN103] [p. 157] This seems to suggest that, at least in some cases, the server may be considered to be a permanent establishment even if a dependent agent or employee is not physically present to monitor and maintain the server. [FN104] At the very least, the discussion in the commentary provides an argument by analogy to those countries who may want to assert their tax jurisdiction over business profits that can be attributed to the server.

(iii) Summary: Erosion of Source-Country Business Profit Revenues

The changes wrought by the Internet . . ., which drastically reduce the need for a seller or a service provider to have a physical presence in the country where its customer is located, threaten fundamentally to alter this division of revenue by shifting the balance of taxing jurisdiction, and revenue, decisively in favour of the country of residence. Since income flows between countries are not necessarily balanced and in the case of flows between developing and developed countries are often severely imbalanced, such a shift could have profound revenue consequences. [FN105] As suggested by the above quote, e-commerce transactions do not seem to fit within the traditional international tax regime where corporate profits are typically allocated to the source country on the basis of a permanent establishment. Technological developments have advanced to the point where countries can engage in anticipated significant international trade and investment via e-commerce without a physical presence within the source country. This may result in the loss of potentially significant revenues to the treasuries of source countries. But the governments of e-commerce importing states might argue that they should participate in the taxation of business profits that arise from the opportunities presented by their markets. [FN106] [p. 158] The emergence of e-commerce poses another important challenge to taxation according to traditional permanent establishment principles: the Internet facilitates the conduct of traditional commerce from physical locations outside of the foreign markets. In an era of increased global competition, multinational firms are constantly looking for cost-saving opportunities to centralize operations by removing duplication of activities, expertise, or resources in the foreign markets where their customers exist. As a result, multinational companies with existing permanent establishments in source countries may begin to shift some or all of their business operations away from the permanent establishments into residence-based e-commerce operations. Developments in communications technology will likely make it easier for these companies to begin replacing their existing source-country business activities with activities generated from the home country via the Internet. [FN107] This will further erode the ability of capital-importing countries to impose their income taxes on activities that previously were conducted through the permanent establishment. [FN108]

These operations/business model shifts include the following: (1) replacing physical establishments with websites that transfer transaction costs to the customer (e.g., obtaining

product information and selecting a product); [FN109] (2) reducing source-country offices [p. 159] necessary for customer support and after-sales services; [FN110] and (3) reducing the need to place intermediaries (e.g., distributors, agents, and wholesalers) in foreign markets because their functions can be performed from remote locations via the Internet. [FN111] E-commerce importing countries as well as capital-importing countries-- especially developing countries--should be very concerned with these developments. The emergence of e-commerce and these business model shifts have the potential to significantly erode the revenues currently derived from source-country taxation of business profits. Developing countries have often complained that the existing profit attribution rules work in favor of residence countries by permitting source-country taxes to be avoided or evaded through the conduct of a related business outside of the permanent establishment. [FN112] The potential for companies to offer more and more goods and services without a permanent establishment in source countries will greatly increase these concerns.

b. Transfer Pricing Issues

As previously indicated, it is often necessary to establish whether a permanent establishment exists in a source country before attributing deductions or profits to this permanent establishment. [FN113] Thus, an initial problem involving international transfer pricing is deciding whether a permanent establishment exists in the context of e-commerce transactions. The Australian Taxation Office has noted a number of factors related to e-commerce that may exacerbate existing transfer pricing problems, including "increased difficulties with valuing the contributions of related parties or parts of the same entity where businesses become highly integrated." [FN114] Also, "[t]he speed, frequency, anonymity and integration of exchanges over the Internet will place great pressure on the transactional and comparability [p. 160] principles." [FN115] The highly integrated nature of many e-commerce products is problematic in view of the traditional methods for resolving international transfer pricing issues. Current guidelines often look at transactions on a case-by-case basis and attempt to find comparable transactions to obtain an objective arm's length price. [FN116] It might be difficult or impossible to evaluate the separate components of an e-commerce transaction. [FN117] An additional issue surrounds the difficulties in the characterization of many e-commerce transfers of intangible goods and services. The evaluation of these potentially unique payments is a particular sore point under a system that was initially created to deal with traditional transfers of physical goods across borders. Again, it will be difficult to find comparable non-arm's length transactions in order to come up with the appropriate transfer price. Characterization issues are discussed in the next subpart.

c. Income Characterization

"In both the business-to-business and business-to-consumer markets, digital products such as software, travel services, entertainment and finance are the leading e-commerce products." [FN118] The intangible nature of these products and services will likely require a re-evaluation of certain existing international tax rules and practices. [FN119] E-commerce transactions make it more difficult to determine whether a transfer of goods has occurred, whether services have been performed, or whether an intangible product has been licensed. For example, a physical book sold from one country to the next creates active business profits that will be taxed in the source country as long as a permanent establishment exists. But, as the Treasury [p. 161] Department notes, a digitized form of this same book may give rise to either sales proceeds or

royalties (since copies of the book can easily be made and sold and thus the initial payment represents compensation for the use of a copyright) which, as previously discussed, are only subject to (usually low or nil) withholding tax rates in the source country. [FN120] Or perhaps the book is updated from time to time via the Internet and therefore payment for services has arguably taken place. The problem results from the fact that international tax rules apply very different tax treatments to each of these different categories of income, despite the seeming economic similarities of the example. [FN121]

The U.S. Treasury Department has proposed regulations on the classification of computer program transactions, which may ultimately provide a framework for resolving these issues. [FN122] The proposed regulations do not try to classify the transaction as either tangible or intangible, since computer programs can be sold on a disk or sent in digitized form via the Internet. [FN123] Rather, the proposed regulations seek to determine what type of copyright has been transferred; the transaction will generally be treated as a sale of goods (and not a copyright license generating royalty income) as long as the purchaser does not receive the right to reproduce the software for distribution to the public. [FN124] The rules strive to treat functionally equivalent transactions the same way. Yet, as the above example with respect to the digital book indicates, it is often difficult to disentangle the different components of the transaction in order to determine how a payment should be characterized since the same transaction may create multiple forms of income. E-commerce vendors may be able to circumvent the [p. 162] proposed regulations by creating nominal aspects of the transactions to generate whatever type of income they want (e.g., generate business income instead of royalty income).

d. Tax Administration

A number of challenges confront tax authorities who wish to collect revenues derived from profits associated with e-commerce transactions. [FN125] These challenges include (1) the difficulties in determining the identity of Internet vendors and consumers; (2) the lack of an audit trail surrounding the use of electronic money; (3) the lack of audit control points arising from reduced number of intermediaries (e.g., the financial institutions that previously were necessary to facilitate a number of transactions); and (4) unintentional nonreporting of profits to foreign tax authorities (e.g., many consumers may not be aware of their withholding tax obligations when they purchase an e-commerce good that generates, for instance, royalty income). These tax authorities may soon be confronted with thousands of businesses conducting e-commerce transactions within their borders. [FN126] The ability to monitor and tax these transactions will be hampered by the often ineffective exchange of information between most national tax authorities. The OECD has recently recommended greater global tax administration cooperation in the context of harmful tax competition. [FN127] If the mandate is expanded, these proposals may also serve to increase the information flow with respect to e-commerce transactions. Further, e-commerce businesses may incur significant tax compliance burdens if they must file returns in all countries where their servers or websites exist. This could occur if the permanent establishment concept is extended to encompass these activities. Businesses that venture into the heretofore unknown world of commercial cyberspace without any definitive tax rules to guide them already face at least the potential for double taxation. This uncertainty [p. 163] will likely increase their costs of doing business as well as enforcement costs on behalf of tax authorities.

C. GOVERNING PRINCIPLES

This subpart discusses the international tax policy principles that could serve as a guide to any proposals that address the concerns raised in the previous subparts. These principles--neutral tax treatment between e-commerce and traditional forms of commerce, existing international tax principles, international cooperation, and administrative simplicity--represent the general views espoused by the government and international reports that have been touched on previously in this Article. [FN128] In my view, any proposals in this area must be aligned with these principles in order to have a realistic chance for implementation. These principles will thus be used to evaluate possible alternatives to taxing e-commerce in Part III of this Article as well as my proposals contained in Part IV.

1. Neutrality

On the one hand, taxation should be neutral between e-commerce and conventional commerce. The Treasury Department stresses: "Neutrality requires that the tax system treat economically similar income equally, regardless of whether earned through electronic means or through more conventional channels of commerce. Ideally, tax rules would not affect economic choices about the structure of markets and commercial activities." [FN129] The White House further indicates that "the United States believes that no new taxes should be imposed on Internet commerce." [FN130] On the other hand, taxation should be neutral between different forms of e-commerce. A leading commentator concludes: "The implication for the taxation of electronic commerce is that the income tax should not discriminate between types of income, depending on whether income is from the [p. 164] sale of tangible products, licensing of intangible products, or provision of services." [FN131]

2. Existing International Tax Principles

The Treasury Department also indicates that it is preferable to apply existing international tax principles to e-commerce. [FN132] Similar views have been stressed by the White House, [FN133] the Commission of the European Communities, [FN134] and others. [FN135] The reliance on existing principles such as the permanent establishment concept is thought to be preferable since these principles are generally applied in most countries and have promoted cross-border trade and investment throughout much of this century. These principles--although unquestionably imperfect--reflect the current international consensus surrounding how cross-border business activities and their related profits should be taxed. For good or ill, international tax rules have generally developed less from theoretical concerns than from countries coming to an agreement on practical ways to tax international business income while preserving the greatest amount of fiscal sovereignty. [FN136] Any suggestions to radically alter these principles would not likely gather international support, which leads to the next guiding principle.

[p. 165]

3. International Cooperation

Significant international cooperation will be required to confront the challenges posed by the taxation of e-commerce. [FN137] Unfortunately, an international body like the World Trade Organization does not exist for tax matters. [FN138] The OECD is the most influential international organization for tax issues, but it is restricted to input and negotiations in most cases with its member states. Nevertheless, the OECD has made efforts in recent years to derive

input from nonmembers in such matters as harmful tax competition and the Multilateral Agreement on Investment and is probably best suited to arrive at the requisite international consensus. [FN139] [p. 166] As indicated, the current international tax regime provides an arguable balance between the interests of capital-exporting and capital-importing nations since these latter nations get to impose their income taxes over most significant active business profits. Proposals ought to take into account a similar balanced view when it comes to creating rules for dividing up future revenues derived from taxing e-commerce profits. The allocation of these revenues among nations will prove to be a very sensitive issue since most governments will fear losing out on a new mode of commerce that may one day conceivably match traditional forms of commerce. These governments will be very reluctant to enter into any agreements that threaten these potential revenues. In an era of increased cross-border investment and trade flows where greater international cooperation is being sought to curtail such activities as harmful tax competition, the wealthier countries of the world can no longer afford to ignore the interests of developing nations as they have arguably done in the past. [FN140]

4. Administrative Simplicity

Proposed changes to accommodate the taxation of e-commerce should not be overly complex. [FN141] The international tax codes of many developed nations are already burdened with extremely complex rules. Proposals should take into account the fact that most nations do not possess the administrative resources or expertise to protect their tax bases through complicated formulas or to track down business [p. 167] activities outside of their borders. [FN142] Thus, the administrative costs to tax authorities has to be taken into account. The proposals should minimize the compliance costs that would be incurred by businesses that could be forced to comply with the tax rules of a number of different jurisdictions (e.g., if an e-commerce business were forced to file a tax return in every country where consumer downloaded its product). Accordingly, the proposals should be fairly simple so that businesses can anticipate the tax consequences of their transactions. Further, the proposals should seek to minimize unrealistic compliance expectations of individual consumers (e.g., the requirement to withhold and remit a certain percentage of a royalty payment for a downloaded software product).

III. ALTERNATIVES TO TAXING E-COMMERCE BUSINESS PROFITS

The following discussion reviews a number of potential alternatives to impose income taxes on the profits generated by e-commerce transactions. Some proposals, such as the "bit tax," [FN143] are not discussed since international consensus appears to have moved away from them.

A. DO NOTHING

Although the consensus from commentators, governments, and international organizations appears to be that some action is necessary to accommodate the challenges posed by the taxation of e-commerce business profits, it could be suggested that the existing regime can handle these challenges. E-commerce transactions can be analogized to mail-order transactions or home shopping channels (or other "traditional" forms of e-commerce) [FN144] and thus it can be argued that existing tax rules and bilateral tax treaties will suffice. It is unlikely, however, that the current international taxation regime is capable of dealing effectively with these new

challenges. [FN145] [p. 168] Unlike mail-order, other direct marketing businesses, or traditional forms of e-commerce where cross-border sales have never been significant, Internet e-commerce is simply a revolutionary way of conducting trade and business. [FN146] As discussed, international e-commerce trade and investment is expected to generate hundreds of billions of dollars in revenues within the next few years. Furthermore, since significant amounts of revenues are at play, the inability of the current international tax regime to address issues like income characterization, permanent establishment, and transfer pricing suggests new rules are needed. In addition, the absence of clear tax rules to govern this emerging form of commerce will inhibit the development of e-commerce. [FN147] This uncertainty will only encourage countries to attempt a "tax grab" by asserting their tax jurisdiction over the profits generated by e-commerce. This will result in either (1) international double taxation as two or more countries impose tax on the same business activity or (2) an unfair allocation among countries as some nations "give in" or are simply unaware that business profits are being generated within their borders. The potential problems of international double taxation, undue tax avoidance, and tax evasion will only become more exacerbated under the anticipated exponential growth of e-commerce activities.

[p. 169]

B. RESIDENCE-BASED TAXATION

The Treasury Department indicates: The growth of new communications technologies and electronic commerce will likely require that principles of residence-based taxation assume even greater importance. In the world of cyberspace, it is often difficult, if not impossible, to apply traditional source concepts to link an item of income with a specific geographical location. Therefore, source based taxation could lose its rationale and be rendered obsolete by electronic commerce. By contrast, almost all taxpayers are resident somewhere. [FN148] As a result, the Treasury Department suggests that residence-based taxation of e-commerce may be the appropriate solution. [FN149] Other commentators have also favored moving toward a purely residence-based system of taxing business profits derived from e-commerce. [FN150] Under this system, source countries would be unable to tax the profits generated by e-commerce transactions even if a permanent establishment arguably existed under traditional treaty or national law principles. [FN151] Proponents of a purely residence-based system are often concerned that e-commerce will escape taxation altogether unless the resident is taxed. [FN152] And yet a residence-based system raises a number of difficult issues. For example, it is often difficult to identify where the taxpayer is a resident. This problem will only be exacerbated by the new technologies that make e- commerce possible. There are two general methods countries use to determine whether corporations are residents. [FN153] First, many countries, including the United States, have [p. 170] adopted a "place-of-incorporation" test: a corporation is considered a resident if it is incorporated within the country in question. [FN154] Corporations incorporated outside of the country are considered to be nonresidents. As such, residency can change by simply changing the country of incorporation. [FN155] Further, the place-of-incorporation test does not require a business to maintain an economic presence within the country; the simple act of filing articles of incorporation will suffice to fulfill the residency requirement.

Second, many countries have adopted a "place of central management and control" test to determine whether a company is a resident. [FN156] This test normally involves looking to the location of a company's head office or the board of directors' regular meetings. The Australian Taxation Office suggests that the development of new technologies presents a number of challenges to this test because it is often difficult to establish the place of management and control. [FN157] Commentators have also noted that the development of videoconferencing, which allows directors or upper-level corporate officers to maintain residences in different jurisdictions, poses a challenge to the place of central management and control test. [FN158] [p. 171] At times, two or more countries may assert the right to tax earnings on the basis of residency. Accordingly, tax treaties include "tie-breaking" provisions to determine which country has the right to tax. Many treaties indicate that, in the case of competing residency claims, a company is resident where its place of effective management is located. [FN159] Under this rule, the same problems associated with discovering the place of central management and control for e-commerce transactions will continue to persist. [FN160] Nevertheless, the Australian Taxation Office indicates: "There is sufficient authority to indicate that it is likely that the courts will be able to modify the application of the central management and control test to the Internet environment. . . ." [FN161]

If a purely residence-based system were implemented, companies would be given an incentive to relocate their e-commerce base of operations to low or nil tax jurisdictions like tax havens. In general, profits from these e-commerce transactions would not be taxed by the residence country until they were distributed back to the parent company. [FN162] Taxes would thus be deferred or possibly avoided altogether. The Treasury Department recognizes this issue and indicates: If [controlled foreign corporations] can engage in extensive commerce in information and services through Web sites or computer networks located in a tax haven, it may become increasingly difficult to enforce [rules governing the taxation of their profits]. Some persons engaged in electronic commerce may already be locating their businesses offshore. . . . [T]his presents enforcement problems because it may be difficult to verify the identity of the taxpayer to whom foreign base company sales income accrues and the amount of such income. [FN163] However, a revision of tax rules to ensure that undistributed earnings are taxed by the residence country will not do anything to [p. 172] prevent start-up e-commerce companies from locating their operations within tax havens in order to avoid paying taxes. A company that is initially a resident within one of these countries may never pay any tax on its e-commerce profits under a purely residence-based approach. There are already indications that e-commerce businesses are responding to this tax incentive. For example, most e-commerce pornography operations are situated within Guyana. [FN164] And most of the world's on-line gambling takes place on sites located within Grenada, home of Sports International. [FN165] Movement toward a residence-based system would invariably favor countries that are net exporters of e-commerce goods and services. The greatest beneficiary of this system would likely be the United States since it currently leads the world in the production and export of these goods and services. [FN166] This leads to perhaps the most serious drawback of the proposal: a residence-based system would dramatically affect the current allocation of tax revenues. "[A] wholesale move to residence-based taxation would entail radical shifts in the international distribution of tax revenues, especially from [less developed countries] to developed countries. Many would not think this fair and it will not be popular in many countries." [FN167]

As discussed, the guiding principles in the taxation of e-commerce include the need for international cooperation in resolving the challenges presented by this new form of commerce. It is unlikely that many, if not most, countries in the world would support a move toward pure residence-based taxation since their future tax revenue streams would be adversely affected. Proposals to move toward a purely residence-based system of taxation would thus not likely attract the requisite international consensus and may not resolve a number of additional challenges confronting the taxation of e-commerce business profits. [FN168]

C. FORMULARY TAXATION

The e-commerce income tax base could be divided among different nations according to some formula. This approach would [p. 173] replace the existing transfer pricing rules that determine profit allocation. [FN169] Under this formulary approach, a business with operations in more than one country would be treated as a single taxable entity: factors such as payroll, property, and sales would determine how profits generated by e-commerce would be allocated among the different countries. [FN170] The formula apportionment process resembles, in a number of ways, the system already used by some federal countries such as the United States and Canada to divide income tax revenues among their subfederal states and provinces. [FN171] E-commerce formulas would presumably use factors that match industry specific requirements. The formulary approach would probably have the advantage of better matching highly integrated e-commerce profits with the jurisdiction that contributed the economic resources to produce the profits. [FN172] It would also overcome many of the hurdles associated with applying the current transfer pricing system to highly integrated (and often intangible) e-commerce goods and services.

The approach, however, suffers from a number of deficiencies. E-commerce transactions that are similar in economic nature to traditional commerce (e.g., digitized books versus "real" books) would be treated differently since the former transaction would be subject to the formulary approach, while the traditional commerce would still be taxed according to existing principles (with the corresponding possibility of very different tax treatments). The formulary approach hence breaches the neutrality criterion as well as the need to use existing international tax policy principles. [FN173] [p. 174] Neutrality could be preserved if the entire international system for the taxation of business income were switched to a global formulary apportionment system. It is unlikely, however, that an international consensus will develop around switching to this new form of taxation; in recent years, the OECD, [FN174] a committee of European Union tax experts, [FN175] and the U.S. Treasury Department have all come out against global formulary apportionment. [FN176] Further, countries that are net importers of e-commerce goods and services will likely argue for rules that strengthen source apportionment while net exporters of these products and services will argue for apportionment based primarily on residence. [FN177] Part III.E briefly discusses the formulary approaches that could be taken to strengthen destination-based taxation of e-commerce business profits. It may also be necessary to harmonize or approximate the different national tax bases associated with e-commerce for formulary apportionment to be workable. [FN178] This need for tax base uniformity, although arguably warranted, would likely be perceived by [p. 175] governments as placing too many restrictions on a nation's fiscal sovereignty. [FN179]

D. USE TAX TREATY "FICTIONS"

As discussed, the permanent establishment provisions of most tax treaties contain "fictions" that permit the source state to apply its income tax on activities that would otherwise escape source taxation. [FN180] Under the OECD Model Treaty, for example, shipping and air transport businesses are taxed only where the place of effective management is located. [FN181] E-commerce transactions can arguably be analogized to these situations because this form of commerce is highly mobile and shifts to different jurisdictions with great frequency. In fact, e-commerce can arguably exist in many jurisdictions simultaneously. Thus, it can be argued that e-commerce businesses should similarly be taxed only in their place of effective management or only as residents. This approach would suffer from the same limitations as a shift to a purely residence-based system of taxation, including the difficulty in determining a place of effective management for the e-commerce transactions.

In addition, the model tax treaties, as well as some national tax laws, employ fictions that permit the source state to tax the earnings of certain artists and athletes who earn significant incomes within the source state despite the absence of a permanent establishment. [FN182] The source state should arguably be permitted to tax these earnings because the artists and athletes derive substantial financial compensation by performing in the source state despite the temporary nature of their activities. Similar arguments can be made with respect to e-commerce which may call for the use of permanent establishment fictions. For example, a tax treaty could contain a provision that simply indicates that profits related to e-commerce transactions would be [p. 176] attributable to a fictional permanent establishment, such as a website that is briefly stored within a consumer's hard drive when it is accessed, within a source country as long as the sales activity passes some threshold amount, such as gross sales to consumers above $100,000. There could not, however, be a "duration" component to the test because the e-commerce transaction may be concluded almost instantaneously, such as when a software program downloads directly to the consumer's hard drive. This would of course diminish the principle of permanent establishment by completely erasing the need for the existence of some temporal and geographical presence within the source state. [FN183] According to one commentator, however, certain permanent establishment fictions have already accomplished this in rare cases. [FN184]

In short, some type of fiction could be created to tax e-commerce profits on goods and services at the place where they are purchased or the country of destination. The creation of such a fiction, however, would undermine existing international tax principles that rely on some "economic allegiance" (which is currently defined as some significant geographic and temporal permanence) with source countries prior to the application of source-state income tax. The fiction would also breach the neutrality principle by creating different regimes for the taxation of e-commerce transactions and traditional forms of commerce. Finally, the fiction would likely rely on the ultimate destination of the e-commerce transaction, which creates additional problems, as discussed in the next subpart.

E. DEVELOP DESTINATION-BASED RULES

Additional rules could also be developed to help to ensure source countries share in revenues derived from e-commerce business profits. [FN185] One proposal in this direction would classify e-commerce service income along a "man-machine distinction" because it is often [p. 177] difficult to determine where this service has been performed. [FN186] The new environment created by e-commerce, it is suggested, necessitates a distinction between services that require significant human activity and services that are largely performed by machines, including software programs. The former type of service would be taxed at the place where the service was performed while the latter type of service would be treated as transfers of tangible or intangible property and taxed where the service was being used. [FN187] Accordingly, source countries would be permitted to apply their income taxes to mechanized service transactions at the place of destination. [FN188]

In a somewhat similar manner, governments could look to existing value-added tax (VAT) rules to determine how the income tax should be divided between resident and source countries. VATs can either be taxed on a destination or origin basis. Under the destination approach, goods and services leave the country tax free, but goods and services entering the country are subject to the VAT. [FN189] Under the origin approach, goods and services are subject to the VAT only where they originate. [FN190] Within the European Union, most supplies of services are deemed to be supplied where the supplier is located. [FN191] However, e-commerce service providers do not need to have a fixed establishment in the country where the consumers are located. The Commission of the European Communities has recently issued a proposed draft directive that defines the place of supply in such circumstances as the place where the customer is located. [FN192] Under the proposal, non-European Union suppliers would be required to register as VAT taxpayers in the jurisdictions where their customers are located. [FN193] [p. 178] Professor Avi-Yonah of Harvard Law School has developed a similar approach by proposing a tax system that imposes a withholding tax (at a rate equal to the corporate income tax rate) on the income of the e-commerce business based on the ultimate destination of the e-commerce goods and services. [FN194] The withholding tax, however, would be imposed only if e-commerce gross income surpasses a specified threshold (e.g., one million dollars) within the source state. [FN195] The tax base would then be shared with other jurisdictions that produced the goods and services as long as they impose a similar tax. [FN196] This is similar to the VAT rule that permits deductions for inputs only for purchases from registered VAT payors. Alternatively, a portion of the e-commerce profits could be attributed to the source country through the use of a formula that considers sales at destination and other factors that influence production, such as payroll and property. [FN197] As noted above, this formulary approach to taxing profits generated by e-commerce transactions suffers from a number of deficiencies. [FN198]

There are a number of additional problems associated with the creation of rules that effectively try to tax e-commerce activities based on the ultimate destination of the goods and services. First, a tax placed on the profits that occur in the country of consumption would begin to resemble more and more an indirect consumption tax and less a direct income tax. This leads to several points. Countries can and have already developed federal indirect taxes to be applied against the consumption of goods and services: all of the OECD member states, except the

United States and Australia, have implemented a VAT. [FN199] These VATs or other consumption taxes emphasize taxing individuals and legal business entities on what they take out of society, [p. 179] measured partly by what they consume, while an income tax emphasizes taxing persons on what they contribute to society, measured partly by their income. [FN200] Consumption taxes thus generally focus on where consumption takes place (i.e., the source state) while income taxes focus on where income is produced (i.e., the residence state). Under existing international tax principles, consumption taxes and income taxes are hence treated very differently in most circumstances. [FN201] Other than the situation within the European Union where VATs are harmonized to a large extent, international tax agreements do not generally deal with consumption taxes. [FN202] This does not, however, present too many problems because most countries have adopted destination-based VATs, in which goods and services are exported tax free, but imports are subject to the tax. [FN203] Perhaps the most important issue revolves around the use of tax treaties to avoid double taxation. Tax treaties contain provisions that indicate international double taxation will be relieved either by way of credit or by the exemption method. [FN204]

For example, countries that tax their residents on a worldwide basis grant foreign tax credits to ensure that the foreign operations of their multinational firms will be able to reduce their domestic taxes by the amount of foreign taxes paid. [FN205] However, relief is only granted for income taxes. Arguably, destination-based taxes on e-commerce profits that resemble a consumption tax might not fit within the definition of this tax, especially if this tax is imposed on a gross basis against which no deductions are permitted and not as a typical net basis income tax. It may thus be necessary to fundamentally alter the approach of most tax treaties to take into account the use of these destination-based e-commerce taxes. [FN206] [p. 180] Furthermore, there are a number of practical administrative problems associated with taxing e-commerce profits on the basis of destination, especially those profits associated with sales transactions to individual consumers within these source states. [FN207] As discussed, e-commerce transactions often eliminate the link between income-producing activities and their source. This is particularly true for direct e-commerce transactions (i.e., goods and services provided in digital form directly to the consumer's computer). Communications technology developments are making it difficult, or impossible, to identify where customers are located. [FN208] This identification is a key prerequisite to any attempts to impose a tax in the country of destination. However, vendors are often unable to determine where their customers are located since their servers cannot identify the physical location of the customer. [FN209] The situation is further complicated as the end consumers may eventually use "unaccounted" electronic payment systems where they [p. 181] will not be identified as a party to the transaction and no independent records will be kept. [FN210] Some of the new electronic payment systems, including e-cash and stored value cards, are designed to operate as unaccounted systems. [FN211] These unaccounted electronic payments can be sent somewhere that does not have any connection with, for example, a website. [FN212] Even if credit cards, the most popular payment method, are used, it may be difficult or impossible for a vendor to ascertain a consumer's address: state laws in the United States prohibit the release of credit card payment information to businesses, including information regarding the customer's billing address. At any rate, one study suggests that 39% of all e-commerce credit card orders may be based on fraudulent information. [FN213]

At this point, it is impossible to say whether it will be technologically feasible to track e-commerce transactions to a consumer's state with any great certainty. Recent developments, however, offer some hope in this area. The Clinton administration is considering a tax system that involves the use of electronic "resident cards" for consumption tax purposes that identifies the country of the Internet buyer. [FN214] A company called Taxware International has developed a software program to assist businesses with calculating their taxes attributable to Internet transactions, but this company has been unable to devise a way to determine the Internet customer's [p. 182] physical location. [FN215] Further, current efforts to determine a customer's location may ultimately be frustrated by future technological developments that make it easier for consumers to hide their location.

Finally, the "cultural" aspects of the Internet and its users may also inhibit destination-based taxation attempts. Many current users are notoriously protective of their privacy and will view any attempts by governments to restrict their privacy as overly intrusive. [FN216] There has been significant attention of late to these privacy issues as some governments argue that encryption-based security will facilitate crimes on the Internet. [FN217] Nevertheless, there is a growing consensus among industry participants and some governments that there should be no restrictions on encryption software; "[s]ince the openness is clearly a major contributing factor to the success of the Internet, it is a factor that countries change at substantial risk to their effective participation in the emerging global information economy." [FN218] The ability of users to secure their e-commerce transactions from government entities will make it more difficult for tax authorities to trace these transactions to the end consumers. [FN219] As a result of privacy concerns, the European Union has recently passed a directive that restricts the use of information on consumers that can be collected and sold using the Internet or other electronic sources. [FN220] The directive requires e-commerce businesses to inform consumers when they gather information on them and tell them how the information will be used. [FN221] Further, the directive requires the companies to obtain "unambiguous" consent from these consumers [p. 183] before they can use the information. [FN222] Although the directive does not apply to the information collection by state authorities, including presumably tax authorities, [FN223] it may make it more difficult for vendors to seek out the ultimate location of their customers. Consumers may be willing to consent only to the use of information that permits the sale to go forward, and argue that their physical location is irrelevant to the completion of the transaction. [FN224] The United States and other countries currently pursue a policy of self-regulation in which industry develops its own privacy guidelines for Internet-based commercial activity. These guidelines may ultimately place additional hurdles in front of attempts to determine a consumer's location. [FN225]

In addition to these consumer identity issues, there are further tax administration reasons against adopting source-state taxation of e-commerce based on ultimate destination, at least with respect to individual consumers. [FN226] It is anticipated that, at least in the initial stages, a large share of international e-commerce will be conducted by small- and medium-sized companies. Low start-up costs will open up the opportunity for thousands of companies to "go global" with their e-commerce businesses. [FN227] But these companies may often not have the resources or know-how to comply with the tax laws of foreign jurisdictions if they are somehow forced to pay income taxes to the foreign governments of every customer. [FN228] Any proposals that would

[p. 184] place this additional compliance burden on these companies may inhibit the growth of e-commerce. [FN229]

Further, the imposition of foreign income taxes from multiple tax jurisdictions would create a number of opportunities for international double taxation even if the consumer identification issues are resolved. As discussed, the residence country will have to either exempt the profits subject to source-country taxation or provide sufficient foreign tax credits to offset the source-country tax. In theory, the tax authorities of the source country could assist in this matter by providing information on the identity of taxpayers within their jurisdiction. Many tax treaties have provisions providing for the exchange of information between different national tax authorities. [FN230] In practice, however, most tax authorities do not have an ongoing exchange of information about taxpayer identity or income streams, and the provisions within the tax treaties are of little use. [FN231] In any event, these tax authorities would likely have to expend significant resources if they are forced to monitor the expected increase in small businesses that trade internationally through the use of emerging information technologies. Many countries will have insufficient resources to police and ensure compliance of this increase of business activity from potentially thousands of businesses located outside of their jurisdictions. In summary, the strengthening of source-country taxation of e-commerce along destination-based rules faces a number of serious tax administration concerns.

[p. 185]

F. COMMENT ON THE ALTERNATIVES

It appears that the above alternatives suffer from a number of deficiencies. They might upset the current allocation of tax revenues among nations, undermine existing international income tax principles, or suffer from administrative problems. The next Part sets forth a practical common-ground approach derived partly from these existing proposals.

IV. BALANCING RESIDENCE-BASED TAXATION OF E-COMMERCE WITH EXPANSION OF SOURCE-COUNTRY TAX BASE

The following proposal is meant to serve as a potential framework for the negotiation of protocols to amend existing bilateral tax treaties. The first proposal would effectively create a residence-based taxation regime for international e-commerce business income by denying permanent establishment status to servers and websites. This approach favors the interests of e-commerce exporting nations. But e-commerce importing nations and/or developing nations may understandably wonder why they should suffer the consequences of new technological developments that erode traditional concepts such as permanent establishments (and with which they may fundamentally oppose even in the absence of e-commerce). In order to balance the approach with the interests of e-commerce importing nations, this Article proposes an e-commerce withholding tax on all e-commerce payments above a specified threshold. Further, e-commerce importing nations should be permitted to negotiate a restricted force of attraction clause within their bilateral tax treaty. This type of provision expands the source-country's tax base by increasing the amount of business profits that will be subject to source-state taxation in certain circumstances.

The proposals are designed to be sufficiently flexible to take into account the different and often opposing interests of countries. Some, or perhaps many, e-commerce importing countries may decide not to request the withholding tax or the restricted force of attraction clause if they feel that cross-border trade and/or investment flows into their countries would be unduly impeded by these provisions. For example, an advanced economy that is a net capital exporter but currently a net e-commerce importer may decide to negotiate the withholding tax but choose to forego the restricted force of attraction clause. A developing nation that is both a net capital importer and a net e-commerce importer may choose to request both clauses. The following subparts describe the proposals in greater detail.

[p. 186]
A. RESIDENCE-BASED TAXATION

1. Deny Servers and Websites Permanent Establishment Status

The first proposal is to create an additional provision in tax treaties [FN232] to ensure that computer servers, computer networks, telecommunication equipment, and related hardware and software equipment or webpages, websites, and other digital manifestations arising from this equipment are not treated as permanent establishments. [FN233] As discussed, the taxation of international e-commerce business income raises the issue of whether a computer server or similar equipment can be considered a permanent establishment under provisions of a tax treaty. [FN234] If this type of equipment constitutes a permanent establishment, many of the resulting tax planning opportunities would be extremely problematic for tax authorities throughout the world. The problem is simply that [p. 187] servers (1) can be located anywhere in the world or in multiple jurisdictions, (2) can transfer their programs almost instantaneously to another jurisdiction, (3) do not require any connection to income-producing activities, and (4) do not have to be maintained by the employees or agents of the company that is engaged in e-commerce transactions.

If servers or websites constitute permanent establishments, companies would be able to take advantage of the nature of these servers or websites to shift profits to low or nil tax jurisdictions or to otherwise defer or avoid taxation on e-commerce profits. A former U.S. Treasury Department official has indicated that under current tax treaties between the United States and other countries "one has to go a long, long way to remotely find a permanent establishment in the Internet/server type of environment." [FN235] Other tax authorities apparently do not take such a view, especially if the server can perform "intelligent" functions that replicate human activity. [FN236]

The existence of a server thus currently constitutes a gray area under international tax principles and countries may be tempted to make a "tax grab" by imposing their income taxes on the profits generated by servers or websites that are located within their jurisdictions. This tax grab will be especially enticing for countries that are net importers of e-commerce goods and services. [FN237]

Denial of permanent establishment status should occur no matter what functions the program performs within the server. A functionality test would open up a Pandora's box of disputes surrounding whether the program is sufficiently "human-like" to be [p. 188] considered an agent

and thus a permanent establishment. [FN238] This type of test would be subject to potential manipulation by companies engaging in e-commerce because, if they wished to pass the functionality test in order for the server to be considered a permanent establishment, they could simply increase the functions the program performs. Or, if they did not wish to have their server considered as a permanent establishment, they could decrease the functions. The denial of permanent establishment would help to alleviate transfer pricing problems because one would no longer have to attribute any profits to the server or related equipment. From a transfer pricing perspective, it does not seem fair to allocate any profits to the server, even if the company maintains a full-time employee at the server's location to maintain, reprogram, or otherwise service the server. Although the costs of the server and related costs (including salaries of employees) should be deductible as expenses incurred while pursuing profit-making activities, the mere existence of an employee or employees will again create the possibility for manipulation if there is some type of threshold test before the server can be considered a permanent establishment.

For example, many multinational firms currently manipulate their transfer prices by locating head offices or financial offices in low tax jurisdictions or jurisdictions that offer tax incentives for such operations. [FN239] Profits generated by these operations are often taxed at a lower rate than the profits from other aspects of the multinational firm's business. Head offices and financial offices are often the most mobile aspects of a multinational firm's business, and some countries (e.g., the Netherlands and Luxembourg) have recognized this fact and created very favorable tax treatments for such activities. [FN240] Servers or websites, however, are far more mobile than head offices or financial offices and are thus subject to a much greater [p. 189] potential for manipulation. It seems likely that at least some countries will feel the need to "compete" for these revenues by enacting favorable taxes for server business activity. [FN241] This may worsen an already bad situation by encouraging "harmful" [FN242] global tax competition. [FN243] Further, the profits allocated to a head office or a financial office will often only be a small, although significant, part of a multinational firm's total profits. In contrast, the business activity and corresponding profits located within the server may arguably be the entire profit-making center for a business engaged in e-commerce. Many firms are already making significant profits through e-commerce. The temptation to locate servers in relatively lower tax jurisdictions will only increase as this new form of commerce begins to realize its potential. This raises the specter of deferral, avoidance, and evasion of residence-country tax. [FN244]

If permanent establishment status is denied to a company's offshore server or website, the company may be tempted to simply incorporate a shell company in the country where the server is located; taxation of the profits associated with the server would be deferred until they are distributed back to the parent company by way of dividends. The Treasury Department notes that this will place further pressure on the existing controlled foreign corporation rules of the residence country. [FN245] [p. 190] These rules are already incredibly complex and under constant attack by new international tax planning developments. [FN246] E-commerce may become the breaking point in the ability for the United States and other governments to protect their tax bases if deferral opportunities are created by permitting profits to be associated with server activity. [FN247] The controlled foreign corporation rules of these countries will likely have to be amended to ensure that profits related to servers or websites can be taxed on an

accrual basis by the residence country. For example, the United States taxes certain sales and services income (foreign base income) earned by conduit subsidiaries whether or not the profits are distributed back to the parent corporation. [FN248] However, these rules also state that property that is manufactured within the subsidiary's country will not give rise to foreign base income. [FN249] As a result, e-commerce businesses may employ a programmer located within the tax haven (or perhaps from a remote location) to alter the server's program in order for the software to sufficiently transform any digital property which may then be considered to be "manufactured" within the tax haven.

The OECD Council has recently recommended drafting a list of tax havens according to specified factors. [FN250] Perhaps countries should [p. 191] simply tax on an accrual basis any e-commerce income generated within these tax havens without resorting to current categorization methods under most controlled foreign corporation rules. This solution would not, however, stop problems associated with countries that are not tax havens competing for e-commerce revenues by adopting special tax incentives for foreign investments. Nor would it stop problems associated with countries attempting to attract these businesses through general low effective corporate income tax rates such as they have in Ireland. Even if the controlled foreign corporation rules can be successfully modified to inhibit the use of a tax haven as an e-commerce base of operations, a residence-based tax approach, as suggested here, may still offer an incentive for certain start-up e-commerce businesses to begin their operations in tax havens. These start-ups would be considered residents of their tax haven countries and thus they would not have to pay any income tax on their business profits. [FN251] A more radical approach, such as formulary apportionment or a destination-based tax, might ensure that these tax haven e-commerce companies would have to pay taxes, but these approaches involve a number of concerns that argue against their implementation.

2. Taxation of the Resident Company

Once websites and servers are eliminated as a potential source for taxation, [FN252] residence countries will largely be responsible for imposing and collecting their income taxes on e-commerce businesses. Identifying the party who is the resident responsible for paying income taxes on e-commerce profits is a necessary prerequisite for the imposition of an income tax. [FN253] As discussed, there are a number of problems associated with identifying the resident. [FN254] In fact, the Australian Taxation Office attempted to discover the "real world" identity of Australian commercial enterprises operating websites and [p. 192] found that in 15% of the cases they could not do so. [FN255] In one case, they arrived at the purported postal address of a business operating a website and found only a hole in the ground. [FN256] Accordingly, a registration system was proposed where businesses conducting e-commerce would have to register their Internet Protocol (IP) numbers and the physical location of their main office. [FN257] This is a sound proposal, and efforts in this area should be extended to the international arena. Efforts could be directed in this direction by existing international organizations that regulate telecommunications companies. [FN258] It is recognized, however, that this type of regulation of the Internet is currently a charged topic of debate among scholars, with some suggesting that regulation is not possible because Internet businesses can effectively evade the regulation due to the decentralized nature of the network. [FN259] At any rate, it is clear that unilateral domestic legislation in this area will be of little use because it may simply encourage businesses to set up shop in more favorably regulated jurisdictions. Although it would be

practically impossible to get consumers to register their locations in some central database (for privacy reasons among others), there are many sound business reasons that would encourage businesses to register. Current consumers of e-commerce goods and services often express concerns surrounding the inability to gauge the trustworthiness of Internet vendors. [FN260] Hence, e-commerce [p. 193] businesses and other businesses in the European Union are now subject to a directive that restricts in many ways how they deal with customer information that has been electronically collected. [FN261] Countries must appoint a public authority to monitor the businesses that are subject to the directive. [FN262]

The United States prefers a self-regulation approach in which businesses voluntarily register their locations to encourage customer trust and loyalty. [FN263] This central registration system could also act as a kind of "Better Business Bureau" where consumers could check to see if any complaints had been lodged against e-commerce vendors. As a result, a type of central registration system would arguably foster the growth of this new form of commerce. Once the resident is identified, taxing authorities could resort to the traditional "tie-breaking" provisions of tax treaties that try to resolve residency disputes if they arise. [FN264] Judicial tests would likely be able to modify the "place of effective management" to take into account the existence of new communication technologies. [FN265] It is probably best for the commentaries to the model tax treaties to offer some guidance in the area of videoconferencing and intranet e-mail discussions to ensure that the residence is treated as the place where the management's important business decisions are actually made (e.g., perhaps by looking at where the majority of the directors or officers physically resided at the time the decision was made). [FN266] Resort could be made to the "competent authorities" provisions in the [p. 194] tax treaties to settle problematic areas where it is virtually impossible to identify the place of effective management. [FN267]

3. Transfer Pricing

Once residency has been determined, it is necessary to divide the e-commerce profits among the related business entities of the resident firm if these entities contributed to the creation of the profits. As discussed, e-commerce places greater strains on the existing transfer pricing mechanisms because e-commerce products and services are often highly integrated and intangible in nature. [FN268] Still, e-commerce does not present new transfer pricing problems in the sense that the issues have not been confronted by taxpayers and tax authorities. Rather, e-commerce transfer pricing issues are concentrated in areas where transfer pricing rules are currently under strain. Denying servers and related equipment the status of permanent establishment would remove the obstacle of determining arm's length charges between the server and related legal (e.g., parent or affiliate corporations) or nonlegal business entities (e.g., other permanent establishments). [FN269] As long as the server is not considered to be performing a "function" for transfer pricing purposes, profits will be attributed to the residence country. Once this is done, charges can be allocated to any permanent establishments or legal entities in other countries that contributed to the underlying profit-making potential of the e-commerce good or service. This can be accomplished by using existing transfer pricing rules. The OECD guidelines indicate that comparability factors used to determine arm's length transfers include functions performed, risks undertaken, and existing contract terms. [FN270] Tax authorities are directed to look into the substance of the transaction instead of its form. [FN271] Many "global collaborative" [FN272] e-commerce efforts may involve few [p. 195] risks relating to much of the activity that takes place outside of the country where the business is based. [FN273] The

commentary to the OECD Model Treaty suggests that the permanent establishment should be treated as a subdivision, instead of a separate independent entity, in certain cases. [FN274] As such, there is no need to determine whether profit should be allocated to the subdivision since it does not perform any substantive risk-taking functions.

An OECD study reviewed issues surrounding when a permanent establishment should be treated as a mere subdivision and offers a number of useful observations in the context of e-commerce transfer pricing issues. [FN275] After reviewing answers to a questionnaire submitted by OECD member states, the OECD noted: It would seem that the arm's length price principle is accepted for final transfers of goods . . . . This applies not only to tangible assets . . . but also to certain intangible assets (know-how, patents and trademarks)--although, of course, final transfer of a patent or of know-how is quite exceptional. In all other cases, notably as regards central administrative services [and] the right to use intangible assets, . . . the general rule is allocation of actual (historic) cost. [FN276] Later on, the OECD discusses more specifically transfers of technology and concludes that it may be more straight-forward to allocate intangibles without any mark-up for profit or royalty. [FN277] The [p. 196] evaluation of e-commerce intangible transfers at historic or actual cost (i.e., without adding any profit elements) would reduce the problems associated with identifying comparable transactions to determine an appropriate profit mark-up.

In order to reconcile the arm's length and cost allocation principles, the OECD has developed a test that asks whether the transfer of the good or service is "one of the same type which the enterprise might in the ordinary course of its activity be likely to have offered to or be requested to supply by an independent third party[.]" [FN278] If the answer is no, then the use of actual costs is appropriate. [FN279] The answer would seem to be negative for most global collaborative efforts to generate e-commerce profits because these efforts would likely be directed at either rationalizing the overall costs of the business or increasing general e-commerce sales. [FN280] The affiliates based in source countries would likely have been compensated already by the parent company. This compensation often includes compensation for risks undertaken and is based on market rates (i.e., non-arm's length rates) such as the payment of salaries for computer "coders" working in foreign countries. [FN281] As such, historic cost allocation may be appropriate for many related party e-commerce collaborative efforts that involve permanent establishments.

[p. 197] Of course, things become much more problematic when transfers must be evaluated according to arm's length principles. Current transfer pricing rules offer little guidance for the pricing of related party e-commerce goods and services. [FN282] These goods and services may vary to a great degree between different companies and traditional comparability analysis may not be feasible. [FN283] As such, it has been suggested that greater resort to profit-split methods may be necessary because under these methods there is not any need to find comparable goods and services. [FN284] Rather, profits are allocated to each country depending on the contribution of businesses within each country and according to market returns for similar business activities. Accordingly, these profit-split methods can be tailored to the specific facts and circumstances of the taxpayer. [FN285]

A sensible suggestion has been put forward for a heavier reliance on the residual profit-split method under U.S. tax law. [FN286] Under these rules, routine contributions (defined as contributions similar to those made by unrelated businesses involved in similar business activities) are first assigned to the various business operations and then nonroutine or residual profits (e.g., profits from a unique intangible property) are allocated to the related businesses that incurred the costs to produce the residual profits. [FN287] Multinationals with especially complex e-commerce transactions could also resort to Advance (Transfer) Pricing Agreements to establish an agreed-upon pricing methodology for allocating costs [p. 198] among the different related parties. [FN288] These agreements may involve one or more foreign tax authorities and the taxpayer would hence be protected from international double taxation on its e-commerce transactions. [FN289]

B. WITHHOLDING TAX ON INTERNATIONAL E-COMMERCE PAYMENTS

As discussed, if profits from an e-commerce transaction cannot be attributed to a permanent establishment within a source country, then the source country will not generally be allowed to apply its income tax to these profits. The main area of concern is that e-commerce will rarely require a significant physical presence within the source country and therefore the net e-commerce importing nation will lose out on the collection of revenues from this new form of commerce. The following rules are designed to ensure that the source country will enjoy revenues from significant e-commerce activity taking place within its country despite the absence of any permanent establishment.

1. Below the Threshold

An initial hurdle surrounds the characterization of the e-commerce income that is generated within the source country. As discussed, the characterization of income arising from e-commerce transactions is problematic because the transactions may be considered to generate sales proceeds, services income, royalties, or some other income. [FN290] The proposed U.S. Treasury Regulations seem to move in the right direction because they try to determine the substantive rights that were transferred. [FN291] Still, the anticipated increase in direct e-commerce transactions may create administrative difficulties in monitoring these characterization issues. Further, a digital product or service may arguably give rise to multiple types of income and it would be necessary to apply the appropriate tax treatment to separate [p. 199] components of a transaction, which may not be administratively feasible. In order to relieve these administrative problems, one suggestion is to create a provision within the model tax treaties that deems all cross-border transfers of e-commerce goods, services, and capital that generate active business income to generate income from sales proceeds within the source country, unless the gross income from these transfers surpasses a threshold amount. [FN292] In other words, the residence country alone would be able to impose its income tax on any below threshold e-commerce transactions that would generate active business income such as royalties, services, sales of business inputs, or rents, as long as there is not a permanent establishment within the source country. Further, any e-commerce payment from a source-country consumer or business for the purchase of these deemed e-commerce goods and services from a foreign company would not be subject to any source-country withholding tax for below threshold sales, unless the income gives rise to passive investment income like portfolio interest or portfolio dividends. This proposal may seem unusual, but it is important to note that current tax treaty

rules that distinguish the tax treatment of different categories of active business income--dividends, interest, rents, royalties, etc.--do not seem to follow any sensible principle in the first place. [FN293]

The threshold amount would have to reflect the fact that significant business activity was taking place within the country. This is similar to the notion that a permanent establishment acts as evidence of significant operations. [FN294] Perhaps an amount like $1 million (adjusted for changes in inflation) would suffice if international consensus could develop in this area. [FN295] It has been suggested that this type of gross threshold would be administratively enforceable because [p. 200] the gross sales amounts can be determined by reviewing the records of third parties such as customers of the resident company. [FN296] In the absence of any permanent establishment, this deeming rule ensures that the residence country alone can tax any transactions below the threshold amount, despite the fact that a source country could apply its withholding tax if the transaction previously would have generated certain categories of income such as royalty income. This would reduce the monitoring costs associated with determining whether the e-commerce good or service should be characterized as generating, for example, royalties or services income (and the associated potential for double taxation by countries that disagree with each other's characterization). Further, it would resolve some of the administrative problems associated with ensuring that source-country consumers withhold and remit any taxes to their governments (at least for below threshold amounts). For below threshold gross income amounts, the proposal would also reduce compliance costs on the part of small- and medium-sized e-commerce businesses because they would no longer have to seek a foreign tax credit for any foreign withholding taxes paid, nor would they have to file a tax return with these foreign jurisdictions. [FN297]

2. Above the Threshold

Any transactions above the gross sales threshold (e.g., $1 million) would be deemed to generate "e-commerce royalty income" that would be subject to a source withholding tax that could be separately negotiated within tax treaties. This proposal is similar to an "approach" developed by Professor Richard Doernberg of Emory [p. 201] University School of Law. [FN298] However, the proposal differs from his approach in a number of significant aspects. [FN299] The tax--like traditional tax treaty withholding taxes--would be imposed on the total (or gross) amount of the payment to the resident company instead of a net-basis like an income tax. As such, the effective withholding tax rate for the transaction may be significantly higher than an effective income tax rate on the profits associated with the same transaction. Further, the withholding tax would be applied on all cross-border transfers of inputs to businesses or sales to individuals despite the absence of any permanent establishment within the source country. Yet it is clear that nations will not permit a "new" (i.e., additional) tax to be applied on e-commerce business profits. In order for the proposal to work, the residence state company must be able to receive credit for the withholding taxes to be applied against any residence state taxes that are owed on the same transaction. Payments for foreign withholding taxes are generally creditable against domestic taxes at any rate when countries tax their residents on a worldwide basis. [FN300] Further, Professor Doernberg suggests that the residence-country company should be permitted to elect to file as a net-basis taxpayer in the source state and receive a tax refund for the withholding tax, if the withholding tax burden was greater than the [p. 202]

domestic income tax burden that would otherwise be payable on the international transaction. [FN301]

As a result, this approach is intended to allocate the tax base among states, not raise the overall level of taxation. If this approach worked seamlessly (and little in life does), [the residence state company] would be indifferent because the overall level of tax would be unchanged, although the withholding by [the source state] may result in a transfer of tax revenue from [the residence state to the source state]. [FN302] The e-commerce business-to-business royalty withholding tax should be enforceable by the source country since most of the payments to residence-country companies would have to be deducted by the source-country company (or the payment for the input would go into the company's cost of goods sold, which decreases the company's profit on the sale of the goods and hence reduces the tax liability). Professor Doernberg notes that source-country tax authorities can deny the deduction or tax benefit unless the source-country firm can demonstrate that it has fulfilled its withholding obligations. [FN303] The linkage between the cross-border payment and the deduction and tax benefit hence makes the proposal administratively feasible.

The royalty withholding tax on e-commerce business-to-consumers transactions above the threshold may present enforcement problems for source countries because it would often be difficult to identify these consumers as well as to ensure they withhold and remit the proper amount of their payments to the source-country's tax authorities. Further, it may be difficult for similar reasons to determine when the gross sales threshold has been surpassed for these consumer transactions. However, it may not be politically feasible to essentially prevent source countries from enjoying at least potential tax revenues [p. 203] from these transactions. Further, technological developments, especially as a result of VAT concerns, may ultimately resolve this issue. [FN304]

At any rate, the e-commerce business-to-consumer market is currently small in relation to the e-commerce business-to-business market, which represents over 80% of the total market. [FN305] Presumably, most of these consumer transactions would fall below the threshold in the near future. E-commerce importing countries would have to develop the appropriate mechanisms to enforce the withholding tax (as they are currently struggling to do in order to impose their VATs) in order to enjoy a portion of the revenues associated with the business profits derived by e-commerce sales to consumers.

3. The Five Percent Solution

Professor Doernberg indicates that the withholding tax rate should reflect international consensus, negotiation, and empirical information to ensure that source countries are properly compensated for the erosion of their tax base resulting from this new form of commerce. He suggests that a 10% rate may be reasonable. [FN306] Another way of looking at the problem, however, is to ask what the appropriate rate should be from a practical perspective (i.e., what source countries can "get away with" without imposing unacceptable efficiency constraints on e-commerce flows). It is clear that this withholding tax may impede cross-border e-commerce trade and investment in a number of ways, including (1) the potential for double taxation that results when the withholding tax is not creditable against domestic tax, [FN307] (2) the creation of additional compliance costs where the residence-country firm must file a tax return in the

foreign [p. 204] jurisdiction in some circumstances, [FN308] (3) the creation of additional tax rules to ensure source-country tax authorities can enforce the tax, [FN309] and (4) the waste of resources devoted to tax planning to avoid the withholding tax instead of devoting these resources to "real" economic activity. [FN310]

There has been a general reduction in tax treaty withholding tax rates in the past two decades. [FN311] This reduction corresponds to a general trend toward liberalization of trade and investment among nations. In order to reduce the barriers to e-commerce cross-border flows discussed above, it may make more sense to use a rate of 5% as the starting point for a suggested withholding tax rate in the three model tax treaties. This approach may not match revenue losses resulting from e-commerce activities in many circumstances, but it would alleviate some problems. [FN312] A 5% rate would reduce the amount of double taxation at risk. The lower rate would hence reduce the number of e-commerce [p. 205] businesses that would be required to file in a foreign jurisdiction to obtain a tax refund for withholding taxes paid in excess of domestic income tax on the same activity. Finally, it is unlikely that companies would spend resources on tax planning to get around a tax rate this low, especially if the companies cannot find another country with a lower rate in its tax treaty network. Countries that disagree with the suggested 5% rate could negotiate a higher rate on a bilateral basis. Still, many e-commerce importing countries may complain that the withholding tax does not compensate them for the revenue losses associated with moving toward residence-based taxation of e-commerce profits. The next proposal alleviates some of these concerns, although it is still, from a practical perspective, probably not possible to conclusively match revenue losses associated with being a net e-commerce importing country.

C. THE RESTRICTED FORCE OF ATTRACTION RULE

The withholding tax discussed previously would allocate some revenues to e-commerce importing nations. In order to further balance the residence-based taxation of e-commerce profits, e-commerce importing countries and/or capital-importing nations may additionally insist on the placement of a restricted force of attraction provision within their tax treaty networks. The adoption of this rule would help to alleviate concerns surrounding the use of the Internet as a means of shifting existing functions from permanent establishments to remote locations outside of source countries. [FN313]

1. The Rule

The United Nations Model Treaty sets out the restricted force of attraction rule: The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to (a) that permanent establishment; (b) sales in that other State of goods or merchandise of the same or similar kind as those sold through that permanent establishment; or (c) other business activities [p. 206] carried on in that other State of the same or similar kind as those effected through that permanent establishment. [FN314] The OECD Model Treaty and the United States Model Treaty do not include subsections (b) and (c) within their provisions that deal with the allocation of business profits. Under these two treaties, source countries can subject foreign business operations to their

income tax only if an existing permanent establishment is contributing to the profits generated within the source country. [FN315] The restricted (or "limited") force of attraction principle allows an existing permanent establishment within the source country to attract other income by the same foreign business entity, even though this income is not directly related to the permanent establishment. This effectively expands the source-country's tax jurisdiction.

The force of attraction principle, however, is limited to transactions that are similar to the ones entered into by the permanent establishment. Thus, if the permanent establishment is a sales and marketing division of the home country's business, then the principle would serve to attract similar types of business activity such as home office sales of similar merchandise to the same source country. For example, an original equipment manufacturer (OEM) for the automobile industry based in the United States may have a sales office in France used to distribute its manufactured power trains to a French car manufacturer. This French manufacturer would soon have the ability to order the power trains from the OEMs on-line extranet without consulting the OEM's sales office in France. Under the restricted force of attraction rule, the profits associated with the supply of power trains directly from the United States would be taxed by France. If the permanent establishment, however, is a manufacturing facility, then these home office sales will not be attracted because the business activity is not similar. As indicated, this provision is contained within the United Nations Model Treaty as a suggested provision for tax treaties with developing nations. [FN316] But the force of attraction rule has precedent in [p. 207] previous [FN317] as well as current [FN318] U.S. tax law. The force of attraction rule can be found presently in many existing tax treaties throughout the world, primarily within bilateral tax treaties involving a developing nation. [FN319]

My review of the forty-eight tax treaties that have been negotiated by the United States indicates that five of these treaties have adopted restricted force of attraction rules with respect to business profits, [FN320] while an additional five treaties have adopted the "full force [p. 208] of attraction rule" [FN321] that goes beyond the attraction rule set out in the United Nations Model Treaty. [FN322] Nevertheless, a U.S. Treasury Department Technical Explanation indicates: This limited "force of attraction" rule is frequently requested by developing countries to prevent avoidance of their tax at source. It has been agreed to in some other U.S. income tax treaties, such as those with India and Indonesia, although it is not in the U.S. Model and does not represent the preferred U.S. policy. [FN323] It is important to note up-front that the current conception of profit attribution solely to the permanent establishment, as envisioned in the OECD Model Treaty and U.S. Model Treaty, should not be viewed as an international tax practice that is etched in stone for all of eternity. The principle is not inviolable as the commentary to the OECD Model Treaty notes: Some countries have taken the view that when a foreign enterprise has set up a permanent establishment within their territory it has brought itself within their fiscal jurisdiction to such a degree that they can properly tax all profits that the enterprise derives from their territory, [p. 209] whether the profits come from the permanent establishment or from other activities in that territory. [FN324]

2. Expand Source-Country Tax Base

The restricted force of attraction provision expands a source-country's tax base by attracting transactions to a permanent establishment even if this permanent establishment did not contribute to these transactions. As such, net importing countries would collect more revenues from foreign

commercial activities within their borders under this provision than they would under the approach set out in the OECD Model Treaty or the United States Model Treaty. According to what appears to be the most comprehensive study of the permanent establishment principle, which was conducted before the emergence of e-commerce, modern commercial practices have already eroded the permanent establishment concept to a large extent. [FN325] The study thus concludes with a proposal to consider a movement toward the United Nations restricted force of attraction rule. [FN326] There are thus strong arguments that can be made to move toward this type of regime, even in the absence of e-commerce.

[p. 210] The current international taxation regime was set up to acknowledge the fact that both residence and source countries should share in the revenues derived from cross-border commercial transactions: companies from the residence country may have produced a good or service, but the consumers within the source country create the opportunity for the profit. [FN327] E-commerce, which erodes or demolishes the permanent establishment principle in many cases, will likely upset this balance. Since it does not appear feasible or administratively workable to attribute e-commerce profits to source countries under the principles developed within the OECD Model Treaty and the U.S. Model Treaty, steps should be taken to strengthen source-country taxation along existing practices and principles. The United Nations force of attraction principle is one such way. The restricted force of attraction rule will expand the tax base for traditional commercial activities (and some e-commerce activities as discussed next) and serve as a proxy for lost revenues under the residence-based taxation of e-commerce proposed previously.

The OECD's main opposition to the force of attraction rule seems to lie in its belief that the rule will interfere with the way in which commercial ventures are conducted in other countries. [FN328] But it is [p. 211] questionable whether this rule would impede cross-border investment because the rule would not necessarily impose a greater tax burden on a multinational firm's operations. [FN329]

3. Reduce Erosion of Source-Country E-Commerce Tax Base

As discussed, a concern exists that multinational firms will take advantage of information technology developments and begin (or currently are) transferring existing permanent establishment activities in source countries to Internet-based operations outside of the source country. [FN330] Under current permanent establishment attribution rules, the profits derived from these e-commerce activities cannot be subject to source-state taxation as long as the permanent establishment is not (or cannot be identified as) contributing to the activities. [FN331] Thus, it appears that the Internet will lead to a further erosion of the source-country's tax revenue as multinational firms shift parts or all of the activities within permanent establishments to remote locations outside of the source country. The limited force of attraction rule, however, would continue to attract profits to the permanent establishment as long as it continues to exist in some form and continues to perform similar functions. As such, the restricted force of attraction provision would curtail the erosion of source-country tax base, at least to a certain extent. The proposed rule, however, would cease to have this effect if the residence-country company closes down its permanent establishment (or, for example, removes employees or dependent agents located in the source country). It would also cease to apply if the assets used within the permanent establishment are transferred into a corporation under the laws of the source country

because the source country would then treat the former permanent [p. 212] establishment as a resident and adverse residence-country capital gains tax may be triggered. [FN332] However, the profits of most "pure" e-commerce businesses would never be allocated to source countries, unless and until they are swallowed up by larger multinationals, because they would not likely possess a "fixed place" of business which has been the traditional conception of the permanent establishment principle. These firms, however, may begin to use agents in foreign jurisdictions who would fall within the permanent establishment definition. Foreign agents may be necessary to understand the nature of these markets as well as to conclude complex business-to-business high technology contracts, especially if the negotiations are conducted in languages that are foreign to the resident company employees. The restricted force of attraction rule would serve to attract income from the home-country's operations that are generated directly between the resident country's business and the foreign customers as long as the income is similar to the business income generated by the agent's activities.

4. Reduction of Tax Avoidance

Prior to the emergence of e-commerce, countries--especially developing countries--had argued that some type of force of attraction rule is necessary to reduce tax avoidance and evasion. These countries asserted that it is often difficult to identify the residence-country profits that should be associated with a permanent establishment and that residence-country companies structure their business activities to take advantage of this difficulty. [FN333] The OECD acknowledges that "[i]t is no doubt true that evasion of tax could be practised by undisclosed channelling of profits away from a permanent establishment and that [p. 213] this may sometimes need to be watched." [FN334] But it downplays this point by suggesting other concerns should be predominant. [FN335]

A way to partly alleviate the concerns about tax avoidance is the addition of a "serious economic reasons" test at the end of the United Nations restricted force of attraction rule. [FN336] For example, the United States-Mexico tax treaty indicates: "However, the profits derived from the sales [as a result of the restricted force of attraction provision] shall not be taxable in the other State if the enterprise demonstrates that such sales have been carried out for reasons other than obtaining a benefit under this Convention." [FN337] These tests try to ensure that foreign companies will only structure their source-country operations away from the permanent establishment for nontax reasons. Even the addition of such language to a restricted force of attraction principle does not guarantee the absence of tax avoidance. Legislation designed to combat tax abuse is often difficult to enforce because the firm under suspicion can usually argue there was a commercial reason for its activities. It also takes significant resources [p. 214] on the part of the source-country tax authorities to police this type of abuse. Most developing nations that have expressed these tax avoidance concerns likely do not possess these resources. The main point here, however, is that the development of e-commerce will likely facilitate such tax avoidance, especially the nonpayment of foreign income taxes that should have been allocated to a source-country permanent establishment. As discussed, the Internet permits firms with existing permanent establishments (e.g., sales offices) to shift at least part of their activities previously performed by the permanent establishment to the residence country or elsewhere. A restricted force of attraction rule would help to identify the profits associated with residence-country company activities (i.e., any activities taking place in the source country that are similar

to activities conducted by an existing permanent establishment) and ensure that they are allocated to the source country.

This identification issue is especially important as a result of the possibility of characterizing source-country e-commerce activities as auxiliary in nature. The OECD and United States Model Treaties exclude from source-country taxation a list of business activities of an auxiliary and preparatory nature. [FN338] The list ends by excluding "the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character." [FN339] Auxiliary activities include collecting market information about a foreign country; keeping stocks of goods and merchandise for storage, display, delivery, or processing by another enterprise; purchasing goods or merchandise; and collecting information for the use of headquarters abroad. [FN340] The commentary to the OECD Model Treaty indicates: It is often difficult to distinguish between activities which have a preparatory or auxiliary character and those which have not. The decisive criterion is whether or not the activity of the fixed place of business in itself forms an essential and significant part of the activity of the enterprise as a whole. Each individual case will have to be examined on its own merits. [FN341]

The emergence of e-commerce raises a host of issues surrounding what types of activity performed within the host country will be considered as auxiliary and what types will be considered [p. 215] "essential and significant." The Australian Taxation Office notes that e-commerce transactions can be disaggregated into different functions which, by themselves, will only be considered auxiliary or preparatory in nature, but when linked via the Internet constitute "a viable business that is not subject to tax in any jurisdiction." [FN342] It may be possible for a resident company to maintain a fixed place of business within the source country that performs an arguable auxiliary function (e.g., maintaining a warehouse full of goods), while the essential and significant functions are performed abroad via the Internet (e.g., concluding the sales contracts). Or perhaps the company maintains the auxiliary fixed place of business and lets independent agents in the source country perform sales and delivery functions. [FN343] Another issue concerns whether or not e-commerce research and development in the source country creates a permanent establishment. [FN344] These ambiguities may permit resident e-commerce companies to avoid source-country taxation through tax planning.

The ambiguities would be resolved partially by the suggested restricted force of attraction principle in the case in which a resident company controls a fixed place of business that performs auxiliary functions and performs its "core" business outside the fixed place via another permanent establishment. The restricted force of attraction rule assists in identifying transactions, including e-commerce transactions, that should be subject to source-state taxation. As long as the residence-country company maintains some permanent establishment within the source country (e.g., a dependent agent), the profits associated with the arguably auxiliary fixed place of business will be attracted if they are similar activities. This will prevent residence-country companies from trying to functionally separate auxiliary fixed places of business within the source country from the nonauxiliary permanent establishment in order to avoid source-country taxation.

[p. 216]

V. CONCLUSION

The emergence of new communications technologies, the rise of e-commerce, the globalization of business, and the movement in many countries toward service and information-oriented industries have created a number of challenges to the international income tax regime. With respect to e-commerce, perhaps the greatest challenge to this regime is the inability to identify the source of many direct e-commerce transactions where the good or service may never assume a tangible form. The current method of allocating source-state taxing authority over income arising from permanent establishments seems particularly fruitless when applied to this new form of commerce. Nevertheless, states, international organizations, and many commentators have generally asserted a preference for maintaining traditional international tax rules and practices to meet these challenges.

Accordingly, this Article has proposed a number of changes to current tax treaty models that are in line with existing and familiar international tax rules. The proposals follow the principle of neutrality in that no additional taxes would be imposed on e-commerce transactions and that the same tax treatment would be imposed on traditional commerce and e-commerce, with the exception of the proposed creditable withholding tax on above-threshold payments. The proposals are designed to attract international consensus by acknowledging the interests of both e-commerce exporting and e-commerce importing states. E-commerce importing nations and capital-importing nations-- especially developing nations--may support the proposals since they would strengthen source-based taxation rules along with a potential corresponding increase in revenues. Nations that are beginning to build significant e-commerce industries would be presented with rules that both permit them to tax the profits generated by these activities and protect their tax base against new information technology advances that create opportunities for tax avoidance and tax evasion.

A drawback of the proposals is that they may be criticized as half-measures: they do not address many of the tax problems that are taking on increasing importance as the world becomes more and more economically integrated. For example, traditional arm's length transfer pricing methods may be ineffective to deal with this highly integrated world economy. While it is recognized that most of these problems predated the development of Internet-related commerce, new technological developments such as the Internet will further increase [p. 217] the strains on the existing international tax system. At some point, it may be sensible to switch to a global apportionment formula or some other regime that would more realistically reflect the highly integrated nature of business activities conducted by multinational firms. A more radical approach, however, is unlikely to be adopted until sufficient international consensus exists. Such a consensus does not currently appear to exist as countries continue to struggle to maintain fiscal sovereignty and control over their national tax rules. These countries may only agree to radical reform if they are confronted with the very real possibility that the current regime is in danger of imminent collapse. Until such a case is made out, the recommendations within this Article are designed to promote business certainty in the e-commerce arena and allocate revenues to countries that import e-commerce goods, services, and capital.

[FNa1]. Assistant Professor, Thomas Jefferson School of Law; J.S.D. 1998, J.S.M. 1996, Stanford University Law School; LL.B. 1993, Queen's University Law School; H.B.A. 1990, University of Western Ontario Business School. I would like to thank Professor Richard Doernberg, Professor Reuven Avi-Yonah, and John Loukidelis for comments on an earlier draft of this Article. Zack Tyson of Thomas Jefferson School of Law provided extremely valuable research assistance. Any errors are my own responsibility.

[FN1]. For example, a shoe manufacturer based in the United States (the residence country) may want to sell its shoes to consumers in France (the source country) for a total profit on the sale of $10 per pair of shoes. Both the United States and France may assert their tax jurisdiction over the profits, resulting in double taxation of the same business transaction. The 1919 meeting of the International Chamber of Commerce and the 1920 Brussels Financial Conference both appealed to the League of Nations to provide guidance to eliminate double taxation. See Arvid A. Skaar, Permanent Establishment: Erosion of a Tax Treaty Principle 78 (1991). The League formed a committee of four prominent economists to study the issue of double taxation in 1921. See id. at 79. For a historical overview of these developments, see generally John Huston & Lee Williams, Permanent Establishments: A Planning Primer 1-10 (1993), and Michael J. Graetz & Michael M. O'Hear, The "Original Intent" of U.S. International Taxation, 46 Duke L.J. 1021, 1041-1108 (1997).

[FN2]. See Skaar, supra note 1, at 82-85. Hence, under the example mentioned in the previous note, France would be permitted to tax the profit on the sale of shoes as long as the United States manufacturer maintained, for example, a sales or marketing office in France. The United States would agree to relieve the burden of double taxation by either exempting the profits from its tax or by granting a foreign tax credit. If the shoes were sold directly from the U.S. manufacturer to the consumer in France then the United States alone would tax the profits. See infra text accompanying notes 28-36. In 1927, a committee of senior tax administrators commissioned by the Council of the League of Nations introduced, in a draft model bilateral tax treaty, the modern notion of a "permanent establishment" that continues to the present time. See Skaar, supra note 1, at 84-85. Under most current tax treaties, a permanent establishment is defined as a fixed place of business or other business operation with a geographic or temporal economic permanence within the source country. See infra Part II.A.2.b. This permanent establishment definition has also been expanded to include agents who habitually conclude contracts within the source country. See infra notes 99-100 and accompanying text. Most of the world's bilateral tax treaties are based on model tax treaties. See Daniel Sandler, Tax Treaties and Controlled Foreign Company Legislation 2 (2d ed. 1998).The most influential model treaty is the Organisation for Economic Co-operation and Development (OECD) model treaty. See 1 Organisation for Econ. Co-operation and Dev., Model Tax Convention on Income and on Capital (1997) [hereinafter OECD Model Treaty]. The United States employs its own model treaty that is similar in most respects to the OECD Model Treaty. See United States Dep't of the Treasury, Model Income Tax Convention, Sept. 20, 1996, 1 Tax Treaties (CCH) P214 [hereinafter U.S. Model Treaty]. The model treaty developed by the United Nations includes provisions that are more favorable to the interests of capital-importing countries and developing countries. See United Nations Model Double Taxation Convention Between Developed and Developing Countries, Jan. 1, 1980, Tax Treaties (CCH) P206 [hereinafter United Nations Model Treaty]. Under articles 5 and 7 of each model treaty, it is generally indicated that the source country is not permitted to apply its income

tax on a foreign business operation unless a permanent establishment exists and, in the case of the OECD Model Treaty and the U.S. Model Treaty, business profits are attributable to this permanent establishment. See infra text accompanying notes 34-36.

[FN3]. See Skaar, supra note 1, at 84-86.

[FN4]. Countries that export capital and products--mainly developed countries--generally would prefer a system of taxation that taxes income exclusively where it is produced (i.e., residence-based taxation) since this allows their governments to tax business activities that take place outside of their borders. Countries that are net capital importers generally would prefer international tax rules that would strengthen their ability to tax business activities within their borders (i.e., source-based rules). The permanent establishment concept arguably represents a balance between these two views since it allocates taxing jurisdiction to source countries only when there is a significant "economic allegiance" to this country. Developing countries, however, have argued in the past that the requirement for a permanent establishment prior to the application of source-country income tax is not in their interest. See discussion infra Part II.A.2.b.

[FN5]. Office of Tax Policy, U.S. Dep't of the Treasury, Selected Tax Policy Implications of Global Electronic Commerce §7.2.3.1, at 20 (1996) (visited Oct. 1, 1999) <http://www.fedworld.gov/pub/tel/internet.txt> [hereinafter Treasury Report].

[FN6]. The author attended the OECD Ministerial Conference on Electronic Commerce in October 1998, where government and industry participants strongly endorsed the need to maintain traditional international tax policy principles. See Joint Declaration of Business and Government Representatives: Government/Business Dialogue on Taxation and Electronic Commerce (1998) (visited Sept. 15, 1999) <http://www.oecd.org//daf/fa/e_com/ottawa.htm> (issued at the OECD Ministerial Conference on Electronic Commerce, Ottawa, Can., Oct. 7-9, 1998) ("The taxation framework for electronic commerce should be guided by the same taxation principles that guide governments in relation to conventional commerce."); Committee on Fiscal Affairs, Org. for Econ. Co-operation and Dev., Electronic Commerce: Taxation Framework Conditions 4 (1998) (endorsed by the OECD member states on October 8, 1998 at the OECD Ministerial Conference on Electronic Commerce) (visited Oct. 21, 1999) <http://www.oecd.org//daf/fa/e_com/ottawa.htm> [hereinafter Taxation Framework Conditions] (suggesting that conventional commerce taxation principles should apply to e-commerce); see also Australian Taxation Office, Tax and the Internet: Discussion Report of the Australian Taxation Office Electronic Commerce Project (1997) (visited Sept. 1, 1999) <http://www.ato.gov.au/ecp> [[[hereinafter Australian Report] (noting that some difficulties exist in applying traditional tax principles); President William J. Clinton & Vice President Albert Gore, Jr., A Framework for Global Electronic Commerce §I.1 (1997) (visited Oct. 10, 1999) <http://www.iitf.nist.gov/eleccomm/ecomm.htm> [[[hereinafter White House Report] (advocating a predictable legal environment to support global business and commerce); Commission of the European Communities, A European Initiative in Electronic Commerce, COM(97)157 final P56 [hereinafter European Report] (noting that tax systems should provide legal certainty to promote the growth of e-commerce); Inland Revenue & HM Customs and Excise, Electronic Commerce: UK Policy on Taxation Issues P10 (1998) (visited Oct. 10, 1999)

<http://pipe.ccta.gov.uk/coi/coipress.nsf> [hereinafter UK Report] ("[T] he U.K. does not believe it is necessary at this stage to make any major changes to existing tax rules."); Minister's Advisory Comm. on Elec. 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 P2.4.3.3 (1998) (visited Oct. 10, 1999) <http:// www.rc.gc.ca/ecomm> [[hereinafter Canadian Report] (recommending continuance of existing tax rules with respect to e-commerce); Organisation for Econ. Co-Operation and Dev., Electronic Commerce: The Challenges to Tax Authorities and Taxpayers (1997) (visited Sept. 5, 1999) <http://www.oecd.org//daf/fa/e_ com/turku.htm> [[hereinafter OECD Turku Report] (analyzing traditional approaches such as permanent establishment and transfer pricing and the challenges in applying these methods to e-commerce).

[FN7]. See, e.g., Charles E. McLure, Jr., Taxation of Electronic Commerce: Economic Objectives, Technological Constraints, and Tax Laws, 52 Tax L. Rev. 269, 313 (1997) ("Both income and sales taxes contain rules that can be understood in historical context but have little economic rationale. 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."); see also Howard E. Abrams & Richard L. Doernberg, How Electronic Commerce Works, 14 Tax Notes Int'l 1573, 1589 (1997) ("What may be a sound rule from a tax policy perspective may be totally unworkable in light of available technology .... Perhaps the most significant implication of the growth of electronic commerce for tax policy may be that technology rather than policy will determine the tax rules of the 21st century.").

[FN8]. Still, there have been observations in recent years that a number of factors are placing strain on the current international tax system. See, e.g., Sandler, supra note 2, at 1. These factors include the globalization of business and the growth of cross-border investment and trade activities, the integrated nature of multinational firm activity, the movement toward service-oriented economies, and the development of new information technologies. Despite the gradual liberalization of government trade and investment policies over the past few decades, the international tax regime has not undergone any significant changes. See Arthur J. Cockfield, Tax Integration Under NAFTA: Resolving the Conflict Between Economic and Sovereignty Interests, 34 Stan. J. Int'l L. 39, 49 (1998). This has occurred largely as a result of the reluctance on the part of national governments to give up fiscal sovereignty. See id. at 49-50 (indicating that the current trend toward the reduction of barriers to the mobility of goods, services, and capital as well as increased commercial competition is inconsistent with the lack of progress in tax areas). As a result of the pressures on the current system, commentators have suggested a number of alternatives. See Klaus Vogel, World-wide vs. Source Taxation of Income--A Review and Reevaluation of Arguments, in Influence of Tax Differentials on International Competitiveness 115, 136-66 (1990) (arguing that efficiency and equity concerns call for a move to source-based taxation); Reuven S. Avi-Yonah, The Structure of International Taxation: A Proposal for Simplification, 74 Tex. L. Rev. 1301, 1303-16 (1996) (calling the current international tax regime a "flawed miracle" and proposing the taxation of individuals by the residence country and the taxation of corporations under source-based rules); Robert A. Green, The Future of Source-Based Taxation of the Income of Multinational Enterprises, 79 Cornell L. Rev. 18, 74 (1993) (suggesting a move to an international tax system that uses the residence of individuals as the exclusive basis for income tax jurisdiction); Robert J. Peroni, Back to the

Future: A Path to Progressive Reform of the U.S. International Income Tax Rules, 51 U. Miami L. Rev. 975, 981 (1997) (recommending simplification of rules to strengthen residence-based taxation).

[FN9]. This Article does not cover property taxes, the taxation of financial instruments, or indirect tax issues (e.g., sales taxes or value-added taxes). For recent discussions on sales taxes, see Charles E. McLure, Jr., Electronic Commerce, State Sales Taxation, and Intergovernmental Fiscal Relations, 50 Nat'l Tax J. 731 (1997). The European Union has focused attention on the value-added tax treatment of e-commerce transactions. For a review of these issues, see Ine Lejeune et al., Does Cyber-Commerce Necessitate a Revision of International Tax Concepts?, 38 Eur. Tax'n 2 (1998).

[FN10]. For a description of these treaties, see supra note 2. This would ensure that different nations would, as a starting point, have reference to the same suggested changes within these three model tax treaties. Certain countries may wish to adopt only certain changes on a bilateral basis.

[FN11]. See discussion infra Part IV.C.1.

[FN12]. See I.R.C. §§1, 11 (1994). The United States, unlike the vast majority of countries, also taxes individuals on the basis of citizenship. See Treas. Reg. §1.901-1(a)(1), (3) (as amended in 1987).

[FN13]. See Treas. Reg. §1.901-1.

[FN14]. See, e.g., I.R.C. §901; Treas. Reg. §1.901-2 (as amended in 1991) (imposing limits on the foreign tax credit, including an overall limit that prevents the credit from offsetting U.S. taxes on U.S. source income).

[FN15]. For example, under the so-called "subpart F" rules, U.S. shareholders who constructively own at least 10% of a "controlled foreign corporation" must include in their annual income, inter alia, a portion of certain types of undistributed passive income (e.g., rents, royalties, and interest) of the controlled foreign corporation. See I.R.C. §§951-954.

[FN16]. See Organisation for Econ. Co-operation and Dev., Harmful Tax Competition: An Emerging Global Issue 41, 63 n.5 (1998) [hereinafter OECD Tax Competition Report].

[FN17]. For a review of the different tax policies of a number of industrialized countries, see Hugh J. Ault, Comparative Income Taxation: A Structural Analysis (1997).

[FN18]. For example, Canada taxes its residents on a worldwide basis but exempts from taxation in most circumstances any dividends paid from foreign affiliates if the income was generated in a tax treaty partner country. The exemption, however, only applies to active business income, certain capital gains and interaffiliate dividends. See Income Tax Act, R.S.C., ch. 1, § 95(1) (1985 & Supp. 5) (Can.).

[FN19]. See I.R.C. §864(c). Certain types of active business income that fall under a full force of attraction principle, however, are deemed to be effectively connected with the trade or business. See id. §864(c)(3); infra text accompanying note 319.

[FN20]. See I.R.C. §864(b).

[FN21]. See Hanfield v. Commissioner, 23 T.C. 633, 638 (1955); see also Lewenhaupt v. Commissioner, 20 T.C. 151, 163 (1953) (holding that profit-oriented businesses are a trade or business if they are regular, considerable, and continuous).

[FN22]. See Hanfield, 23 T.C. at 638; Lewenhaupt, 20 T.C. at 163.

[FN23]. For a discussion of the application of U.S. tax rules to e-commerce transactions emanating from abroad, see James D. Cigler et al., Cyberspace: The Final Frontier for International Tax Concepts?, 7 J. Int'l Tax'n 340 (1996) (discussing the limitations of U.S. tax rules on e-commerce, which can be conducted without a physical base within the United States); see also Peter A. Glicklich et al., Internet Sales Pose International Tax Challenges, 84 J. Tax'n 325 (1996) (discussing whether Internal Revenue Code provisions relating to sales of tangible personal property cover e-commerce sales); Thomas Kesoglou, Note, International Tax Complications: Can Personal Services Constitute a U.S. Trade or Business on the Internet?, 22 Rutgers L. Rec. 4 (1997) (arguing that e-commerce personal services activities will not constitute a trade or business in the United States under existing principles).

[FN24]. For example, the concept of carrying on business in Canada includes any activity in which a person solicits orders or offers anything for sale in Canada through an agent or employee, whether the contract or transaction is to be completed inside or outside Canada. See Income Tax Act, R.S.C., ch. 1, § 253 (1985 & Supp. 5) (Can.). This broad definition might capture certain e- commerce transactions.

[FN25]. There are rare examples of multilateral tax treaties such as the one used by the Nordic countries. For discussions on multilateralizing the OECD Model Treaty, see Michael Lang et al., Multilateral Tax Treaties: New Developments in International Tax Law (1998).

[FN26]. See supra note 2.

[FN27]. See OECD Model Treaty, supra note 2; U.S. Model Treaty, supra note 2; United Nations Model Treaty, supra note 2.

[FN28]. See OECD Model Treaty, supra note 2; U.S. Model Treaty, supra note 2; United Nations Model Treaty, supra note 2.

[FN29]. See OECD Model Treaty, supra note 2; U.S. Model Treaty, supra note 2; United Nations Model Treaty, supra note 2.

[FN30]. See OECD Model Treaty, supra note 2, arts. 10-12; U.S. Model Treaty, supra note 2, arts. 10-12; United Nations Model Treaty, supra note 2, arts. 10- 12. For a discussion on this

point, see, for example, Alvin C. Warren, Jr., Alternatives for International Corporate Tax Reform, 49 Tax L. Rev. 599, 599- 601 (1994).

[FN31]. See OECD Model Treaty, supra note 2, arts. 10-12; U.S. Model Treaty, supra note 2, arts. 10-12; United Nations Model Treaty, supra note 2, arts. 10- 12; see also Warren, supra note 30, at 599-601 (outlining the conventional approach).

[FN32]. See, e.g., Treas. Reg. §1.901-1 (as amended in 1987). The United States normally limits the foreign tax credit to income taxes. See Treas. Reg. §1.901-1 (as amended in 1987). Certain foreign taxes paid in lieu of an income tax, including withholding taxes, also qualify for foreign tax credits. See id. §1.903-1 (as amended in 1983).

[FN33]. For example, the United States generally imposes a rate of 30% on most passive investment income, such as interest or royalties. See I.R.C. § 881(a)(1) (1994). The U.S. Model Treaty, however, suggests much lower rates, such as 5%, for dividends in most circumstances and no withholding tax on interest and royalties. See United States Model Treaty, supra note 2, arts. 10-12.

[FN34]. See OECD Model Treaty, supra note 2, art. 7; U.S. Model Treaty, supra note 2, art. 7.

[FN35]. See discussion infra Part II.B.2.c.

[FN36]. See supra note 34 and accompanying text.

[FN37]. See OECD Model Treaty, supra note 2, art. 7(2); U.S. Model Treaty, supra note 2, art. 7(2). For a discussion of a number of permanent establishment concepts, see Organisation for Econ. Co-operation and Dev., Model Tax Convention: Attribution of Income to Permanent Establishments (1994) [[[hereinafter OECD PE Paper].

[FN38]. U.S. Model Treaty, supra note 2, art. 5(1).

[FN39]. Id. art. 5(2).

[FN40]. Id. art. 5(4).

[FN41]. See discussion infra Part II.B.2.a.i.

[FN42]. See OECD Model Treaty, supra note 2, art. 5; United Nations Model Treaty, supra note 2, art. 5; infra note 100 and accompanying text.

[FN43]. See OECD Model Treaty, supra note 2, commentary to art. 5, PP2-30.

[FN44]. See id. art. 5; U.S. Model Treaty, supra note 2, art. 5(5).

[FN45]. See Skaar, supra note 1, at 111-12.

[FN46]. See OECD Model Treaty, supra note 2, commentary to art. 5, P5 ("[T] he place of business has to be a 'fixed' one. Thus in the normal way there has to be a link between the place of business and a specific geographical point."); id. P6 ("[A] permanent establishment can be deemed to exist only if the place of business has a certain degree of permanency, i.e.[,] if it is not of a purely temporary nature.").

[FN47]. See OECD Model Treaty, supra note 2, art. 17.

[FN48]. See discussion infra Part III.D.

[FN49]. For a detailed history of the development of permanent establishment principles, see Skaar, supra note 1, at 65-101.

[FN50]. OECD Model Treaty, supra note 2, commentary to art. 7, P3.

[FN51]. See, e.g., Graetz & O'Hear, supra note 1, at 1074-89 (indicating that the U.S. delegation pushed for the permanent establishment concept in the League of Nations deliberations of 1927 and 1928 because it wanted to protect U.S. businesses with foreign operations from excessive foreign taxes).

[FN52]. See Skaar, supra note 1, at 88-89; 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, 252-53 (1998).

[FN53]. See Zapata, supra note 52, at 252. For a more comprehensive discussion of these developments, see Skaar, supra note 1, at 88-95. See also Zapata, supra note 52, at 252-53 (discussing the point of view of many developing countries during the origins of the permanent establishment principle).

[FN54]. See Skaar, supra note 1, at 88; Zapata, supra note 52, at 252.

[FN55]. See Skaar, supra note 1, at 89.

[FN56]. See id. at 89-90.

[FN57]. See Zapata, supra note 52, at 252.

[FN58]. See id.

[FN59]. In 1963, the OECD drafted its first Double Taxation Convention on Income and Capital that was based on the League of Nations model. See Skaar, supra note 1, at 96.

[FN60]. For example, Mexico did not enter into any tax treaties until its tax treaty with Canada in 1991. See Income Tax Convention, Apr. 8, 1991, Can.- Mex., Can. Tax Rep. (CCH) P34, 685.

[FN61]. Skaar, supra note 1, at 573.

[FN62]. See, e.g., OECD Model Treaty, supra note 2, art. 9(1). The OECD Model Treaty provides:
[Where] conditions are made or imposed between ... two [related] enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.
Id.

[FN63]. See infra text accompanying notes 80-82. Multinational firms are increasingly using "intranets" or internal networks on the Internet that are only accessible by the users from the company. Multinational firms also now often use an "extranet" that provides a connection between the company's internal electronic network and the internal network of its customers and suppliers. The extranet can cover all of the elements of a business relationship, from ordering goods and services to payment for these goods and services.

[FN64]. For example, almost 70% of the trade in manufactured products between Canada and the United States consists of non-arm's length intrafirm trade. The amount of U.S.-Canada related party transactions reached $166 billion in 1993. See Robert Turner, Study on Transfer Pricing 1 (Technical Comm. on Bus. Tax'n Working Paper No. 96-10, 1996).

[FN65]. See Committee on Fiscal Affairs, Org. for Econ. Co-operation and Dev., Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 25-41 (1994) [hereinafter OECD Guidelines].

[FN66]. For example, the IRS may allocate taxable income to reflect the income of related taxpayers. See I.R.C. §482 (1994); Treas. Reg. §1.482- 1.

[FN67]. See I.R.C. §482 (1994); OECD Guidelines, supra note 65, at 29-30.

[FN68]. See Treas. Reg. §1.482-1(d).

[FN69]. Three options are available for arm's length pricing under the comparable pricing category. The comparable uncontrolled price method specifies an arm's length price by looking to sales of similar products between unrelated parties. See Treas. Reg. §1.482-3(b) (as amended in 1995). The resale price method permits the taxpayer to subtract a mark-up from the price that would have been sold to unrelated parties. See id. §1.482-3(c). Under the cost plus method, the taxpayer adds a profit percentage--that would have been earned in an arm's length transaction--to its costs of producing the product. See id. §1.482-3(d). In addition to the comparable transaction approach, the IRS can use two profit-based formulas. Under the profit-split method, the taxpayer determines its total taxable income among the related parties and then allocates the income in proportion to the contribution of each party. See id. §1.482-6. The comparable profit method permits the taxpayer to establish a range of profits for the related party (e.g., by using rates of return for similar business activities) if the transfer involves the sale of goods or the license of intangibles. See id. §1.482-5. If the related party's profits fall within this range, then its transfer prices will be accepted by the IRS. If the related party's profits fall outside the range, then the

IRS can adjust the transfer prices so that the profits fall within the range.
The regulations indicate that a taxpayer must keep documentation to support the "best method" for pricing its intercompany transfers, "the method that, under the facts and circumstances, provides the most reliable measure of an arm's length result." Id. §1.482-1(c) (1994). The OECD guidelines emphasize the use of the traditional comparable transaction report and indicate that profit-split methods should only be used as a "method of last resort." See OECD Guidelines, supra note 65, at 55-60. The possible appropriate transfer pricing rules for e-commerce transactions will be discussed later in this Article. See discussion infra Part IV.A.3.

[FN70]. For a thorough explanation of the technological features relating to e-commerce transactions, see generally Abrams & Doernberg, supra note 7, at 1573-85.

[FN71]. See Treasury Report, supra note 5.

[FN72]. Id. P3.2.1, at 6.

[FN73]. Abrams & Doernberg, supra note 7, at 1573.

[FN74]. For an accessible discussion of typical e-commerce transactions, see Australian Report, supra note 6, PP3.1.1-3.5.3.

[FN75]. The customer typically logs on to a home computer and dials the ISP via the local telecommunications network. The ISP confirms the customer's identity and password before granting Internet access. Once logged on, the customer can then engage the Internet browser software program (e.g., Netscape) and then perhaps use a search engine software program (e.g., YAHOO!) to locate the company's website where the product or service in question can be found.

[FN76]. The Internet relies on Internet Protocol (IP) numbers to identify devices attached to the Internet. These devices can identify each other within the Internet by "dialing" the IP number in a similar way that one calls a person by dialing a telephone number.

[FN77]. See, e.g., European Report, supra note 6, P7.

[FN78]. McLure, supra note 7, at 304.

[FN79]. See Organisation for Econ. Co-operation and Dev., The Economic and Social Impacts of Electronic Commerce: Preliminary Findings and Research Agenda 27 (1999) (visited Sept. 15, 1999) <http://www.oecd.org//subject/e_ commerce/summary.htm> [hereinafter OECD Electronic Commerce Report].

[FN80]. See id. at 27.

[FN81]. See id. at 34-36.

[FN82]. See supra note 63. For example, firms are using these electronic networks to adopt "just-in-time" inventory systems and to improve their ability to forecast demand more accurately. This is expected to lead to a reduction in current United States inventory levels by 20% to 25%, resulting in tremendous savings to businesses. See OECD Electronic Commerce Report, supra note 79, at 37.

[FN83]. See OECD Electronic Commerce Report, supra note 79, at 41.

[FN84]. Information technology industries currently consist of approximately 8% of GDP in the United States (although the definition of these industries varies in many studies).

[FN85]. For example, the amount of information to be processed on a single microchip doubles almost every year or year and a half. See Canadian Report, supra note 6, P1.1. In 1990, 100 million components of information could be stored or processed on a single chip. See id. By 1996, one billion components could be stored. See id.

[FN86]. According to the testimony of Senator William Roth, Senate Finance Committee Chairman, over 50,000 computers are sold each day in the world and the World Wide Web is growing at a rate of 2300% a year. See Internet Tax and Trade Issues: Hearing on S. 442 and H.R. 4105 Before the Senate Comm. on Finance, 105th Cong. 1-2 (1998) (statement of William V. Roth, Jr., Chairman, Senate Committee on Finance).

[FN87]. For a further discussion on these issues, see infra text accompanying notes 210-225.

[FN88]. See, e.g., European Report, supra note 6, PP8-9. The report provides:
[T]he Internet, with its robust and network-independent protocols, is rapidly federating different forms of electronic commerce. Corporate networks are becoming Intranets. At the same time, the Internet is generating many innovative hybrid forms of electronic commerce--combining, for example, digital television infomercials with Internet response mechanisms (for immediate ordering), CD-ROM catalogues with Internet connections (for content or price updates), and commercial Websites with local CD-ROM extensions (for memory-intensive multimedia demonstrations).
Id.

[FN89]. For an overview, see generally Treasury Report, supra note 5; Australian Report, supra note 6; McLure, supra note 7, at 417-21.

[FN90]. See discussion supra Part I.A.2.b.

[FN91]. A server is a computer that is connected to the Internet.

[FN92]. A website consists of a computer program within the server. A website can be physically dispersed across a number of different servers that may be placed in different countries.

[FN93]. Treasury Report, supra note 5, §7.2.3.1, at 22.

[FN94]. See OECD Turku Report, supra note 6, P97.

[FN95]. See Australian Report, supra note 6, P7.2.9. The Australian report provides:
Australia's source rules are challenged by electronic commerce. Universal access to a web site, automation and high mobility mean that most electronic commerce activities may generate considerable revenue without necessarily being located in close physical proximity to the market and without significant use of any infrastructure anywhere. For highly mobile activities, ... source rules based on location are more likely to facilitate tax planning.
Id.

[FN96]. See, e.g., Pierre J. Bourgeois & Luc Blanchette, Income_ taxes.ca.com: The Internet, Electronic Commerce, and Taxes--Some Reflections: Part 2, 45 Canadian Tax J. 1378, 1388-93 (1997) (discussing the difficulty of making the permanent establishment determination using traditional concepts); Ine Lejeune et al., Does Cyber-Commerce Necessitate a Revision of International Tax Concepts?, 38 Eur. Tax'n 50, 50-55 (1998) (discussing whether a seller's server can give rise to the existence of a permanent establishment in the buyer's country); Kyrie E. Thorpe, Comment, International Taxation of Electronic Commerce: Is the Internet Age Rendering the Concept of Permanent Establishment Obsolete?, 11 Emory Int'l L. Rev. 633, 655-56 (1997).

[FN97]. OECD Model Treaty, supra note 2, art. 5(4).

[FN98]. See Lejeune et al., supra note 96, at 51.

[FN99]. See OECD Model Treaty, supra note 2, art. 5(5); U.S. Model Treaty, supra note 2, art. 5(5).

[FN100]. See United Nations Model Treaty, supra note 2, art. 5(6)- (7) (indicating that an insurance agent will be treated as a dependent agent in some cases and deeming independent agents that devote their activities "wholly or almost wholly" on behalf of the resident company to be dependent agents).

[FN101]. An interesting question is whether an Internet Service Provider (ISP) should be considered an agent. A company that wishes to sell or distribute its goods and services must generally use an ISP to put its server (or a server leased by the ISP) on the Internet. The ISP purchases bandwidth from a network provider that is normally a telecommunications company. The ISP assigns an Internet address to the server that allows potential customers to locate the company. It seems likely that the ISP will not be considered a permanent establishment of this company if it merely establishes a connection with the Internet. But it may be possible to establish an agency relationship between an ISP and a server since the ISP "hosts" the server software on its computers, in addition to providing access to the Internet. The Treasury Report indicates that if an agency relationship exists between a local service provider and a foreign person who operates computerized databases, the ISP will likely be considered an independent agent (which generally does not fall within the treaty definition of permanent establishment) and thus there will not be a permanent establishment. See Treasury Report, supra note 5, §7.2.5, at 22.

[FN102]. Software could also
[1]send e-mail to specific target audiences;
[2]provide detailed information on digitized products (or services) to customers;
[3]provide for an electronic order form;
[4]retrieve and transmit the requested product to the customer;
[5]process the sale and the collection of electronic cash (or verify credit information if a credit card is used);
[6]communicate with the accounting software at head office to provide it with the data necessary to record the sale;
[7]direct the electronic cash for deposit to the appropriate financial institution; and
[8]send e-mail to the customer informing the customer of upgrades or soliciting business for other products.
Bourgeois & Blanchette, supra note 96, at 1391.

[FN103]. OECD Model Treaty, supra note 2, commentary to art. 5, P10. The commentary also indicates that if vending machines are set up and then leased, a permanent establishment does not exist. See id. A permanent establishment may exist, however, if the company that owns the machines operates and maintains the machines for its own account or hires a dependent agent to do so. See id.

[FN104]. See Huston & Williams, supra note 1, at 45 (remarking that the commentary indicates that "the vending machines themselves could constitute the fixed place of business. The indication seems inconsistent with the remaining authority in the area.").

[FN105]. David R. Tillinghast, The Impact of the Internet on the Taxation of International Transactions, 50 Bull. for Int'l Fiscal Documentation 524, 525 (1996) (footnote omitted).

[FN106]. See, e.g., Richard L. Doernberg, Electronic Commerce and International Tax Sharing, 16 Tax Notes Int'l 1013, 1015-16 (1998). Professor Doernberg has posited:
Keeping the permanent establishment principle intact may be widely viewed by electronic commerce importing states as unacceptable because they will not be able to share in the tax base generated by electronic commerce income. Consequently, for electronic commerce importing states to continue to accept the permanent establishment principle as currently constituted, it may be necessary for electronic commerce exporting states to make concessions in other areas that will permit sharing of the electronic commerce tax base with electronic commerce importing states.
Id.

[FN107]. For a discussion of the impact of e-commerce on a firm's business model, sectoral organization, and market structure, see OECD Electronic Commerce Report, supra note 79, at 79-102. Studies indicate that standardized products such as automobiles, software, music, and books account for a disproportionate share of e-commerce since buyers will likely wish to examine nonstandardized products prior to purchase.

[FN108]. For example, manufacturing company A based in country A could have a sales office located in country B that sells its products to customers located in country B. Country B can tax the profits attributable to the sales office since it constitutes a permanent establishment under the tax treaty between country A and country B. Company A, however, may begin to move part of its sales and marketing operations that are currently in place in country to B to an e-commerce on-line service operated out of country A. This e-commerce operation could thus gather orders and sell products directly to customers within country B without the use of the sales office in country B. Country B would hence be unable to tax the profits derived from these sales (since they are not attributable to the permanent establishment in country B). Another example might involve the removal of an office in the source country that previously performed a supervisory role over independent agents: the supervision could be accomplished via a remote location through the use of Internet technology where the agents access their instructions through a computer terminal.

[FN109]. For example, auto dealers report productivity gains from their websites where they spend only $25 to deal with an e-commerce generated bid since the customers come "pre-qualified," but several hundred dollars for a face-to-face transaction. See OECD Electronic Commerce Report, supra note 79, at 60.

[FN110]. One research estimate indicates that it costs roughly $500 to $700 to send a service representative into the field, $15 to $20 to handle a customer question over the phone, and about $7 to set up and maintain an Internet-based customer service system. See id. at 61.

[FN111]. The Internet is often referred to as an agent of disintermediation since it often eliminates the need for intermediaries or "middlemen" who previously were required to facilitate different transactions. See id. at 55. A good example is Amazon.com, which has eliminated the necessity for consumers to use a bookstore, or E[p. Trade, which permits retail stock trading without the need for brokers.

[FN112]. See discussion infra Part IV.C.4.

[FN113]. See discussion supra Part II.A.2.d.

[FN114]. Australian Report, supra note 6, P7.6.21.

[FN115]. Id. P7.6.22.

[FN116]. For a brief discussion of these transactional methodologies, see supra Part II.A.2.d.

[FN117]. For example, Internet bookstores such as Amazon.com outsource their distribution network to commercial courier companies. Orders and shipments of the books are generally made directly from the publisher's warehouse. The databases of the Internet bookstore, the publisher, and the transportation company are often fully integrated. Further, the increased use of intranets-- internal networks used by companies that are secured against outside Internet traffic-- makes it easier for global collaborative efforts of a highly integrated nature.

[FN118]. OECD Electronic Commerce Report, supra note 79, at 51.

[FN119]. For a discussion of characterization issues, see, for example, Canadian Report, supra note 6, P4.2.3 ("The growth of electronic commerce will require a re-evaluation of the way certain transactions have traditionally been classified, and how tax should be imposed and collected.").

[FN120]. See Treasury Report, supra note 5, §7.3.2, at 23.

[FN121]. See supra text accompanying notes 28-36. But see OECD Turku Report, supra note 6, P105 (noting that there are important substantive differences between the purchase of a physical book and a digital book including the ability to alter the format of a digital book).

[FN122]. See Prop. Treas. Reg. §1.861-18, 61 Fed. Reg. 58,154 (1996).

[FN123]. See id. For a discussion of the proposed regulations, see Michael J.A. Karlin, Computer Program Prop. Regs. Are a Good But Cautious Start, 8 J. Int'l Tax'n 64 (1997) (indicating the regulations are the correct approach, but that they are too cautious and narrow in scope).

[FN124]. See Prop. Treas. Reg. §1.861-18(b), 61 Fed. Reg. 58,154. The proposed regulations try to determine whether the rights transferred are rights in the underlying copyright or are rights in a copyrighted work. See id. For example, the transfer of a right to copy a computer program will not be considered a right to transfer a copyright unless the right to copy is accompanied by the right to transfer copies of the program to the public. Companies that produce mass-marketed "shrink-wrapped" software argue they are selling goods since the consumer is generally only buying the product for her own use. See Jeffrey E. Clegg, International Taxation of Global Electronic Commerce, 39 Tax Mgmt. (BNA) S-184 (June 22, 1998).

[FN125]. See, e.g., Australian Report, supra note 6, PP8.1.1-8.7.7 (discussing e-commerce tax compliance issues); Canadian Report, supra note 6, P4.2 (discussing tax administration problems associated with the imposition of income taxes on e-commerce profits).

[FN126]. Every foreign company with a website that offers e-commerce goods or services can at least potentially conduct business with customers located in the source country.

[FN127]. See OECD Tax Competition Report, supra note 16, at 45-46 (recommending increasing access to banking information and increasing exchanges of information for transactions occurring in tax havens and other preferential tax regimes).

[FN128]. See, e.g., Taxation Framework Conditions, supra note 6, at 5-6 (listing neutrality, efficiency, certainty, simplicity, effectiveness, fairness, and flexibility as the principles that should apply to e-commerce).

[FN129]. Treasury Report, supra note 5, §6.2, at 16; see also Canadian Report, supra note 6, P2.3 ("Electronic and non-electronic transactions that are functionally equivalent should be taxed the same regardless of their form.").

[FN130]. White House Report, supra note 6, §I.1 ("[Taxation of Internet sales] should neither distort nor hinder commerce. No tax system should discriminate among types of commerce, nor should it create incentives that will change the nature or location of transactions.").

[FN131]. McLure, supra note 7, at 378-79. For a comprehensive discussion of the principles that should drive decisions surrounding the taxation of e- commerce, see id. at 378-80.

[FN132]. See Treasury Report, supra note 5, §1, at 3 ("In most cases, this will require that existing principles be adapted and reinterpreted in the context of developments in technology. In extreme cases, it may be necessary to develop new concepts.").

[FN133]. See White House Report, supra note 6, §I.1 ("The taxation of commerce conducted over the Internet should be consistent with the established principles of international taxation.... The system should be able to accommodate tax systems used by the United States and our international partners today.").

[FN134]. See European Report, supra note 6, P56 ("To allow electronic commerce to develop, it is vital for tax systems to provide legal certainty (so that tax obligations are clear, transparent and predictable), and tax neutrality (so there is no extra burden on these new activities as compared to more traditional commerce).").

[FN135]. See, e.g., Canadian Report, supra note 6, P2.4.3.3 ("[T]he Committee recommends that tax authorities continue to tax electronic commercial transactions in accordance with existing tax legislation. Where necessary, existing rules can be adapted to collect tax revenues."); supra note 6 and accompanying text.

[FN136]. See Cockfield, supra note 8, at 57-58 (discussing how this desire to preserve sovereign control over a tax regime often "flies in the face of economic notions such as aggregate wealth maximization").

[FN137]. See, e.g., Canadian Report, supra note 6, P2.4.3.3 ("[T]o ensure a harmonious global tax regime, international cooperation is strongly encouraged."). All of the government reports under scrutiny within this Article indicate similar sentiments.

[FN138]. For recommendations to create such an organization, see Vito Tanzi, Taxation in an Integrating World 133-40 (1995). But see Robert A. Green, Antilegalistic Approaches to Resolving Disputes Between Governments: A Comparison of the International Tax and Trade Regimes, 23 Yale J. Int'l L. 79, 129-37 (1998) (arguing that the legalistic dispute settlement procedures for international trade disputes under General Agreement on Tariffs and Trade (GATT) may not be appropriate for international tax disputes).

[FN139]. See OECD Tax Competition Report, supra note 16, at 10 (discussing the OECD outreach program to engage nonmember countries in dialogues through regional seminars). OECD member states tend to be capital-exporting nations and these countries may favor strengthening the residence-based taxation of e-commerce transactions. Still, there are many OECD member states that are net capital importers and their interests may be aligned with developing countries who have traditionally favored source-based tax rules. Further, a country may also be both a net capital importer and a net exporter of e-commerce goods and services. These countries may favor residence-based rules for e-commerce products along with a strengthening of source-based rules for traditional forms of commerce. Finally, there are some OECD member states who are currently net importers of e-commerce products, but who anticipate developing strong e-commerce industries in the future that would reverse this trend. These countries may prefer a wait-and-see attitude before deciding what types of proposals they should support.

A review of the 29 OECD member states indicates that 11 member countries had net direct investment inflows in 1996. These countries are Australia, Austria, Belgium, Czech Republic, Hungary, Luxembourg, New Zealand, Poland, Spain, Sweden, and Turkey. See Organisation for Econ. Co-operation and Dev., International Direct Investment Statistics Yearbook 1997, at 12 (1997). Information was unavailable for Greece, Mexico, Switzerland, and Ireland. See id. Information was also unavailable for the year-end direct investment positions for 13 of the OECD member states, although this overall position probably represents a better indication of the status of the member as either a net capital importer or exporter. Further, the data does not include foreign portfolio flows that, in any event, do not generally generate active business income since this form of foreign investment is nonentrepreneurial and does not consist of control on the part of the residence-country company.

The United States is both the world's largest exporter of e-commerce products and services and the world's largest net capital importer (when portfolio flows are taken into account), and thus its ultimate position on any proposal is difficult to gauge despite the traditional U.S. government preference for residence-based international tax rules. See id. The theory behind this policy is that "since the source of income has no bearing on its validity as a measure of ability to pay, the tax burden should be based on 'worldwide income." ' Hugh J. Ault & David F. Bradford, Taxing International Income: An Analysis of the U.S. System and Its Economic Premises, in Taxation in the Global Economy 11, 27 (Assaf Razin & Joel Slemrod eds., 1990). It has recently been argued that U.S. international tax policy originally favored a source-based approach. See Graetz & O'Hear, supra note 1, at 1109 (arguing provocatively that the "original intent" of U.S. international tax practices was to focus on source-based taxation of business income as well as on practical administrative concerns). The transformation of the United States to a net capital importer may ultimately influence a change away from its traditional residence-based taxation preferences.

[FN140]. See OECD Tax Competition Report, supra note 16, at 7-9. For a review of the circumstances surrounding the League of Nations' decision not to adopt the Mexico Draft model treaty that incorporated provisions that favored capital-importing nations, see supra text accompanying notes 51-60.

[FN141]. See, e.g., White House Report, supra note 6, §I.1 ("The system should be simple and transparent. It should be capable of capturing the overwhelming majority of appropriate revenues, be easy to implement, and minimize burdensome record keeping and costs for all parties.").

[FN142]. The United States is one of the few countries in the world that places a significant number (over 400) of tax auditors in foreign jurisdictions.

[FN143]. See, e.g., Employment & Social Affairs, European Commission, Building the European Information Society for Us All: Final Policy Report of the High-Level Expert Group (1997) (visited Sept. 7, 1999) <http:// www.ispo.cec.be/hleg/hleg.html> (proposing a tax on the transmission of "bits" via the Internet).

[FN144]. See, e.g., James D. Cigler & Susan E. Stinnett, Treasury Seeks Cybertax Answers with Electronic Commerce Discussion Paper, 8 J. Int'l Tax'n 56, 63 (1997) (indicating that most Internet or television transactions are comparable to current, more traditional business methods, but noting several unique features of e-commerce).

[FN145]. See, e.g., William C. Benjamin & Michael J. Nathanson, Conducting Business Using the Internet: Gauging the Threat of Foreign Taxation, 9 J. Int'l Tax'n 28, 30 (1998) (indicating that many on-line companies have chosen to limit their sales in order to limit their tax liability until a more stable environment emerges).

[FN146]. For a comparison of traditional forms of e-commerce against Internet-type e-commerce, see European Report, supra note 6, P6 & tbl.1. The Commission of the European Communities reports as follows:
For many years companies have exchanged business data over a variety of communication networks. But there is now accelerated expansion and radical changes, driven by the exponential growth of the Internet. Until recently no more than a business-to-business activity on closed proprietary networks, electronic commerce is now rapidly expanding into a complex web of commercial activities transacted on a global scale between an ever increasing number of participants, corporate and individual, known and unknown, on global open networks such as the Internet.
Id. P6.

[FN147]. See UK Report, supra note 6, P4 (noting that a poll of U.K. businesses indicates they want certainty about tax rules and oppose double or unintentional taxes). But see Australian Report, supra note 6, P9.2.1 ("The current lack of a legal infrastructure to support electronic commerce may be a serious impediment to larger transactions but not necessarily to smaller ones.").

[FN148]. Treasury Report, supra note 5, §7.1.5, at 18-19.

[FN149]. See id. The Treasury Report is clear, however, that the discussion is not intended as a "blueprint" on the taxation of e-commerce transactions, nor does it represent United States legal or policy views. See id. §1, at 2.

[FN150]. See, e.g., Lejeune et al., supra note 96, at 58 ("One cannot at present rule out that, on the basis of sovereignty principles, electronic transactions will be subject to double taxation. The best guarantee in order to avoid double taxation issues would in any case be to abandon the [permanent establishment] concept in favour of exclusive residence-based taxation.").

[FN151]. See id. at 54-55.

[FN152]. It should be noted that the debate surrounding the desirability of residence-based taxation versus source-based taxation precedes the current e-commerce discussion. The current system of taxation--taxing business profits in the source state only if a permanent establishment exists--represents in many ways a balance between the two systems and has persisted for some time despite recommendations to move in one direction or another. See supra note 8.

[FN153]. Residency of individuals, which is often determined by a "facts and circumstances" test, will not be discussed. For a general description of residence for both individuals and business entities, see Brian J. Arnold & Michael J. McIntyre, International Tax Primer 21-25 (1995).

[FN154]. See U.S. Model Treaty, supra note 2, art. 4(3).

[FN155]. But see Arnold & McIntyre, supra note 153, at 23 ("In general, a corporation cannot freely change its place of incorporation without triggering a tax on the accrued gains in respect of its property. Consequently, the place-of-incorporation test places some limits on the ability of corporations to shift their country of residence for tax avoidance purposes.").

[FN156]. Some countries have adopted both the "place-of-incorporation" and the "place of central management and control" tests. Id.

[FN157]. See Australian Report, supra note 6, P7.2.21. According to the Australian Taxation Office,

> The instantaneous and global facilities provided by the Internet are expected to allow residents to more easily influence the operations of their offshore subsidiaries (which would include tax haven entities). There is no clear guidance as to where such a business would be regarded as being really carried on. Moreover, there would be difficulties in applying the concept of central management and control.

Id.

[FN158]. See Bourgeois & Blanchette, supra note 96, at 1395. Commentators have noted:

> The Internet may make it possible for not only directors, but also managers at all levels to attend meetings without leaving their desks, so that the need for a physical head office is eliminated. So-called globalized corporations, with management scattered around the globe communicating via the new technologies, require, for some, a residence criterion for tax purposes based on the location of the principal responsible for the major intellectual property.

Id.

[FN159]. See, e.g., OECD Model Treaty, supra note 2, art. 4(3). The commentary to this article indicates: "It would not be an adequate solution to attach importance to a purely formal criterion like registration. Therefore paragraph 3 attaches importance to the place where the company, etc. is actually managed." Id. commentary to art. 4, P22.

[FN160]. Some tax treaties indicate that dual corporate residents will be denied any benefits from the tax treaties, thereby leaving it up to the corporation not to place itself in a position of dual residence.

[FN161]. Australian Report, supra note 6, P7.2.20 (discussing the difficulties in applying factual tests to e-commerce activities due to the wide variety of business types and modes of operations).

[FN162]. See supra text accompanying notes 14-16.

[FN163]. Treasury Report, supra note 5, §7.3.5, at 26 (footnote omitted); see also McLure, supra note 7, at 417-21 (discussing difficulties presented by the international taxation of electronic commerce as well as possible solutions).

[FN164]. See Cybersex: An Adult Affair, Economist, Jan. 4, 1997, at 64.

[FN165]. See OECD Electronic Commerce Report, supra note 79, at 39.

[FN166]. See id. at 29 (indicating the United States currently accounts for about 80% of the global total of e-commerce).

[FN167]. McLure, supra note 7, at 361-62.

[FN168]. See, e.g., Australian Report, supra note 6, P7.7.11 ("A key concern is the U.S. approach that the communications revolution will see traditional source principles lose their significance and residence based taxation step in and take their place. Our analysis indicates that source and residency principles are equally at risk.").

[FN169]. For a discussion concerning a formulary apportionment system, see McLure, supra note 7, at 418-19.

[FN170]. See id. at 419.

[FN171]. The provincial income tax systems in Canada are far more unified, for the most part, with the federal Canadian income tax system than the U.S. state income tax systems are with the U.S. federal income tax system. The Canadian provinces have generally foregone their right to choose their own income tax base and apportionment formula. See Cockfield, supra note 8, at 63- 64.

[FN172]. For a discussion of problems associated with traditional transfer pricing and the need for a formulary approach, 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)

(indicating that the current use of profit-split methods to resolve some transfer pricing issues indicates a movement toward formulary apportionment).

[FN173]. See, e.g., Canadian Report, supra note 6, P4.1.3.2. A report to the Canadian Minister of National Revenue recites:
Unless it is applied in its stricter form, it would not eliminate the risk of double taxation and it is doubtful whether it would be easier to administer than the current international consensus--that is, the arm's-length principle. More important, it could lead to an unfair allocation of taxes on profits among countries.
The Committee does not consider that the adoption of a global formulary apportionment tax system would adequately address issues raised by electronic commerce.
Id.

[FN174]. See OECD Guidelines, supra note 65, at 65-68.

[FN175]. See Commission of the European Communities, Report of the Committee of Independent Experts on Company Taxation (1992) [hereinafter Ruding Committee Report].

[FN176]. Formulary apportionment has been criticized for, among other things, increasing compliance and enforcement burdens, creating the technical problem of defining a "unitary enterprise," ignoring the difficulty of approximating existing revenues, and using a standard formula where industry practices may vary. See John S. Brown, Formulary Taxation and NAFTA, 49 Tax L. Rev. 759, 761-67 (1994).

[FN177]. See Cockfield, supra note 8, at 65 ("[In the NAFTA context,] [d] etermining which factors should be included in the apportionment formula would also be problematic. Each Member State would seek to establish a formula serving its own interests, and there could be constant argument concerning interpretation of the factors even if agreement is reached.").

[FN178]. See, e.g., Ruding Committee Report, supra note 175, at 130 ("Firstly, and foremost, allocation is suitable only if States have reached an advanced degree of integration, such as common currency, common company law, common accounting standards and common expertise in the tax administrations."); see also Paul R. McDaniel, Formulary Taxation in the North American Free Trade Zone, 49 Tax L. Rev. 691, 714 (1994) ("Given this process, it readily can be seen why it is necessary to implementation of [a formulary taxation] system within the NAFTA zone that the tax bases of the three countries be reasonably harmonized."). But see Richard M. Bird, A View from the North, 49 Tax L. Rev. 745, 745-50 (1994) (suggesting that harmonization may not be required).

[FN179]. See, e.g., OECD Guidelines, supra note 65, at 66 (arguing that formulary taxation "would present enormous political and administrative complexity and require a level of international cooperation that is unrealistic to expect in the field of international taxation").

[FN180]. For discussions on analogizing permanent establishment fictions to e-commerce, see Lejeune et al., supra note 96, at 51-52 (discussing Richard Doernberg, Electronic Commerce and International Tax Rules, in Internet and the Taxation of International Electronic Commerce

(1997)); Thorpe, supra note 96, at 690-91; and supra text accompanying notes 47-48.

[FN181]. See OECD Model Treaty, supra note 2, art. 8 (stating that if management takes place on a ship, then the effective place of management is the home harbor of the ship, and if there is no home harbor, then the place of effective management is where the ship resides).

[FN182]. See id. art. 17; I.R.C. §864(b) (1994); see also Rev. Rul. 70-543, 1970-2 C.B. 172 (stating that a single performance by a foreign athlete or artist constitutes a U.S. trade or business unless a de minimis test is met).

[FN183]. See supra text accompanying notes 45-46.

[FN184]. See Skaar, supra note 1, at 428-33 (discussing how Norwegian and British tax treaty provisions dealing with offshore petroleum-related business activities have moved to pure source-state taxation and noting that this "alternative implies that several of the traditional conditions for [permanent establishment] under the basic rule are completely abandoned").

[FN185]. For a discussion on the need to create rules to strengthen source-country taxation of e-commerce, see David L. Forst, The Continuing Vitality of Source-Based Taxation in the Electronic Age, 15 Tax Notes Int'l 1455, 1455 (1997) (arguing that the Internet has not changed the "fundamentals of how income is earned").

[FN186]. See Peter A. Glicklich et al., Electronic Services: Suggesting a Man-Machine Distinction, 87 J. Tax'n 69, 69-70 (1997).

[FN187]. See id. at 70. Cross-border services income is generally subject to U.S. income tax and sourced to the place where the services were performed. If the personal service is performed by a nonresident outside the United States, the income is treated as foreign source income and generally not subject to U.S. tax. See I.R.C. §862(a)(3) (1994).

[FN188]. The authors offer the following examples of these types of mechanized transactions: information searches, online security monitoring, online gambling, and online banking. See Glicklich et al., supra note 186, at 69-70.

[FN189]. See Charles E. McLure, Jr., The Value-Added Tax: Key to Deficit Reduction? 31 (1987).

[FN190]. See id.

[FN191]. See Council Directive 77/338, art. 9, 1977 O.J. (L 145) 1, 5.

[FN192]. See Proposal for a Council Directive Amending Directive from the Commission 77/388, COM(97)4 final at 3.

[FN193]. See id. All telecommunications services will be brought within the scope of article 9(2)(e) of the Council Directive 77/338 so that the place of supply becomes the place where the

customer is located. See Susan M. Lyons, International Consensus Needed in Taxation of Electronic Commerce, 14 Tax Notes Int'l 1199, 1203 (1997).

[FN194]. See Reuven S. Avi-Yonah, International Taxation of Electronic Commerce, 52 Tax L. Rev. 507, 532-41 (1997).

[FN195]. See id. at 545.

[FN196]. See id. at 554-55.

[FN197]. But see McLure, supra note 7, at 418-19 (discussing Peggy B. Musgrave, Principles for Dividing the State Corporate Tax Base, in The State Corporation Income Tax: Issues in Worldwide Unitary Combination 228 (Charles E. McLure, Jr. ed., 1984) (arguing that, under economic analysis, countries should rely only on supply-based apportionment factors and thus sales at destination should not be included in the formula)).

[FN198]. The formulary approach would not likely attract international consensus, would go against traditional international tax principles, and would breach neutrality requirements. See supra text accompanying notes 173-179.

[FN199]. Australia currently has a national sales tax that will soon be replaced with a "Goods and Services Tax" (GST). GST is a polite way of saying VAT and is the term used in Canada and New Zealand.

[FN200]. See, e.g., Arthur Cockfield, The Impact of U.S. Consumption Tax Reform on Canada, 4 NAFTA L. & Bus. Rev. Am. 74, 76 (1998).

[FN201]. This occurs despite the fact that many income tax systems have elements of consumption-tax systems such as granting tax relief for savings that are placed in pension funds.

[FN202]. See, e.g., OECD Model Treaty, supra note 2, art. 2(1) (indicating the treaty applies to taxes on income and on capital).

[FN203]. See, e.g., European Comm'n, Org. for Econ. Co-operation and Development, Value-Added Taxes in Central and Eastern European Countries 101 (1998).

[FN204]. See OECD Model Treaty, supra note 2, arts. 23A-23B; U.S. Model Treaty, supra note 2, art. 23.

[FN205]. See OECD Model Treaty, supra note 2, arts. 23A-23B; U.S. Model Treaty, supra note 2, art. 23.

[FN206]. In addition, destination-based tax rules may also breach the desired neutral tax treatment between traditional commerce and e-commerce. For example, if a company in country A (the residence country) ships a book to a warehouse in country B (the source country) for sale to citizens of country B, then country B will be unable to impose its income tax on the sale since

a warehouse does not constitute a permanent establishment under most tax treaties. If the same book is shipped from company A to a citizen in country B after the citizen orders the product from the Internet, then country B will be able to impose its income tax on all or part of the profits associated with the transaction if source rules are strengthened based on the ultimate destination of the goods.

[FN207]. Take an example of an e-commerce firm A located in Palo Alto, California. A offers digitized software products and on-line gambling services via its website. Any consumer located anywhere in the world can purchase these goods and services as long as he or she has Internet access. There are thus literally millions, perhaps hundreds of millions, of potential customers located in dozens of different countries. A will often be unable to identify the location of these customers or perhaps will be able to identify them only with great effort (e.g., tracing payments). Is it reasonable to create an international tax regime where tax authorities in both residence and source countries must attempt to monitor the location of these customers or force A to somehow find the location? One of the most influential architects of U.S. international tax policy, T.S. Adams, once said, "[I]n agreements allocating tax sources for the purpose of preventing double taxation, the tax should not be assigned to a jurisdiction which cannot effectively administer and collect the tax." Graetz & O'Hear, supra note 1, at 1101. "[A]greements to abolish or restrain double taxation must be based on a variety of practicable grounds, among which the possibility of successful administration is the most important." Id. at 1102 (alteration in original).

[FN208]. For indirect e-commerce (e.g., on-line ordering of physical products), it might be possible to source the income to the warehouse located in the source country. This approach, however, would inhibit the desired neutral tax treatment of digital products versus tangible products. It would also change the current regime where auxiliary or preparatory activities for traditional commerce are generally not considered to give rise to source-state taxation. See discussion infra Part IV.B.2.

[FN209]. The vendor's server will usually be able to identify the IP address of the consumer, but this IP address may not have any relationship to the user's country. There are a number of companies that enable anonymous surfing of the Internet in order to protect the privacy of the user. These companies include Anonymizer.com, Onion Routing, and Zero-Knowledge Systems, Inc.

[FN210]. See, e.g., Australian Report, supra note 6, PP4.1.2-4.1.3. Examples of "accounted" payment systems are credit cards or checks. An example of an unaccounted payment system is cash, but consumers in this case must typically be present to give the cash to the vendor, which is not the case with unaccounted electronic payment systems.

[FN211]. For a discussion of how Internet technologies present enforcement challenges to tax authorities, see Jon M. Peha & Robert P. Strauss, A Primer on Changing Information Technology and the FISC, 50 Nat'l Tax J. 607, 616-20 (1997).

[FN212]. E-cash, for example, is purchased from a bank or other financial institution and is a kind of "token" stored on a computer disk or smart card. It can circulate freely after this initial purchase and will no longer involve the financial institution. E-cash, however, is generally

anonymous only for the payor (i.e., the end consumer) because the issuing institution will likely know the identification of the recipient of the currency when the token is redeemed.

[FN213]. See CyberSource Corp., Credit Card Fraud Against Merchants: What Internet Merchants Need to Know 3 (1998) (visited Sept. 6, 1999) <http:// www.cybersource.com>. The study is based on client surveys taken in 1997 and represents a percentage of the number of all orders.

[FN214]. Consumers would first have to obtain digital "resident" cash cards at banks that would permit merchants to identify the country of the consumer without revealing any other information. Consumption taxes would then be collected at the time of sale and placed with an escrow agent who would funnel the money to the appropriate government. See Internet Taxation System Is Mulled by White House, Wall St. J., Sept. 11, 1998, at B4. Further, Intel announced in February 1999 that its new Pentium III chip will contain a serial number that will permit Internet companies to identify the computer that contacts their websites.

[FN215]. Taxware International must rely on the business itself to provide information concerning the location of its customers. See Telephone Interview with Jon W. Abolins, Manager of Tax Research, Taxware International (Nov. 1998).

[FN216]. See, e.g., David G. Post, Anarchy, State, and the Internet: An Essay on Law-Making in Cyberspace, 1995 J. Online L. 3, P31-41 <http:// warthog.cc.wm.edu/law/publications/jol/post.html> (discussing the limits on governmental ability to impose regulations on Internet users who can evade traditional jurisdictional limits).

[FN217]. See Australian Report, supra note 6, P6.4.5.

[FN218]. Id. P6.4.5; see also id. P6.4.6 (indicating that the Australian Taxation Office does "not recommend [that] any prohibition be introduced on encryption software").

[FN219]. It is currently unclear whether governments should regulate the Internet in such a way that they will be provided with a correct "key" to conduct audits and investigations of taxpayers. In my view, it is unlikely that this type of regulation is feasible in an environment like the Internet. "Digital signatures" and other authentication tools can help to identify a document's sender, but only if they are combined with identity certificates supplied by a competent certifying authority. This authority can be located anywhere in the world and it is likely that many consumers will not submit to any government-mandated authority if they do not want their identities known.

[FN220]. See Council Directive 95/46, 1995 O.J. (L 281) 31.

[FN221]. See id. art. 10.

[FN222]. See id. art. 7(a).

[FN223]. See id. art. 3.

[FN224]. Unconsented processing of information, however, is acceptable for compliance with a legal obligation. See id. art. 7(c). It is doubtful whether the European countries will be willing to enact laws to force vendors to request and keep track of all of their customers' locations.

[FN225]. For a discussion on the self-regulatory approach, see Michael Hintze, Data Privacy: Self-Regulation Works, N.Y. L.J., Nov. 9, 1998, at T3.

[FN226]. A factor that inhibits source-state taxation is the disintermediary nature of e-commerce transactions where traditional middlemen such as distributors, financial institutions, and retailers are removed from the chain that connects producers to consumers. Tax authorities often depend on these middlemen to create a necessary audit trail of a transaction under scrutiny. This also makes it problematic to tax resident companies because the middlemen are often relied upon to keep tax records that can be traced back to the resident company.

[FN227]. It is recognized, however, that some commercial websites are quite costly to design and maintain.

[FN228]. It might, however, be possible to create de minimis rules where the e-commerce vendor is subject to source-state taxation only for transactions above a certain threshold. This would of course favor small firms over large firms.

[FN229]. A report made to the Canadian Minister of National Revenue identifies several concerns surrounding unintentional nonreporting by e-commerce participants. These concerns include:
[1]the vendor's inability to identify the purchaser's country of residence;
[2]the vendor's knowledge, or lack of knowledge, of the tax legislation of the purchaser's country of residence; and
[3]the purchaser's lack of knowledge of the tax implications of payments to non-residents and related procedures (e.g., the need to withhold and remit [a percentage of the purchase price to local tax authorities]).
Canadian Report, supra note 6, P4.2.1.2.

[FN230]. See, e.g., OECD Model Treaty, supra note 2, art. 26. Double taxation issues can be resolved through the "competent authorities" provisions in most tax treaties, but the resolution of taxpayer complaints through these provisions is very costly and time-consuming.

[FN231]. The exception to this rule is the mechanisms used by many European Union member states to exchange information concerning cross-border income flows. As of January 1, 1993, the Single Market, the elimination of border tax controls, and VAT harmonization have all called for heightened information exchange among different national tax authorities. See Council Directive 95/46, 1995 O.J. (L 281) 31.

[FN232]. More specifically, the proposal could amend article 5 of the model tax treaties. There are four basic parts to article 5 of the three model tax treaties that relate to the definition of permanent establishment: (1)a basic definitional rule which sets out the "fixed place of business" concept, (2)a list of examples of different types of permanent establishments, (3)a list of

activities or fixed places of business that are not permanent establishments, and (4)a list of "fictions" that deem permanent establishments to exist in certain circumstances for certain individuals, such as artists and entertainers. See OECD Model Treaty, supra note 2, art. 5; U.S. Model Treaty, supra note 2, art. 5; United Nations Model Treaty, supra note 2, art. 5.

[FN233]. The effect of the proposals would be to exempt e-commerce transactions from source-country income taxation to a greater extent in comparison with traditional commerce since e-commerce transactions rarely require a permanent establishment, unless the restricted force of attraction rule attracts the e-commerce transaction. As such, the proposed residence-based taxation of e-commerce generally follows the international tax policy principle of capital export neutrality (i.e., neutral as between investing at home or abroad). This seems particularly appropriate due to the high mobility of this type of investment. Residence-based taxation discourages resident e-commerce companies from trying to minimize their tax burdens by relocating their business activities offshore. The taxation of traditional forms of commerce will tend to follow the principle of capital import neutrality (i.e., neutral as between domestic and foreign investors) because profits will not be taxed by the residence country if they are attributable to a permanent establishment within the source country. Economists tend to favor capital export neutrality since it promotes efficiency in the allocation of investment over capital import neutrality, which promotes efficiency in the allocation of savings. The reason is that users of capital (i.e., businesses) tend to be more sensitive to differences in returns than are suppliers of capital (i.e., savers). Distortions that occur when deviating from the principle of capital export neutrality tend to be greater than distortions that occur when deviating from capital import neutrality. Businesses and governments, however, often favor capital import neutrality (and the source principle) because it is easier to implement with respect to business profits. This preference seems unlikely to continue, however, in the case of profits derived from e-commerce transactions because source states would have a difficult time identifying and taxing these profits. For a discussion of capital export and import neutrality considerations, see Sijbren Cnossen, Reform and Harmonization of Company Tax Systems in the European Union 45 n.31 (1996).

[FN234]. See discussion supra Part II.B.2.a.i.

[FN235]. Alison Bennett, Electronic Commerce: Treasury to Issue Paper Examining Range of Electronic Commerce Tax Issues, Daily Tax Rep., June 28, 1996, at D11 (quoting Alan Wilenski, former Deputy Assistant Secretary for Tax Policy) (internal quotations omitted).

[FN236]. See supra text accompanying notes 102-104; see also Australian Report, supra note 6, P7.2.15 ("A web site located on a server, that is fixed in time and location, and through which business is carried on may constitute a [permanent establishment]."); 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) (visited Sept. 6, 1999) <http://www.rc.gc.ca/ecomm/ecrspe4.htm> ("Whether a file server fits the definition of a [permanent establishment] will depend on the facts and circumstances of the particular case. This issue 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.").

[FN237]. As a result, many nations are beginning to take steps to tax e-commerce transactions occurring within their borders. See, e.g., India Plans to Tax Internet Transactions, 17 Tax Notes Int'l 158, 158 (1998).

[FN238]. See discussion supra Part II.B.2.a.ii. Note that the European Court of Justice has indicated that, at least for VAT supply purposes, a permanent establishment requires the presence of technical and human means. See Case 168/84, Berkholz v. Finanzamt Hamburg-Mitte-Altstadt, 1985 E.C.R. 2251, 2263 (finding that gambling machines on board a ship do not constitute a permanent establishment despite the regular maintenance of these gambling machines by staff on the ship).

[FN239]. See Alex Easson, Tax Competition and Investment Incentives, 2 E.C. Tax J. 63 (1997) (discussing the various tax incentives that countries use to successfully attract head offices and financial or administrative offices of foreign businesses).

[FN240]. See Ruding Committee Report, supra note 175, at 102, 108-09, 114 tbl.5.5 (discussing surveys of European Union businesspeople in which nearly half of respondents claimed that taxation is always or usually a major factor in the decision as to where to locate a production plant, and roughly two-thirds of respondents claimed that taxation is always or usually a major factor in financial decisions of multinational firms).

[FN241]. See, e.g., Green, supra note 8, at 21 ("As long as multinationals have the ability to shift the reported source of their income, governments imposing source-based corporate income taxes will have an incentive to compete for this shiftable income.").

[FN242]. Recent work by the OECD has tried to distinguish between arguably "good forms" of tax competition (e.g., the use of tax policies to promote efficiency) and more "harmful" forms of this competition (e.g., the use of tax havens or preferential tax incentives for foreign investors). See OECD Tax Competition Report, supra note 16, at 19-35.

[FN243]. There are already indications that nations will begin to offer tax incentives to e-commerce companies. For example, the government of Malaysia announced it would grant 5 to 10 year corporate income tax exemptions as an incentive for foreigners to set up businesses within its "multimedia super corridor." See K.W. Leong & May Lam, Malaysia's PM Reveals Details of Multimedia Super Corridor, 13 Tax Notes Int'l 1049, 1049 (1996).

[FN244]. Denial of permanent establishment status is necessary to permit tax authorities to extend their practical jurisdiction over e-commerce activities. For example,

> The Internet presents challenges for practical jurisdiction because the mobility and potential anonymity of Internet based businesses gives them geographical independence. A business using an Internet site that is outside of Australia may have placed itself outside of the practical jurisdiction of the Australian Taxation Office, depending on what view is taken as to where the business is being conducted.

Australian Report, supra note 6, P7.2.8.

[FN245]. For a brief description of these rules, see supra text accompanying notes 15-16. The Treasury Department correctly asserts, "If [controlled foreign corporations] can engage in extensive commerce in information and services through Web sites or computer networks located in a tax haven, it may become increasingly difficult to enforce Subpart F." Treasury Report, supra note 5, §7.3.5, at 26.

[FN246]. Recent regulations have been proposed by the U.S. government to restrict what is perceived to be excessive tax avoidance through new international tax planning vehicles. See I.R.S. Notice 98-11, 1998-6 I.R.B. 18 (indicating that new regulations will be issued to constrain the use of "hybrid branches" that circumvent the subpart F rules in the I.R.C.), withdrawn by I.R.S. Notice 98-35, 1998-27 I.R.B. 1, 35; I.R.S. Notice 98-5, 1998-3 I.R.B. 49, 51-52 (indicating that new regulations will be issued to curtail the use of tax-motivated transactions with a purpose of generating foreign tax credits to shelter low-taxed foreign-source income from U.S. tax).

[FN247]. See Australian Report, supra note 6, PP7.2.22-7.2.23 (discussing how many digital products may fall under the definition of royalties and thus can escape controlled foreign corporation provisions if they satisfy the exclusory test for tainted royalty income, and stating that "[t]he potential escalation in involvement in [controlled foreign corporations] by individuals and small businesses may severely test the [Australian Taxation Office's] ability to enforce the [controlled foreign corporation] provisions"); Canadian Report, supra note 6, P4.2.2.3 (discussing how the Canadian tax system "is really protected only by taxpayer self-assessment" and how the Internet will make it easier to place transactions in off-shore countries and thus avoid the imposition of Canadian tax).

[FN248]. Subpart F income includes certain sales and services income that is earned by conduit subsidiaries of United States parent corporations. See I.R.C. §§952(a)(2), 954 (1994).

[FN249]. See id. §954(d)(1)(A); Treas. Reg. §1.954-3(a) (as amended in 1983).

[FN250]. See OECD Tax Competition Report, supra note 16, at 23, 71. The factors that identify whether a country is a tax haven include the following: (1)no or nominal taxes, (2)lack of an effective exchange of information, (3)lack of legal transparency, and (4)the absence of a requirement of substantive economic activities. See id. at 23.

[FN251]. See supra text accompanying notes 164-165.

[FN252]. The mere existence of a permanent establishment will generally not fulfill the residence requirement in most tax treaties. See, e.g., U.S. Model Treaty, supra note 2, art. 4(1)(a) ("The term 'resident of a Contracting State' does not include any person who is liable to tax in that State in respect only of income from sources in that State or of profits attributable to a permanent establishment in that State.").

[FN253]. There are four tasks that can be considered essential to effectively administering an income tax: (1)identifying the taxpayer; (2)proving a link between the taxpayer and the taxable transactions; (3)identifying taxable transactions that give rise to an income tax liability; and

(4)collecting the income tax from the taxpayer, which requires access to the taxpayer or its assets. See Canadian Report, supra note 6, P4.1.1.

[FN254]. For example, there is not necessarily a direct correlation between an Internet Protocol (IP) number and the geographical location of a computer.

[FN255]. See Australian Report, supra note 6, P7.3.2.

[FN256]. See id.

[FN257]. The Australian Taxation Office report contains a review of two options to ensure greater accountability for commercial use of IP numbers. The first option would involve "the maintenance of a public register to record the issue or transfer of IP numbers to be used commercially," along with details such as name and business address. Id. P8.2.6. The second option would involve "the licensing of commercial websites and of organisations that operate or host websites." Id.; see also Canadian Report, supra note 6, P4.2.1.1 (recommending programs to identify businesses conducting e-commerce).

[FN258]. Regulation over international telecommunications companies may be necessary in this area in order to ensure these companies request their lessees to provide IP numbers.

[FN259]. See, e.g., David R. Johnson & David Post, Law and Borders--The Rise of Law in Cyberspace, 48 Stan. L. Rev. 1367, 1370-76 (1996) (arguing most prominently in support of this view); see also Llewellyn Joseph Gibbons, No Regulation, Government Regulation, or Self-Regulation: Social Enforcement or Social Contracting for Governance in Cyberspace, 6 Cornell J.L. & Pub. Pol'y 475, 478-84 (1997) (arguing that regulation over commercial uses of the Internet may be necessary, but that regulatory efforts directed at individual free speech are undesirable); Post, supra note 216, PP33-40 (discussing the difficulties in regulating an environment where users can evade jurisdictional limits imposed by governments); Steven R. Salbu, Who Should Govern the Internet?: Monitoring and Supporting a New Frontier, 11 Harv. J.L. & Tech. 429, 452-62 (1998) (discussing the need for uniformity of laws and regulations that govern the Internet).

[FN260]. See, for example, Canadian Report, supra note 6, P2.4.2.2, which states:
In conventional commerce, even if one is shopping in a store one has never frequented before, signs of trustworthiness are readily observable.... In the electronic marketplace, however, much of this information is not available. Other methods are needed to establish trust in an electronic business environment. At a minimum, it will be crucial to clearly establish with whom customers are dealing.
Id. (emphasis added).

[FN261]. See Council Directive 95/46, 1995 O.J. (L 281) 31; supra text accompanying notes 220-224.

[FN262]. See Council Directive 95/46, 1995 O.J. (L 281) 31, art. 28.

[FN263]. See White House Report, supra note 6. Currently, a nonprofit company called TRUSTe reviews the privacy practices of participating websites and issues a "trustmark" icon on the website of the companies that comply with the guidelines. By "clicking" on this icon, a consumer can find out what information is collected by the website and how the data is used. See TRUSTe Homepage (visited Oct. 15, 1999) <http://www.truste.org>.

[FN264]. See supra text accompanying notes 150-161.

[FN265]. See supra text accompanying notes 156-161.

[FN266]. The U.S. Treasury Department notes that many technological developments are extensions of current communications devices. For example, a videoconference can be viewed as a substitute for a conference call. See Treasury Report, supra note 5, §7.4.2, at 27. The Treasury Department also indicates that, as a result of the possible ascendancy of residence-based taxation, it is probably necessary for the United States and other countries to review and possibly harmonize existing residency rules. See id. §7.1.5.

[FN267]. For example, if an individual resides in two states, then the tax authorities of the states settle this question under most tax treaties. See, e.g., OECD Model Treaty, supra note 2, art. 4(d). Still, it is recognized that taxpayer use of these provisions is costly, inefficient, and lengthy.

[FN268]. See supra text accompanying notes 114-118.

[FN269]. Further, servers or websites act as mere intermediaries with little or no risk and thus it does not seem appropriate to allocate to them a share of the income that results from the e-commerce transaction. See Lejeune et al., supra note 96, at 55.

[FN270]. See OECD Guidelines, supra note 65, at 30-34.

[FN271]. See id. at 34.

[FN272]. The Treasury Department maintains:
Global collaboration is not a new concept.... Global collaboration requires transfer pricing and source of income principles, to correctly allocate the resulting income between the countries involved.
... As the ways in which companies collaborate globally to provide services continue to grow, it may be appropriate to consider the creation of general principles for the arm's length allocation of broader categories of services income based on each situation's particular facts. These rules could be implemented through Treasury Regulations and international consensus. To the extent that capital is not a material income-producing factor in this situation, it would be expected that the place where the component services were performed would be of primary importance in allocating such income.
Treasury Report, supra note 5, §7.5.2, at 27-28.

[FN273]. For example, a German e-commerce company might have an affiliate company based in France that employs several computer programmers to create computer codes. The

programmers are paid salaries at the going market rate (i.e., equivalent to arm's length), do not own any equity in the German company, and simply e-mail their work to the German parent on a monthly basis.

[FN274]. See OECD Model Treaty, supra note 2, commentary to art. 5, PP40-41.

[FN275]. See OECD PE Paper, supra note 37.

[FN276]. Id. at 17.

[FN277]. See id. at 20. The paper provides:
As between associated members of a group, there are normally two methods of dealing with intangible costs and rights. The members of the group may agree on some cost sharing mechanism whereby the historic costs of creating the intangible rights are shared between the members of the group. Alternatively, the costs may be borne by one member of the group in which case it is appropriate that other members of the group be expected to pay to the owning member an appropriate royalty etc. having regard to the value of the rights being used.... Similar conditions should, in principle, apply in allocating the profits of a single entity. However, it may be extremely difficult to allocate 'ownership' of the intangible right solely to one part of the enterprise and to argue that this part of the enterprise should receive royalties from the other parts as if it were an independent enterprise.... In such circumstances it would be appropriate to allocate the historic costs of the creation of such intangible rights between the various parts of the enterprise without any mark-up for profit or royalty.
Id.

[FN278]. Id. at 29.

[FN279]. See id.

[FN280]. See id.
The answer to this question will be in the affirmative if the expense was initially incurred in performing a function the direct purpose of which is to make sales of a specified good or service and to realise a profit through a permanent establishment. The answer will be negative if, on the basis of the facts and circumstances of a specific case, it appears that the expense was initially incurred in performing a function the essential purpose of which is to rationalise the overall costs of the enterprise or to increase in a general way its sales.
Id. The test is now enshrined in OECD Model Treaty, supra note 2, commentary to art. 7, P17.2.

[FN281]. See Lisa Peschcke-Koedt, A Practical Approach to Permanent Establishment Issues in a Multinational Enterprise, 16 Tax Notes Int'l 1601, 1612 (1998) (arguing that as long as the local affiliate has been compensated at arm's length prices for its services, then no further income should be attributed to the affiliate).

[FN282]. Although the OECD guidelines discuss transactions that are "so closely linked or continuous that they cannot be evaluated adequately on a separate basis," the corresponding examples are not helpful. OECD Guidelines, supra note 65, at 35.

[FN283]. See, e.g., Charles E. McLure, Jr., U.S. Federal Use of Formula Apportionment to Tax Income from Intangibles, 14 Tax Notes Int'l 859, 862 (1997) ("[T]here are generally no comparable uncontrolled prices and neither the resale price method nor the cost-plus methodology is likely to be adequate in dividing the income of an enterprise in which valuable and unique intangible assets are important.").

[FN284]. See, e.g., Australian Report, supra note 6, P7.6.22; see also Avi-Yonah, supra note 8, at 1347 (suggesting that, in the context of traditional forms of commerce, countries should use profit-split methods based on a unitary approach when no comparable transactions are available). But see Lejeune et al., supra note 96, at 56-57 (discussing the problems associated with using profit-split methods on e-commerce transactions).

[FN285]. See, e.g., McLure, supra note 283, at 870 (concluding that neither traditional arm's length/separate accounting methodology nor formula apportionment satisfactorily divides multinational firm income, especially income from intangible assets, but that some formulas for specific classes of taxpayers may be appropriate). For a brief discussion of the profit-split methods available under U.S. law, see supra text accompanying notes 67-69.

[FN286]. See Treas. Reg. §1.482-6(c)(3) (as amended in 1995); Avi-Yonah, supra note 194, at 545-50.

[FN287]. See Treas. Reg. §1.482-6(c)(3)(A); id. §1.482-6(c)(3)(B).

[FN288]. The IRS's Advanced Pricing Agreements procedure is set forth in Rev. Proc. 96-53, 1996-2 C.B. 375.

[FN289]. See Canadian Report, supra note 6, P4.2.2.7. (discussing the need for stronger exchange-of-information and audit agreements as well as mutual-collection agreements to confront e-commerce transfer pricing challenges).

[FN290]. See discussion supra Part II.B.2.c.

[FN291]. See Prop. Treas. Reg. §1.861-18(b), 61 Fed. Reg. 58,154 (1996). But see Cigler & Stinnett, supra note 144, at 63 (indicating that the proposed regulations show deficiencies when applied to on-line services); Karlin, supra note 123, at 73 (indicating that the regulations cannot and do not do anything to resolve the problems associated with differing treatment of sales of property and the rendering of services).

[FN292]. Therefore, the proposal does not apply to passive investment income for items such as portfolio dividends, portfolio interest, or sales that generate capital gains. The different categorization of passive investment income and active income follows sound economic rationales, but the different tax treatment imposed on active business income does not appear to follow any sensible rationale. See Avi-Yonah, supra note 8, at 1308-10.

[FN293]. See Doernberg, supra note 106, at 1016 ("Categorization of income from an economic standpoint is inherently artificial. In the marketplace, a seller does not care (aside from tax

considerations) how a payment received is categorized, as long as the payment is fair value for what was sold."); Robert A. Green, The Troubled Rule of Nondiscrimination in Taxing Foreign Direct Investment, 26 Law & Pol'y Int'l Bus. 113, 151 (1994).

[FN294]. See supra text accompanying notes 49-50.

[FN295]. This is the threshold amount mentioned by Professor Avi-Yonah in his proposal to use VAT principles to permit source-country taxation of e-commerce business profits. See Avi-Yonah, supra note 194, at 536.

[FN296]. See id. ("A net figure would require that a tax administration know the taxpayer's income from sales into a jurisdiction, which it typically would not have the information to determine .... For the same reason, a threshold based on a percentage of total sales worldwide seems impracticable since it requires knowledge available only to the taxpayer.").

[FN297]. The proposal to tax e-commerce transactions mainly on a residence-based basis would alleviate the need for e-commerce companies in most circumstances to file income tax returns in the source country, have foreign taxpayer identification numbers, provide financial data, etc., simply because source-country consumers have purchased their goods and services. The proposals would hence significantly reduce compliance costs for these businesses and would ensure that the growth of e-commerce is not inhibited. The Internet creates an environment where international trade is now open to small independent companies by lowering start-up costs for such ventures. It is not practical (or feasible), however, to expect these companies to comply with the tax rules of a foreign jurisdiction or, quite possibly, multiple jurisdictions.

[FN298]. See Doernberg, supra note 106. Professor Doernberg characterizes his article as an "approach" and not a proposal since, he indicates, it "lacks many of the details for it to be considered a full-fledged proposal." Id. at 1015. The Australian Taxation Office also suggests that the definition of royalties should be widened to protect its revenue base because Australia is currently a net importer of e-commerce goods and services. See Australian Report, supra note 6, P7.2.19. The report notes, however, that this approach might complicate tax administration. See id.

[FN299]. Under Professor Doernberg's approach, a withholding tax could be imposed on any source-country payment to a residence country for e-commerce goods or services only as long as the payment erodes the tax base of the source country. See Doernberg, supra note 106, at 1016. Erosion of the source-country tax base occurs if a company or a person within this country can deduct the payment or if the payment goes into the company's cost of goods sold (which decreases the company's profit on the sale of goods). See id. Further, payments made by consumers in the source country to vendors located in residence countries would not be subject to withholding since the consumer does not generally deduct the costs associated with his or her purchase. See id. Accordingly, Doernberg's approach would not impose the withholding tax on direct or indirect e-commerce sales to consumers who live in foreign countries. Rather, the approach focuses almost exclusively on business-to-business e-commerce transactions. See id. at 1017.

[FN300]. See supra text accompanying notes 31-33.

[FN301]. See Doernberg, supra note 106, at 1016-17 (indicating that the additional compliance costs of this election are justified by the overall benefits of a single withholding rate to all deductible cross-border payments).

[FN302]. Id. at 1016.

[FN303]. See id. at 1017. The proposal could have the added benefit of helping to ensure the residence state company (the payee) does not avoid residence state income taxation. A source country could enact a national tax rule that indicates the e-commerce withholding rate equals, for example, 40% for transactions with companies based in nontax treaty partners. The lowered tax treaty rate of 5% would apply only if the payee submits documentation to the withholding agent in the source country. This is roughly how the Internal Revenue Code permits payee companies to enjoy reduced withholding tax rates in tax treaties for certain types of income (e.g., interest, rents, and dividends). See I.R.C. §1441 (1994); Treas. Reg. §1.1441 (as amended in 1997). This documentation could include the address of the payee and other certifications of its qualification for the treaty reduction. The submission of these documents might inhibit tax avoidance strategies by the resident company, which must disclose the true nature and location of its business in order to benefit from the lower treaty rate.

[FN304]. See supra note 212 for a discussion of a resident smart card.

[FN305]. See OECD Electronic Commerce Report, supra note 79, at 34-36.

[FN306]. He calls this the "10 percent solution." See Doernberg, supra note 106, at 1015.

[FN307]. Foreign tax credits are normally limited by foreign source net income after expenses, while the withholding taxes apply to gross income. The United States, however, grants foreign tax credits for foreign taxes paid in lieu of an income tax, including many gross withholding taxes. See I.R.C. § 903, Treas. Reg. §1.903-1 (as amended in 1983). Other countries may not have similar legislation in place, thereby creating the potential for double taxation. Further, the United States rules regarding foreign tax credits are quite complex and prohibit "cross-crediting" of different types of income categories. See I.R.C. §904(d). For example, interest income subject to a withholding tax rate that is 5% or higher is placed in a separate category. Would an e-commerce interest payment taxed at a rate of 10% be placed in this category? In addition, small e-commerce firms may not have sufficient resources to ensure that they receive credit for foreign taxes paid--they may simply be unaware of the additional filing that is necessary to receive credit.

[FN308]. This would be the case when an e-commerce firm must elect to file as a net-basis taxpayer in the foreign jurisdiction. Many of these firms will presumably be start-ups that will suffer losses or small profits in the beginning lean years. As such, they would have to file a return in the source country in order to obtain a refund on the withholding taxes paid and may be subject to interest charges in some cases.

[FN309]. Source-country firms must incur the additional costs of withholding and remitting the e-commerce payment to their own tax authority. E-commerce payments may be structured to come in on a continual basis if there is an ongoing relationship between the residence-based e-commerce company and the recipient company. Rules would have to be created to provide the recipient company with relief in this area (e.g., by permitting the recipient company to elect to remit on a quarterly basis). The source country must enforce these rules. Professor Doernberg notes, however, that the linkage between the deduction or tax benefit and the e-commerce payment assists source-country tax authorities, since they can deny the deduction or benefit unless the source-country firm can demonstrate it has fulfilled its withholding obligation. See Doernberg, supra note 106, at 1017.

[FN310]. In order to avoid this e-commerce withholding tax, an e-commerce firm could establish a holding company in a state with a treaty that provides for a lower withholding tax rate with the source country. This is a typical example of "treaty shopping." The United States alone has insisted on provisions within its tax treaties to prevent this type of treaty shopping. See U.S. Model Treaty, supra note 2, art. 22. Other countries do not have these provisions because they feel such a provision might inhibit cross-border investment. Further, an e-commerce company may argue that the payment should be considered a traditional payment and thus should either not be subject to the special withholding tax or should be considered as a royalty or another form of income that may be subject to a lower or nil rate in the tax treaty.

[FN311]. The OECD Model Treaty suggests rates of 5% for dividends (for foreign direct investment), 10% for interest, and no tax on royalties. See OECD Model Treaty, supra note 2, arts. 10-12.

[FN312]. It might make more sense to insist on a minimum rate of 5% and allow tax rate competition (through attracting investments via treaty shopping) only above this rate, but it is unlikely that this proposal would be acceptable to many countries who may not wish to incorporate any e-commerce withholding tax into a tax treaty with a country where e-commerce flows are expected to be relatively balanced.

[FN313]. See supra text accompanying notes 107-112.

[FN314]. United Nations Model Treaty, supra note 2, art. 7(1). Subsections (b) and (c) of this article seem to distinguish between sales (subsection b) and other business activities (subsection c). Subsection (c) indicates that any business activity that is similar to the one conducted via the permanent establishment will be attributable to the permanent establishment. See id. art. 7(1)(c). Subsection (b) serves to limit attributable sales activity to sales of a similar kind of merchandise and not to all sales activities. See id. art. 7(1)(b).

[FN315]. See OECD Model Treaty, supra note 2, art. 7; U.S. Model Treaty, supra note 2, art. 7.

[FN316]. The provisions within this model treaty are substantively similar to the OECD Model Treaty and the U.S. Model Treaty in most respects. There are, however, several provisions that try to strengthen source-country taxation of business profits. For example, the United Nations Model Treaty indicates that construction sites are considered to be permanent establishments if

they last 6 months, see United Nations Model Treaty, supra note 2, art. 5(3)(a), whereas the OECD Model Treaty indicates a minimum period of 12 months, see OECD Model Treaty, supra note 2, art. 5. Further, the United Nations Model Treaty expands the definition of agent (deeming in some circumstances independent agents to be dependent agents under art. 5(7)) and deems insurance companies to have a permanent establishment as long as insurance premiums are collected by a person other than an independent agent. See United Nations Model Treaty, supra note 2, arts. 5(7), 7.

[FN317]. Prior to 1966, as long as a foreign person was engaged in a trade or business within the United States, all investment income by this foreign person within the United States would be taxed at the regular corporate or individual income tax rate. For a discussion, see Klaus Vogel et al., United States Income Tax Treaties 321-23 (1995). This was justified by the argument that a business with a permanent establishment in a foreign country had brought itself under the other state's taxing jurisdiction to an extent that was qualitatively different from the casual presence of a nonpermanent establishment business. Source-state taxation should thus also be applied to activities within the source country that were not connected to the permanent establishment. Pursuant to legislation introduced in 1966, however, the United States currently only taxes investment income that is "effectively connected" with the conduct of a trade or business in the United States. See supra text accompanying notes 19-20. Other investment income is now subject only to U.S. withholding tax rates (or lowered tax treaty rates) on the gross amount of the income. See I.R.C. §871(a) (1994) (individuals); id. §882 (corporations).

[FN318]. The full force of attraction rule continues in an important form for investment income other than capital gains and fixed or determinable income (e.g., passive investment income such as interest or royalties). See I.R.C. §871(a). This type of income--which includes active business income such as sales, services, or manufacturing income--is treated as effectively connected income as long as the taxpayer conducts a trade or business in the United States. See id. §864(c)(3). For example, a foreign taxpayer might sell products to U.S. customers from a U.S. base as well as directly from its home office. As a result of the existence of the base, which meets the conduct of a trade or business test, the income derived from the home office sales will be treated as effectively connected even if these sales were conducted without any connection to the U.S. base. See Treas. Reg. §1.864-4(b) (as amended in 1996).

[FN319]. For a discussion of the limited force of attraction principles within Latin American tax treaties, see Zapata, supra note 52, at 259-60.

[FN320]. These treaties have been negotiated with a number of countries. See, e.g., Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital, Oct. 24, 1993, U.S.-Kaz., S. Treaty Doc. No. 103-33, art. 6, reprinted in 3 Tax Treaties (CCH) P5303; Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Sept. 18, 1992, U.S.-Mex., S. Treaty Doc. No. 103-7, art. 7, reprinted in 3 Tax Treaties (CCH) P5903; Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Sept. 12, 1989, U.S.-India, S. Treaty Doc. No. 101-5, art. 7, reprinted in 2 Tax Treaties (CCH) P4203; Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Mar. 14, 1985, U.S.-Sri Lanka, S. Treaty Doc. No.

99-10, art. 7, reprinted in 4 Tax Treaties (CCH) P8503 (not yet in effect).

[FN321]. These treaties have also been negotiated with a number of countries. See, e.g., Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, July 1, 1957, U.S.-Pak., 10 U.S.T. 984, art. 3, reprinted in 3 Tax Treaties (CCH) P7303; Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Feb. 20, 1950, U.S.-Greece, 5 U.S.T. 47, art. 3, reprinted in 2 Tax Treaties (CCH) P3403; Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Sept. 13, 1949, U.S.-Ir., 2 U.S.T. 2303, art. 3, reprinted in 2 Tax Treaties (CCH) P4441, replaced by Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains, July 28, 1997, U.S.-Ir., S. Treaty Doc. No. 105-31, reprinted in 2 Tax Treaties (CCH) P4401; Convention Respecting Double Taxation and Taxes on Income, May 6, 1948, U.S.-Den., 62 Stat. 1730, art. 3, reprinted in 2 Tax Treaties (CCH) P2501. These treaties, which were all negotiated prior to 1960, are the result of a historical anomaly.

[FN322]. Under this full force of attraction principle, which extends the permanent establishment concept beyond the one envisioned in the United Nations Model Treaty, all business profits generated by a foreign business activity are attracted to any existing permanent establishment employed by the foreign business. There is thus no requirement that the transactions be similar to the ones concluded through the permanent establishment. The full force of attraction principle seems to appear only rarely within tax treaties and, in the case of the United States, results from a previous era's tax treatment of foreign investments within the United States. See supra note 317.

[FN323]. Treasury Dep't Tech. Explanation of the Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Sept. 18, 1992, reprinted in 3 Tax Treaties (CCH) P35,840.

[FN324]. OECD Model Treaty, supra note 2, commentary to art. 7, P5. The limited force of attraction proposal may, however, have both a positive and negative effect on the ability of tax authorities to administrate their tax rules. On the one hand, "the UN force of attraction approach makes it unnecessary to scrutinize the circumstances around similar business activities to decide whether the conditions for a [permanent establishment] are met for all of them, as long as one [permanent establishment] can be established." Skaar, supra note 1, at 337. Determining the income attributable to a permanent establishment is often a question of fact, which gives rise to the potential for double taxation when tax authorities disagree with each other on these facts. The force of attraction rule makes it unnecessary to distinguish between different sources of business profits within the same country and thus it has been called "an administratively convenient solution." See id. On the other hand, disputes may arise surrounding whether the transactions are sufficiently similar to warrant source-country taxation. Source states may be tempted to tax profits from business activities that are not similar to the activities carried on by the permanent establishment or that are not capable of being performed by it. This may lead to double taxation if the resident country disagrees with the source-country's assessment. Grey areas could be clarified through the commentaries to the model tax treaties.

[FN325]. See Skaar, supra note 1, at 573-74 (noting that the development of permanent establishment fictions, the expansion of agent permanent establishments, and the adoption of limited force of attraction principles by the United Nations and many other nations serve as evidence of this erosion).

[FN326]. See id. at 574 (discussing how industrialized nations will likely block more radical source-state taxation alternatives). The study indicates that
[t]his process [of developing toward increased source-state taxation] may be facilitated by revision of some of the existing model treaties, in particular the ongoing revision of the UN Model Treaty. The ongoing attempts to reintroduce the force of attraction principle are also closely related to this process. The inclusion of non-[permanent establishment] profits in the tax base of an existing [permanent establishment] will serve the purpose of enforcing source-state taxation. A detrimental side-effect, however, may be that tax-treaty provisions become more complicated.
Id.

[FN327]. See, e.g., Klaus Vogel, Klaus Vogel on Double Taxation Conventions 400 (1997) ("If the flows of goods between the two countries involved--or rather, more accurately, the profits resulting from those flows--are balanced, the question of what principle should be applied ... is of relatively little significance, and in such a case adoption of the permanent establishment principle is recommendable because it is practicable.").

[FN328]. See OECD Model Treaty, supra note 2, commentary to art. 7, P8. The commentary provides:
It may be that such a company may have set up a permanent establishment in a second country and may be transacting a considerable amount of business through that permanent establishment in one particular kind of manufacture; that a different part of the same company may be selling quite different goods or manufactures in that second country through independent agents; and that the company may have perfectly genuine reasons for taking this course-- reasons based, for example, either on the historical pattern of its business or on commercial convenience.
Id.; see also Vogel, supra note 327, at 410 ("[The OECD method] is preferable ... because [this] method proceeds from the enterprise's individual organizational structure and avoids restricting entrepreneurial freedom of disposition through fictitiously allocating profits by way of generalizing standards." (emphasis omitted) (emphasis added)). The allocation of profits to an existing permanent establishment can only be considered to be "fictitious" if one proceeds from the concept that permanent establishment itself is not a fiction created to help avoid double taxation and to allocate international tax revenues among nations. Clearly, there are a number of approaches other than using a permanent establishment that would accomplish these two results. The Mexico Draft, discussed supra notes 53-60 and accompanying text, serves as one such example.

[FN329]. Would the restricted force of attraction rule impede cross-border investment if more profits were allocated to permanent establishments? Companies generally only wish to avoid source-state taxes if it increases the total tax burden imposed on their business or if the source-country taxes subject the same economic activity to double taxation. Whether this occurs depends on a number of factors, including the differences between the countries in marginal

effective tax rates, the use of worldwide taxation or territorial taxation, and provisions within tax treaties. See, e.g., Joosung Jun, U.S. Tax Policy and Direct Investment Abroad, in Taxation in the Global Economy, supra note 139, at 55, 56-61 (discussing the ways in which domestic tax policy can potentially affect after-tax rates of return and thus influence international investment flows). It is thus unlikely that the expansion of a source-country tax base through the restricted force of attraction principle would, by itself, impede e-commerce business activity or other traditional business activity. Nevertheless, countries would have to consider this possible eventuality before negotiating such a clause.

[FN330]. See supra text accompanying notes 107-112.

[FN331]. See discussion infra Part IV.C.4.

[FN332]. See supra text accompanying note 155.

[FN333]. The commentary to the OECD Model Treaty sets out the issue as follows:
[The current OECD method of only attributing profits to permanent establishment activities], the argument runs, might leave it open to an enterprise to set up in a particular country a permanent establishment which made no profits, was never intended to make profits, but existed solely to supervise a trade, perhaps of an extensive nature, that the enterprise carried on in that country through independent agents and the like. Moreover, the argument goes, although the whole of this trade might be directed and arranged by the permanent establishment, it might be difficult in practice to prove that that was the case. If the rates of tax are higher in that country than they are in the country in which the head office is situated, then the enterprise has a strong incentive to see that it pays as little tax as possible in the other territory; the main criticism of the [[[OECD] solution ... is that it might conceivably provide the enterprise with a means of ensuring that result.
OECD Model Treaty, supra note 2, commentary to art. 7, P7.

[FN334]. Id. P9.

[FN335]. As indicated, the OECD has asserted that the restricted force of attraction rule interferes with international commercial ventures. See supra text accompanying note 328.

[FN336]. A number of different approaches have been used to modify the United Nations rule. There are two types of limited force of attraction rules that seem only to clarify what types of profits should be attributed to the permanent establishment. See Zapata, supra note 52, at 259. Under the first type, the limited force of attraction rule would apply only if the permanent establishment has been involved with the transaction in some manner. See id. The permanent establishment must actively participate in the transaction before the source state has the right to impose its income tax on the profits generated by the transaction. See id. The second type indicates that the source state may impose its income tax on source-related profits that are similar to the ones effected through the permanent establishment as long as this permanent establishment carries on advertising, marketing, storage, display, or delivery of goods. See id. Both of these types of provisions arguably do not apply any force of attraction principle because some degree of involvement with the transactions must occur within the existing permanent establishment.

See id. at 260. Instead, these provisions merely clarify what profits can be attributed to the permanent establishment, which would likely occur in any event under the OECD model provision. There are two further types of provisions that limit the United Nations restricted force of attraction principle. See id. Under the first type, the source country will not be able to impose its income tax on transactions similar to the ones carried out by the permanent establishment if the foreign taxpayer demonstrates the transactions were carried out "for serious economic reasons." See id. Alternatively, a second type of provision prevents the source country from applying its tax if the foreign taxpayer demonstrates that the transactions could not have been undertaken by the permanent establishment in its ordinary course of business. See id. Both of these provisions serve to limit the United Nations provisions by imposing a test to limit source-country taxation if the foreign business entity had "real" (i.e., not triggered by tax considerations) reasons to avoid using its permanent establishment located within the source country. See id. at 259-60.

[FN337]. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Sept. 18, 1992, U.S.-Mex., S. Treaty Doc. No. 103-7, art. 7(1), reprinted in 3 Tax Treaties (CCH) P5903.

[FN338]. See supra text accompanying note 31.

[FN339]. OECD Model Treaty, supra note 2, art. 5(4)(e); U.S. Model Treaty, supra note 2, art. 5(4)(e).

[FN340]. See U.S. Model Treaty, supra note 2, commentary to art. 5, P4.

[FN341]. OECD Model Treaty, supra note 2, commentary to art. 5, P24.

[FN342]. See Australian Report, supra note 6, P7.5.4.

[FN343]. An IRS ruling reviewed this issue in the context of an independent agent of a United Kingdom business who received merchandise to be held in case customers wished to place small orders. See Rev. Rul. 56-594, 1956-2 C.B. 1126. The agent could not, however, withdraw merchandise from the U.K. company's warehouse in the United States without first receiving instructions. The ruling indicates that a permanent establishment within the United States had not been created. See id. at 1127.

[FN344]. The OECD seems to take the position that research activities will not, in and of themselves, create a permanent establishment as long as their function is to serve the head office. See OECD Model Treaty, supra note 2, commentary to art. 5, P25 (indicating that research establishment activities will not be considered to be auxiliary "if a research establishment were to concern itself with manufacture"); Skaar, supra note 1, at 309.