*The theoretical foundations and continued rationale for source-based taxation in an electronic commerce environment**

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Abstract

This paper is directed at analysing the theoretical foundations and rationale for source–based taxation[1] and argues that these principles remain valid despite changes brought about by globalisation, including the increased incidence of transactions that occur via electronic commerce. The analysis in this paper is not concerned with how source is defined,[2] but rather at establishing that source–based taxation continues to be theoretically justifiable for income that arises from international transactions which are conducted in a globalised business environment, including those that occur through the agency of electronic commerce.

* This paper draws from the author's doctoral work which was published by the IBFD in its Doctoral Series. See Dale Pinto, *E-Commerce and Source-Based Income Taxation* (IBFD, 2003).

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1 Most countries that impose an income tax rely on two jurisdictional bases–the taxpayer's personal connections to a country (residence-based taxation) and the geographical source of income (source-based taxation): Brian J Arnold, 'Controlled Foreign Corporation Rules, Harmful Tax Competition, and International Taxation' in Canadian Tax Foundation (ed), *2000 World Tax Conference Report* (2000) 17:1. Both residence and source-based taxation can be justified in terms of tax policy principles, though this paper is concerned with the theoretical justification for source-based taxation and its application to electronic commerce transactions.

2 For the purposes of the analysis in this paper, the country where a business is based or established will be regarded as the residence country, while the foreign country where this business is conducted will be regarded as the country of source.

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I The Theoretical Basis for Source-Based Taxation and Its Application to Electronic Commerce

A. Benefit Theory

Vogel notes that two competing theories have consistently influenced the reasoning regarding a country's right of taxation – the benefit theory and the sacrifice theory.[3] Under the benefit theory, a jurisdiction's right to tax rests on the totality of benefits and state services provided to taxpayers that interact with a country. Under the sacrifice theory, taxes are viewed as a sacrifice owed to a country due to the higher moral value of community purposes over individual aims. Vogel notes that only the benefit theory seems acceptable today and therefore the remaining analysis and discussion will be made in this context.[4]

As noted above, under the benefit theory, taxes are regarded as the price paid for all state services by all taxpayers taken together, and countries obtain their jurisdiction to tax based on the services (benefits) provided. McLure's observations on the benefit principle accords with this view: 'the country where income originates should be compensated for the cost of providing public services.'[5] Similar sentiments regarding the benefit principle have been expressed much earlier by Thomas S Adams when he observed, 'A large part of the cost of government is traceable to the necessity of maintaining a suitable business environment.'[6] In a broad sense, these costs may be thought of as representing the price of providing a civilised society, thereby justifying the imposition of taxes as compensation to the governments bearing them.

Arthur Harding, in a book on double taxation, developed a similar theory regarding his theory for source-based taxation.[7] Harding argued that economic production resulted not just out of the actions of isolated individuals, but as a result of the *interaction* between these individuals and the State:

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3 Klaus Vogel, 'Worldwide vs Source Taxation of Income – A Review and Re-evaluation of Arguments (Part III)' (1998) 11 *Intertax* 393, 394 ('Vogel–Part III').

4 The arguments relating to the non-acceptance of the sacrifice theory are not centrally relevant to the present discussion (which is concerned with benefit theory) and are therefore not further considered. The details of these arguments can be found in the writings of Vogel: Ibid 394-5.

5 Charles E McLure Jr, 'Source-Based Taxation and Alternatives to the Concept of Permanent Establishment' in Canadian Tax Foundation (ed), *2000 World Tax Conference Report* (2000) 6:4.

6 Thomas S Adams, 'The Taxation of Business' in *Proceedings of the Eleventh Annual Conference on Taxation, National Tax Association* (1917) 185-94, at 186, cited in Michael J Graetz and Michael M O'Hear, 'The "Original Intent" of US International Taxation' (1997) 46 *Duke Law Journal* 1021, 1036.

7 Arthur Harding, *Double Taxation of Property and Income, A Study in the Judicial Delimitation of the Conflicting Claims of Taxing Jurisdiction Advanced by the American States* (1933), cited in Klaus Vogel, 'Worldwide vs Source Taxation of Income – A Review and Re-evaluation of Arguments (Part I)' (1988) 8-9 *Intertax* 216, 220 ('Vogel–Part I').

> We see that the economic existence, nature and function of the State is to be found in this economic mechanism functioning within its territorial limits and contributing to the life, progress and happiness of the individual members of the group and, of necessity, of the group as a whole.[8]

Harding then developed his theory regarding a country's right to tax that is reminiscent of the benefit principle:

> It appears that the State may tax all property, goods, labor, services and the like, which have become identified with the economic structure of the State, by incorporation into or integration with the business mechanism so defined … the right to tax then depends upon the fact that the economic wealth is being used in the coordinated economic task of the social group; that it is producing utility or wealth or service in connection with, as a part of, and because of the economic solidarity of the social group.[9]

Benefits that may be provided by source countries can either be general or specific. In terms of general benefits, education (which relates to the availability and level of labour), police, fire and defence protection represent obvious examples. However, apart from these general benefits, there are more specific benefits that source countries may provide, including a conducive and operational legal infrastructure for the proper functioning of business. Allied with this may be specific government policies, such as keeping exchange rates stable and interest rates low, thereby providing economic stability and business and consumer confidence.[10] Most of these general and specific benefits would be equally (if not more) relevant in an electronic commerce context – this will be explored in more detail when the applicability of the benefit theory in an electronic commerce context is analysed.

Source-country taxation is consistent with the benefit theory. Vogel has argued that as it is usually the country of source that has provided most or all of the benefits relevant for the production of income and therefore incurred costs in providing these benefits, exclusive taxation should occur in the source country as compensation to the government bearing them.[11] Georg von Schanz based his views of international income on quite similar views.[12] Schanz has showed that both the country of residence and the source country can justify a tax claim on the grounds of services (benefits)

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8 Ibid, as quoted in Vogel–Part I, above n 7, 221.

9 Ibid.

10 See, eg, Reuven S Avi-Yonah, 'International Taxation of Electronic Commerce' (Spring, 1997) 52 *Tax Law Review* 507, 520 (arguing that benefits such as these justify source-based corporate taxation in the sense that the source country's government bears some of the costs that are necessary for earning the income and should therefore be compensated for incurring them).

11 Vogel–Part III, above n 3, 398 (observing that, 'The only valid legitimation, therefore can be derived from benefit aspects. Usually it is the state of source that has provided most or all of the benefits relevant for production of the income.').

12 Many of the views on the taxation of foreign income, as far as they are relevant today, can be traced back to Georg von Schanz: Vogel–Part I, above n 7, 218.

provided, but Schanz has argued that the share of services provided by the source state is typically higher than that provided by the state of residence.[13]

The reasoning of Schanz in reaching his views on the primacy of source-based taxation is essentially founded on benefit theory. In his view, residence is *not* a valid criterion for establishing tax liability nor is mere physical presence in a territory, because these criteria 'lead to taxing people who get no benefit or who at best get only a partial benefit from a State's activities.'[14] From this base, Schanz argues that only one principle, 'economic allegiance', can result in a fair distribution of tax burdens and he expresses his views of this principle in terms of benefit theory:

> I want to emphasize that indeed **there is no tax for which no benefit relation relates** … after the circle of taxable persons has thus been determined … society may say: **each person economically bound to me is taxed** …[15] (emphasis added).

Schanz then concludes that where a person is economically bound to his or her state of residence, and also to a source state through business activities (or by way of income arising in that other state), the allegiance to the source state is more important than that to the state of residence.

In considering the applicability of the benefit principle to justify source-based taxation in an electronic commerce context, a question that needs to be addressed is whether source countries should be limited to taxing the income of non-resident businesses only in situations where such businesses have a physical presence[16] in the country of source. That is, in an electronic commerce context, the issue that needs to be analysed is whether the benefit theory is only compatible with having a physical presence in the country of source. This is important since electronic commerce affords businesses the facility to earn profits from interacting with source countries *without* requiring them to maintain a physical presence in the country of source.

In a traditional context, McLure argues that taxation based on the benefit principle suggests that a physical presence is *probably* needed to establish tax nexus for source-based taxation.[17] This is because many of the services described earlier (eg, police

13 Ibid 219, Vogel– Part III, above n 3, 395 (noting that Schanz suggested that the source state should levy three-fourths of the tax that it would ordinarily levy on residents and the state of residence should levy one-fourth of the tax it ordinarily would levy on the domestic source income of non-residents, and further observing that it is a pity that Schanz's proposed division of taxing rights between residence and source countries has almost never been put into practice).

14 Vogel–Part I, above n 7, 219 (arguing further that a burden would be imposed on people if these criteria were used to the advantage of those who would fully benefit from a State's activities and in Schanz's view this would be unfair).

15 Ibid (citing Schanz).

16 The term 'physical presence' is used intentionally here instead of the treaty concept of 'permanent establishment' to avoid addressing the issue of whether a permanent establishment is the proper test of physical presence. This is a matter that relates to the *way* source is defined which is outside the scope of this paper. For present purposes, the main issue is whether the principles that underlie source-based taxation (including benefit theory) are applicable in an electronic commerce context.

17 McLure, above n 5, 6:5.

and fire protection) that benefit businesses which provide tangible goods and services would only be available and relevant in the case where such businesses maintain a physical presence in source countries. An important issue raised by electronic commerce is where income should be regarded as being generated, if all the value of what is sold is created in the residence country but the customers that determine that value are in the source country. In such cases, from an economic perspective, the only contribution of a source country would often only be its customer base or market. In this context, it could therefore be argued that source countries provide little or no benefits relevant to the production of income that would justify source-based taxation under the benefit principle.

This argument can, however, be challenged on two grounds. First, Skaar provides support for the view that even if a business does *not* have a physical presence in the source country it benefits *substantially* from its infrastructure and therefore *should* make a contribution to the source country, consistent with the benefit theory of taxation. According to him:

> **A [permanent establishment] is merely a piece of *evidence* of economic allegiance, not the reason for source-state taxation.** The circumstance that short-term business operations may accumulate substantial profits from domestic sources indicates on the contrary that the taxpayer benefits substantially from the infrastructure of the host country, even though no [permanent establishment] exists. It seems that an enterprise which does not need to invest in immovable facilities, or other fixed places of business, may still derive considerable advantages from the community in which its income sources are located. Today, the performance of a business activity in another country, the duration of the activity and the profits arising from it, are *per se* significant arguments …[that] requires **all enterprises which obtain such benefits from a country to render a corresponding contribution to this society, whether or not they have a [permanent establishment].**[18] (emphasis added).

Second, despite possible claims by non-resident businesses which have no physical presence in source countries that they therefore derive no benefits from these countries, it is argued that source jurisdictions *do* provide significant benefits to companies that carry on business activities with them, even in the absence of a physical presence. Apart from Skaar's analysis noted earlier, non-resident companies that do not maintain a physical presence in source countries nevertheless benefit from the source country's legal system inasmuch as they rely upon it to enforce payment for transactions, uphold intellectual property rights (eg, trademarks), and maintain a pro-competitive and conducive business environment. Indeed, the protection of intellectual property rights (eg, in the case of computer software) is critical to vendors of intangible products and digitised services and the protection of these rights arise independently of the need for any physical presence to be maintained in the source country. Likewise, vendors of digitised content (including music and computer

18 Arvid A Skaar, *Permanent Establishment: Erosion of a Tax Treaty Principle* (1991) 559-60 (framing his concept of the benefit principle in what he refers to as the 'equivalence principle', which he argues requires all enterprises which obtain benefits from a country to render a corresponding contribution to that country, whether or not they have a physical presence in that country).

games) would not have a market in source countries that did not have a suitable telecommunications infrastructure or whose population lacked competency in computers. The provision of these benefits therefore adds weight to the case for source-based taxation under the benefit principle, *even* in the absence of a physical presence in a source country.[19] Further, source countries would need to provide for the waste disposal for packaging materials, consumer protection laws and an infrastructure upon which delivery vehicles can travel (in the case of physically delivered electronic commerce products),[20] and the provision of these benefits strengthens the case for the source-based taxation of electronic commerce transactions.

Therefore, in an electronic commerce context, as benefits would be provided to non-resident vendors even though they may lack a physical presence in source countries, it is arguable that the costs of providing these benefits should justify the right for source countries to tax the resultant income (or at least part of it) under the benefit principle. In other words, it is arguable that the benefit principle continues to justify source-based tax even in an electronic commerce context, where business may be conducted in source countries by non-resident vendors without the need for these vendors to maintain a physical presence in the source country.

B. Neutrality

Neutrality is a fundamental tax policy principle. Essentially, neutrality requires that economic processes should not be affected by external influences such as taxation. In this way, it is argued that 'productivity will be the highest when income producing factors are distributed by [the] market mechanism without public interference.'[21] Therefore, neutrality essentially relates to the concept of efficiency and tax laws which do not interfere with factor distribution by market forces are normally regarded as being 'neutral'.[22]

The principle of neutrality in an international context is normally considered within two dimensions of neutrality: capital export neutrality ('CEN') and capital import

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19 McLure, above n 5, 6:13 (n 28). India has recently released a report on electronic commerce, where it is asserted that value is not created only in the seller's country, but also arises from demand in the buyer's country: 'The Committee is also unable to accept that value-addition takes place only where manufacturing or marketing is done and that the customer base does not create any value-addition. Customer base creates demand. Without demand, there will not be any value': Ministry of Finance, *Report of the High Powered Committee on E-Commerce and Taxation* (2001), <http://www.laws4india.com/indiantaxlaws/notification/ecomcontent.asp> ('Indian Electronic Commerce Report'), cited in David Hardesty, 'India to Go Its Own Way?' (13 February 2002), <http://www.ecommercetax.com/doc/021002.htm>.

20 Ibid 6:6 (observing that 'mail order sales of tangible products may [likewise] place demands on public services').

21 Klaus Vogel, 'Worldwide vs Source Taxation of Income – A Review and Re-evaluation of Arguments (Part II)' (1988) 10 *Intertax* 310 ('Vogel–Part II').

22 Ibid (noting that tax laws will never be completely neutral, but as far as efficiency is desirable, a high degree of neutrality should nevertheless be sought).

neutrality ('CIN'). However, apart from this traditional distinction, the literature reveals a trend to extend the traditional analysis to explore the concept of inter-nation neutrality, especially when neutrality is considered in an international context. This development has been largely influenced by the writings of Vogel.[23] For convenience, the ensuing analysis will be separately conducted under the headings of CEN/CIN and inter-nation neutrality, reflecting the way the subject has developed in the literature.

1. Capital Export Neutrality and Capital Import Neutrality

Richard Musgrave has been credited as being the first to distinguish between capital export and capital import neutrality.[24] According to his definition, 'export neutrality means that the investor should pay the same total (domestic plus foreign) tax, whether he receives a given investment income from foreign or from domestic sources … Import neutrality means that capital funds originating in various countries should compete at equal terms in the capital market of any country.'[25] Vogel has observed that export neutrality consequently implies a system of worldwide taxation with a foreign tax credit, while import neutrality implies a system of exemption, that is, of source-based taxation.[26]

The issue then becomes one of whether capital export neutrality is to be preferred over capital import neutrality. Richard Musgrave was not certain whether capital export neutrality should be preferred over capital import neutrality when he suggested the distinction, though Vogel notes that since the distinction was originally made, Peggy Musgrave has argued for priority for capital export neutrality, as she maintained that inter-nation neutrality was an impossible goal, given the differences in national tax structures and rates as well as in the benefits provided.[27] The rationale for Musgrave's preference for capital export neutrality will be examined later when the arguments in favour of capital import neutrality are analysed. However, before these arguments are detailed, the case for capital export neutrality (which favours residence-based taxation) will first be discussed.

23 Ibid 313. See also, Klaus Vogel, *Taxation of Cross-Border Income, Harmonization, and Tax Neutrality under European Community Law: An Institutional Approach* (1994) 21.

24 Vogel–Part II, above n 21, 311.

25 Ibid (citing Richard Musgrave, 'Criteria for Foreign Tax Credit' in *Taxation and Operations Abroad, Symposium* (1960) 84-85).

26 Ibid.

27 Ibid. See also, Vogel, above n 23, 22 (n 32) and references cited therein.

Preferences for capital export neutrality can be found in the literature relating to neutrality.[28] If this preference is maintained,[29] then it is arguable capital-export neutrality is best achieved by adopting a residence-based tax system. This is because such an approach seeks to tax all investors at their residence country rate, irrespective of where such income was earned. With countries adopting varying rates of tax, this approach arguably serves the goal of capital-export neutrality best as the tax applicable to international income would equal the tax on domestic income in the capital-exporting country and therefore export neutrality would result.

In terms of efficiency, McLure argues that if all nations implement a residence-based tax system, it would lead to the allocation of the world's capital to its most productive use.[30] Conversely, source-based taxation, he argues, would lead to an inefficient allocation of economic resources as it 'discourages investment in high-tax jurisdictions and encourages investment in low-tax jurisdictions.'[31]

Finally, though capital-export neutrality could be achieved under a source-based tax system through the use of a foreign tax credit, because many countries apply a restricted tax credit system,[32] it would arguably only be practically achievable to the extent that foreign rates of tax were less than domestic rates.

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28 See, eg, Charles McLure Jr, 'Substituting Consumption-Based Direct Taxation for Income Taxes as the International Norm' (1992) 45 *National Tax Journal* 145, 146-7, 153 (n 13) (explaining that capital-export neutrality is necessary to achieve an efficient allocation of the world's investments, while capital-import neutrality is necessary for an efficient allocation of savings, considered to be a less significant goal); Vogel–Part II, above n 21, 311 (observing that Peggy Musgrave has argued for a priority of capital export over capital import neutrality: 'it is generally correct as well to conceive of a tax neutrality with respect to all investors of one country, so that tax considerations will not influence their decisions to invest at home or abroad. Such capital-export neutrality will ensure that each national supply of capital available at that tax level will be allocated internationally in its most efficient manner'). Vogel also refers to other commentators who have supported this view, including Richard Musgrave and Bernard Snoy, with Snoy stating that: 'in a world where capital markets are perfect and where the financing of corporate investment projects is not subjected to internal funds constraint, tax neutrality towards capital import is clearly not a prerequisite for efficient allocation of resources': Ibid (citing Bernard Snoy, *Taxes on Direct Investment Income in the EEC, A Legal and Economic Analysis* (1975) 37); Ibid (noting that further support for capital export neutrality can be found in Sato and Bird, 'International aspects of the Taxation of Corporations and Shareholders' (1975) 22 *IMF Staff Papers* 408 ('only capital-export neutrality accords with the objective of world efficiency')).

29 It is has been argued that the capital-export neutrality versus the capital-import neutrality debate is less significant and relevant in a globalising economy: see, eg, Daniel J Frisch, 'The Economics of International Tax Policy: Some Old and New Approaches' (1990) 47 *Tax Notes* 581.

30 Charles E McLure Jr, 'US Tax Laws and Capital Flight from Latin America' (1989) 20 *University of Miami Inter-American Law Review* 321, 325.

31 Ibid.

32 Many countries, including the United States, operate a restricted foreign tax credit system. This is for many reasons, including the concern that to grant a full credit for taxes paid in other countries where foreign rates exceed domestic rates may operate as a subsidy arrangement for one country. However, by operating under a restricted foreign tax credit system, pure capital-export neutrality cannot be achieved.

In summary, the main argument in favour of capital export neutrality rests on the concept of worldwide economic efficiency – the belief that 'only capital export neutrality comports with the goal of economic efficiency, i.e. of allocating production factors in such a way that productivity will be (Pareto-) optimal.'[33]

However, it is arguable that, to the non-economist generally and to businesses in particular, capital import neutrality is preferable as it relies on considerations of international competitiveness rather than theoretical economic efficiency. Further, from the perspective of a vendor that sells products in a foreign country, it might be considered more equitable to be taxed in that country at the same level as other competing businesses in the foreign country, particularly if the level of tax is lower in the foreign country than in the vendor's home country. Considerations of international competitiveness may be especially important and relevant in an electronic commerce context given the increased mobility of business activity that electronic commerce offers. In this sense, inter-nation neutrality would require that a taxpayer who conducts business in another country, and thus utilises the other country's facilities (public goods), should be taxed at no more than anyone else, who, under the same circumstances, uses these facilities to the same extent.[34] In other words, if benefits are utilised by a non-resident business operator, then it is arguable that the non-resident operator should not be taxed at any more than anyone else who uses these facilities to the same extent and this outcome would be compatible with capital import neutrality and taxation in the country of source.

Apart from international competitiveness considerations suggesting taxation at source under the principle of capital import neutrality, the preference for capital export neutrality that has traditionally been evident in the literature has been challenged and, on the basis of these challenges (which suggest that capital import neutrality should prevail), it may be argued that source-based taxation should be preferred over residence-based taxation. It is therefore instructive to review these challenges.

Otto Gandenberger, in a 1983 paper, put forward three arguments, contrary to what has been argued in the literature, in favour of capital export neutrality.[35] First, if a residence system of taxation is employed where the rate of tax in the residence country is higher than the source country, Gandenberger argued that a reduced after-

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33 Vogel, above n 23, 22.

34 At the same time, one may question what benefits are utilised by a non-resident business operator in an electronic commerce context, and the specific issue of benefits was examined earlier and will be returned to when the concept of inter-nation neutrality is analysed later in this paper. For now, it may be briefly stated that a non-resident business operator in an electronic commerce environment would still utilise public goods and services in the source country, including the legal system (eg, to protect intellectual property including copyrights in software delivered digitally) as well as the transport infrastructure (eg, for products ordered on-line but delivered by conventional means).

35 Vogel–Part I, above n 7, 222 (citing Otto Gandenberger, 'Kapitalexportneutralität versus Kapitalimportneutralität. Allokative Überlegungen zu einer Grundfrage der internationalen Besteuerung. Aufsätze zur Wirtschaftspolitik' (1983) Nr. 7. Mainz: Forschungsinstitut für Wirtschaftspolitik.); Vogel, above n 23, 23. What follows on this point is adapted from these sources.

tax profit would reduce the chance of an enterprise to finance new investment in the source country. This is because such an enterprise would have to anticipate a higher overall tax burden than its competitors in a lower taxed country (because of taxation in the residence country) and it therefore could be influenced in its decision (made in the residence country) whether to invest in the country of source. This outcome would be contrary to capital export neutrality being achieved. Second, Gandenberger argued that the level of taxation in any country is likely to correspond to the level of public goods provided, so that a country providing less public goods will often have a lower tax rate than one providing more public goods. If this is true and if the country of source has a lower tax rate than the residence country, an enterprise's decision whether to invest in the lower taxed country could be affected since it would receive less public goods in the lower taxed country than the country of residence, yet it would be subjected to the higher residence country's tax rate.[36] Finally, Gandenberger shows that contrary to what has been written in favour of capital export neutrality, source state taxation *is* adopted by many countries, particularly in cases of deferral.[37] Based on these arguments, Gandenberger concluded that, contrary to prevailing economic theory, capital import neutrality should be preferred over capital export neutrality, implying taxation by source countries.

Other prominent economists, including Leif Mutén, have similarly argued in favour of the advantages of source state taxation and the disadvantages of a residence-based tax system, particularly in the case of developing countries.[38] Norman Ture has advanced the arguments by trying to redefine neutrality as meaning 'that the taxation does not alter the (explicit or implicit) relative prices of goods, services, activities, production inputs, and so forth, in the private sector.'[39] According to him, this definition means that 'neither country will attempt to use its fiscal powers to change relative prices in the other country, any more than it would in the absence of taxes.'[40] From this, Ture argues that residence-based taxation distorts neutrality (as formulated by him), and therefore is inconsistent with economic efficiency. He further argues that only exclusive taxation by source countries and exemption by residence countries will

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36 In other words, an enterprise investing in a lower-taxed source country would be paying a premium to do so as it would receive less public goods in the country of source compared with those it would receive in its country of residence, yet it would still be subjected to a higher residence country rate of taxation.

37 Vogel–Part I, above n 7, 221 (pointing out that Latin America has traditionally emphasised source-based taxation in its income tax laws); Ibid 222 (further observing that the International Chamber of Commerce adopted a resolution in 1955 to the effect that source countries should have the 'sole right' to tax international income. Vogel also gives the example of the International Fiscal Association, which in congresses held in 1961 and 1984, affirmed its support for source-based taxation).

38 Leif Mutén, 'Some Topical Issues Concerning International Double Taxation' in Sijbren Cnossen (ed), *Comparative Tax Studies. Essays in Honor of Richard Goode* (1983). Thomas Horst and Sijbren Cnossen have likewise questioned the preference given to capital export neutrality, claiming, *inter alia*, that it restrains international investment: both cited in Vogel, above n 23, 24.

39 Vogel, above n 23, 24.

40 Ibid.

yield a neutral outcome as it is only such a system that would leave the international flow of capital and commerce unaffected.

Hence, apart from international competitiveness considerations favouring capital import neutrality and therefore source-based taxation, from the economic perspective, a similar conclusion may be reached. Ture's analysis, discussed above, shows that export neutrality can distort relative prices. This supports import neutrality, as do the arguments put forward by Gandenberger, who concludes that a residence-based system would be non-neutral and therefore inefficient. Others, including Barry Bracewell-Milnes and J D Foster have reached similar conclusions, strengthening the arguments in favour of capital import neutrality and therefore taxation based on source.[41] Hence, if the distinction between export and import neutrality is to be maintained, it is argued that preference should be accorded to import rather than export neutrality, thereby favouring source-based taxation. Finally, for the reasons detailed earlier, including considerations of international competitiveness, it is further contended that this analysis would be equally (if not more) applicable in an electronic commerce context.

2. Inter-Nation Neutrality

The above analysis has assumed that the distinction between export and import neutrality will remain. However, it is timely to re-examine the distinction, particularly in an international context and support for this re-examination can be found in the literature.[42] Vogel posits that in an international setting, the question to be raised to achieve neutrality is 'what preliminary conditions must exist in *each* of the countries concerned to prevent the *combined* effect of their tax laws from favouring investment in one of these countries.'[43] That is, Vogel suggests looking for a concept of neutrality *between* countries or inter-nation neutrality.

Such an idea has been suggested previously by others including Norman Ture; however, Peggy Musgrave and others considered it impossible to formulate a concept of inter-nation neutrality because of their belief that the differing structures and levels of taxation that countries maintained created an inherently non-neutral position that presented an insurmountable obstacle to any notion of inter-nation neutrality.[44] Ture

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41 Both cited in Vogel–Part I, above n 7, 222 (noting that Foster's analysis supported Ture's arguments that residence-based taxation distorts relative prices, while Bracewell-Milnes compared the effect of international trade to the prohibitive consequences of customs duties and described such systems to be 'fiscal imperialism').

42 See, eg, Frisch, above n 29, 581 (arguing that the distinction between import and export neutrality may be less relevant in a globalising economy); McLure Jr, above n 5, 6:12 (n 21) (observing that capital export and capital import neutrality are mutually compatible only if tax rates (and the definition of income) are identical in source and residence countries).

43 Vogel–Part II, above n 21, 313.

44 Ibid 311 (noting that Peggy Musgrave discarded the idea of an 'international fiscal neutrality' because she argued that it is virtually impossible to attain, given the differences in national tax structures and rates as well as the benefits provided.).

sought to overcome Musgrave's reservations by arguing that neutrality should be framed in terms of its effect on relative prices – that is, that taxation should not alter the relative prices of goods and services.[45] Viewed in this way, inter-nation neutrality *is* sustainable and means that 'neither country will attempt to use its fiscal powers to change relative prices in the other country, any more than it would in the absence of taxes.'[46] Ture then rejects worldwide taxation and argues for source-based taxation, contending that this would be consistent with inter-nation neutrality.

Vogel puts forward a similar argument, but for different reasons. Vogel suggests that the concept of inter-nation neutrality is feasible if one considers not just taxes but extends the analysis to include other burdens, such as transaction costs, as well as benefits, since to an investor these additional considerations are as important as the level of taxation between countries.[47] Vogel's rationale relates back to the concept of efficiency which underlies the concept of neutrality. As mentioned earlier, efficiency is achieved if economic processes are unimpaired by state influences. Vogel argues that these influences should not only include taxes, but should include other burdens (eg, transaction costs) and benefits and such an argument has much merit. For example, under Vogel's theory, if taxes between two countries are equal but the benefits in the second country are greater, than other things being equal, it can be expected that an investor will choose the second country in preference to the first. Conversely, if benefits in two countries are identical, but taxes and transaction costs are lower in the first country, then one can expect an investor to prefer this country.

Vogel therefore argues that the reference base for establishing neutrality should not be taxes in isolation but the *total* state influence, which includes taxes, transaction costs and benefits. At the same time, as the relation of benefits and burdens between countries will not be the same, Vogel creates a concept that he calls 'administrative net output' which represents the surplus of the total value of state-provided benefits and services over state burdens (including taxes and transaction costs). He then argues that all things being equal, there will be a tendency to invest in countries where the administrative net output is advantageous to the investor and concludes that only source-based taxation can comport with the principle of inter-nation neutrality:

> Inter-nations neutrality then means than this relation must not be altered to the disadvantage of persons investing in foreign countries. In other words, *inter-nations neutrality* requires that *a taxpayer who conducts an enterprise in another country–or market–and thus utilizes the other country's facilities (public goods) can be sure of being taxed no more than anyone else who, under the same circumstances, uses these facilities to the same extent.* This can be achieved only by restricting each country to taxing income from domestic sources. Worldwide taxation is inconsistent with this neutrality principle.[48]

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45 Norman Ture, 'Taxing Foreign Source Income', in *US Taxation of American Business Abroad* (1975) 38, cited in Vogel–Part I, above n 7, 222.

46 Ibid 39.

47 Vogel, above n 23, 25 ('a complete analysis should consider not only taxes, or more broadly state-imposed burdens, but also state-provided benefits, because those are their counterparts that cannot be isolated from such burdens and which are of similar importance to the investor').

48 Vogel–Part II, above n 21, 314.

In considering the applicability of Vogel's conclusions in favour of source-based taxation in an electronic commerce environment, it is relevant to examine the nature of the benefits and transaction costs that are central to his reasoning for inter-nation neutrality. In a traditional context, the benefits to be taken into account in determining inter-nation neutrality could include security, economic stability, infrastructures and direct subsidies, as well as the level of public health, of public education (which impacts on the supply and quality of labour) and information.[49] These benefits would be no-less relevant in an electronic commerce setting, and indeed some benefits, such as protection to be afforded to intellectual property rights, as well as those flowing from secure financial systems may assume greater importance than in a traditional context.

In terms of transaction costs, Matthews observes that they consist of 'the cost of arranging a contract *ex ante* and monitoring and enforcing it *ex post*, as opposed to production costs, which are the costs of executing a contract.'[50] Vogel suggests that transaction costs are determined by the total legal environment of an enterprise and should include not only costs that relate to a contract (or product), but extend to general costs of transactions that are incurred by a business including the cost of information, as well as costs of legal protection, public security, efficiency of administrative agencies and services provided by them as well as costs associated with a stable business and monetary environment.[51] Again, many of these transaction costs, including especially legal costs, information costs and a stable business and monetary environment, would be equally applicable in an electronic commerce context and hence the ensuing analysis should also be applicable to electronic commerce transactions.

If transaction costs are taken into account in determining economic efficiency, it can be argued that capital export neutrality (which supports residence-based taxation) is an unattainable ideal since a residence country cannot ensure that investments, wherever made by its residents, are subject to the same transaction costs in foreign countries where such investments are made.[52] By contrast, capital import neutrality (which supports source-based taxation) would be attainable as foreigners would be subjected to the same transaction and production costs in the country of source as would apply to local enterprises and if no additional burdens were imposed by the residence country on the foreign investor, then competition between local and foreign enterprises in the state of source would be equal, unobstructed and therefore neutral.[53] Therefore, in light of the preceding analysis, it can be argued that source-

49 Ibid 313. See also, the discussion of benefits under the 'Benefit Theory' heading earlier in this paper.

50 R C O Matthews, 'The Economics of Institutions and the Sources of Growth' (1990) 96 *Economic Journal* 903, cited in Vogel, above n 23, 26 (n 44).

51 Ibid.

52 Ibid 27 ('[The residence] state has no influence whatsoever on transaction costs and on other state-induced costs incurred by the foreign investment').

53 Vogel notes, however, that in order for a source-tax system to be truly neutral, it is not taxation alone but the aggregate of state-induced costs and benefits which must fall on investments by residents and foreigners equally: Ibid 28.

based taxation of international electronic commerce transactions can also be justified under the principles of tax neutrality.

C. Equity

Apart from considerations of neutrality, equity is another fundamental tax policy principle. In a tax context, equity considerations which refer to the position of individual taxpayers (individual or taxpayer equity) are normally distinguished from those which refer to the gain and loss of the country of residence and the country of source (inter-nation equity), and Vogel credits Peggy Musgrave for being the first person to make this distinction.[54] The analysis which follows will be conducted separately under the headings of individual and inter-nation equity, consistent with this distinction.

1. Individual Equity

Musgrave rationalises individual equity on the basis of equality, arguing that 'all residents of a certain country who enjoy the protection and other privileges provided by the government of that country … should be taxed by that country at rates equal for all those receiving equal income from whatever source, be it domestic or foreign.'[55] Normally, individual equity is considered in terms of horizontal equity (similarly positioned taxpayers should be taxed similarly) and vertical equity (taxpayers who have higher incomes should pay a correspondingly higher amount of tax).

Doernberg *et al* suggest that considerations of individual equity support *both* source and residence-based taxation. In relation to source-based taxation, they suggest that the principle of individual equity justifies source country taxation of domestic source income derived by non-residents.[56] They also argue that the principle of individual equity justifies residence-based taxation of worldwide income earned by residents. This is on the basis of accepting the argument that taxpayers that earn domestic income should pay the same amount of tax as a similarly situated taxpayer who earns the same amount of income from foreign sources.

Vogel, however, puts forward a contrary view, contending that considerations of individual equity favour *only* source-based taxation, on the basis that 'world-wide taxation by the country of residence may be unjust to the taxpayer who has earned his income in other countries, possibly under adverse conditions, and [further] that residence country taxation is unjust to the source country because it disrupts the source

54 Vogel–Part III, above n 3, 394.

55 Ibid, citing Peggy Richman (now Musgrave), *Taxation of Foreign Investment Income: An Economic Analysis* (1963) 11.

56 Doernberg *et al*, *Electronic Commerce and Multijurisdictional Taxation* (2001) 69 ('For example, under this principle, a resident of Country R [the residence country] and a non-resident earning the same amount of profit from the same type of business activities in Country R should be taxed the same').

country's tax policy decisions.'[57] More specifically, Vogel makes his case on the grounds of legitimation, equality, integrity and redistribution, which he contends, supports exclusive taxation of foreign direct investment income in the country of source.[58] These arguments will be briefly summarised as they are germane to establishing to the rationale for source-based taxation on the grounds of individual equity.

In terms of legitimation, Vogel claims that a tax claim can only be considered equitable if the transaction or event, by the state in question, is legitimate–that is, can be justified. He then uses benefit theory[59] to support his conclusion that source-country taxation is to be preferred on the grounds of legitimation. While legitimation looks to the relationship between a taxpayer and a state, equality looks to the relationship of taxpayers toward each other, and Vogel argues that taxpayers who receive foreign income must be compared not only to similarly situated taxpayers in their country of residence, but to competitors in the source country. Extending the analysis, if tax rates are lower in the country of source than in the residence country, then taxation in the country of residence at its higher rate would be contrary to achieving equality in the source country, even in the case where the residence country credits foreign taxes. In addition, even if a case can be made on the grounds of equality for taxing foreign income at the same rates as domestic income, it can only be regarded as a convincing conclusion with regard to that part of foreign income that has been repatriated to the residence country. This is because '[v]ery often foreign income will be reinvested in the enterprise in the source state; it may even be difficult to withdraw it. In such cases the recipient of foreign income is in quite a different situation than the recipient of a comparable amount of domestic income.'[60] Therefore, equality considerations would *only* be fully consistent with a limited worldwide taxation with a credit–limited to remitted income; they are *not* consistent with the taxation of unremitted income for the reasons provided above.

Apart from legitimation and equality that are most relevant to considerations of individual equity, Vogel puts forward considerations of integrity and redistribution to strengthen his arguments for source-based taxation on individual equity grounds.[61] It is contended that the preceding arguments which support source-based taxation on the grounds of individual equity considerations would be no less relevant in an electronic commerce context. Further, in an electronic commerce context, tax equity may also mean that taxpayers that are engaged in traditional commerce should be treated the same as those who engage in electronic commerce, although this could be a consideration that also relates to tax neutrality.

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57 Vogel–Part I, above n 7, 222 (referring to the German legal experts Hans Flick, Klaus Tipke, Arno Schulze-Brachmann and Horst-Walter Endriss, all of whom have defended this view).

58 Vogel–Part III, above n 3, 394. What follows on this point is adapted from this source.

59 The benefit theory has been detailed earlier in this paper and accordingly will not be repeated here.

60 Vogel–Part III, above n 3, 396.

61 Ibid 397. Arguments based on integrity and redistribution are not detailed here as they are not considered central to the present discussion.

2. Inter-Nation Equity

Apart from individual equity, in an international context, inter-nation equity needs to be considered. Under the principle of inter-nation equity, each country should receive an equitable share of tax revenues from cross-border transactions.[62] An equitable division of tax revenue depends on (a) the allocation of the tax base between the source and residence country, and (b) the tax rate in the source country.[63]

Vogel argues that inter-nation equity tends to strongly favour taxation by the country of source.[64] This is because traditionally it is the country of source that has provided most or all of the benefits relevant for production and without the source country's economic opportunities (ie, market) the income would normally not have been generated. At the same time, however, Vogel accepts that a certain integration of the seller's activities into the economy of the source country is necessary before source country taxing rights arise.[65] This has traditionally been evidenced by the existence of a permanent establishment, or satisfaction of the 'trading within' concept for common law countries. As electronic commerce allows vendors to sell products to consumers in source countries without such integration or physical presence in the source country, it therefore calls into question the taxing right of a source country over income which arises from electronic commerce transactions. However, even if such integration has not occurred, Vogel argues that taxation by the source state *must* be considered under the principle of inter-nation equity:

> It cannot convincingly be denied that providing a market contributes to the sale income at least to some extent as providing the goods does. There is no valid objection, therefore, against a claim of the sales state to tax part of the sales income.[66]

This line of reasoning therefore supports the continued taxation in source countries of income that arises from international electronic commerce transactions. Indeed, over time, countries have asserted their right to tax income received from sales to their residents, reasoning that this income would not have been earned but for the market that they provide. An argument of this nature would seem to be especially strong in cases where customised or made-to-order products are involved, for such products would simply not be made without the market provided. Similar considerations would therefore seem to be applicable and relevant in an electronic commerce context, thereby suggesting the continued application of source-based taxation under the principle of inter-nation equity. Finally, it is relevant to note that the OECD has expressly accepted that one of the tax framework conditions that should govern the taxation of electronic commerce transactions includes the principle of inter-nation equity:

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62 Nancy H Kaufman, 'Fairness and the Taxation of International Income' (1998) 29 *Law and Policy in International Business* 145.

63 Peggy Musgrave, *United States Taxation of Foreign Investment Income* (1969), Chapter VII, cited in Doernberg *et al*, above n 56, 69.

64 Vogel–Part III, above n 3, 398.

65 Ibid 401.

66 Ibid. See also, Indian Electronic Commerce Report, above n 19.

> … [A]ny adaptation of existing international taxation principles should be structured … to achieve a fair sharing of the tax base from electronic commerce between countries …[67]

D. Entitlement

Another rationale for source-based taxation is based on the concept of 'entitlement'– the view that the source country is entitled to tax income that arises within its geographic borders, even if that income accrues to non-resident taxpayers. The entitlement view of taxation is usually associated with Peggy Musgrave who contends that the source country should be entitled to tax income originating within its borders because it is the source country as the 'place of income-generating activity'[68] rather than the country where the income-producer resides (ie, the residence country) that economically contributes to the production of income and therefore the source country should be compensated for its contribution. Musgrave further argues that according to entitlement theory, source countries should be entitled to tax income originating within their borders, since the countries where consumers reside provide services that are complementary to the consumption of their residents.[69]

Apart from these reasons, the right of source countries to tax income based on the entitlement view of taxation may be rationalised on several possible grounds. One is source-country taxation under a benefit rule; [70] another consists of a system of economic rents; and finally, taxation at source based on entitlement may be viewed as a fundamental right of source countries. Under a benefit view, it can be argued that source countries should be able to 'share in the gains of foreign-owned factors of production operating within its borders; gains which are generated in cooperation with its own factors, whether they be natural resources, an educated and/or low-cost workforce, or the proximity of a market.'[71] Other benefits that may be provided by source countries could include transportation facilities and infrastructure, which taken together with a company's own capital, would generate profits that the source

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67 OECD, 'Electronic Commerce: Taxation Framework Conditions' in OECD, *Taxation and Electronic Commerce: Implementing the Ottawa Taxation Framework Conditions* (2001), Annex 1, 228 ('OECD Taxation Framework Conditions').

68 Richard Musgrave and Peggy Musgrave, 'Inter-Nation Equity' in *Modern Fiscal Issues: Essays in Honor of Carl S Shoup* (1972) 71, cited in Richard Doernberg and Luc Hinnekens, *Electronic Commerce and International Taxation* (1999) 306 (n 641).

69 Peggy B Musgrave, 'Interjurisdictional Coordination of Taxes on Capital Income' in Sijbren Cnossen (ed), *Tax Coordination in the European Community* (1987) 198; Peggy B Musgrave, 'Principles for Dividing the State Corporate Tax Base' in Charles E McLure Jr (ed), *The State Corporation Income Tax: Issues in Worldwide Unitary Combination* (1984) 230.

70 It is useful at this point to note the difference between the benefit and entitlement theories. Benefit theory looks to the benefits of services provided to business by the government of a taxing country. However, the entitlement theory is based on economic benefits (eg, the benefits of exploiting a market), rather than public services which are more or less irrelevant under this theory: McLure, above n 5, 6:4.

71 Peggy B Musgrave, 'Sovereignty, Entitlement, and Cooperation in International Taxation' (2001) 26(4) *Brooklyn Journal of International Law* 1335.

country should be entitled to tax under a strict benefit rule.[72] In this sense, the tax revenues collected by source countries may be viewed as an economic rent for the leasing of complementary factors of production to non-residents, or alternatively, may be viewed as a '*quid pro quo* payment for cost-reducing, profit-enhancing services provided by the host country.'[73] (italics added).

Apart from a benefit view of entitlement, Kaufman suggests that another possibility is that under a system of economic rents, the source country could charge an economic rent on that part of a taxpayer's income which exceeds the amount of income the taxpayer would have earned on a domestic investment.[74] This view is especially persuasive in the case of taxes involving natural resources, particularly where such resources are privately owned and their exploitation results in economic rents where profits generated may be considered extraordinary in the sense of exceeding the normal rate of return on capital.[75] Apart from examples such as this, McLure suggests that the entitlement theory may be equally applicable in industries where profits are extraordinary for other reasons, as when there is significant market power.[76]

The final possible rationale for the principle of entitlement is the legal principle of territoriality in international law under which the source country has the competence to tax income resulting from activities occurring within its borders.[77] In this regard, Musgrave observes that the right of a jurisdiction to tax all income arising within its geographical borders is a fundamental entitlement that is reflected in most international tax treaties.[78]

In considering whether the principle of entitlement justifies the taxation of income from electronic commerce transactions in source countries, the issue of whether the entitlement principle allows for source-country taxation in the absence of a physical presence needs to be addressed, as electronic commerce allows for the possibility for business profits to be derived from source countries without the need for any physical presence to be maintained in these countries. The literature shows that the entitlement theory *does* support taxation in source countries even in the case of businesses that lack a physical presence in those countries if entitlement is based on

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72 Kaufman, above n 62, 191 ('A strict benefit rule would allow the host [source] country to impose a direct charge for the intermediate goods that the host country furnishes to the production process.').

73 Musgrave, above n 71, 1335.

74 Kaufman, above n 62, 191.

75 McLure, above n 5, 6:4 (Further suggesting that words such as 'heritage' and 'patrimony' are commonly used to justify the taxation on natural resources).

76 Ibid (citing the example of extraordinary profits and the right to tax them in the case of a company like Coca-Cola, but not in the case of commodities such as wheat).

77 Kaufman, above n 62, 192 (adding that '[t]he legal principle of territoriality, however, does not suggest the measure of the host country's entitlement' and proceeding to suggest that '[a] tempering of the territoriality principle might be found in the principle of non-discrimination, the principle that all activity occurring within the host country's borders should be taxed alike').

78 Musgrave, above n 71, 1335.

economic presence, rather than physical presence.[79] Given that physical presence can be largely insignificant for an electronic commerce transaction, economic presence may be a better indicator upon which source-country tax nexus may be based and there is a body of supporting literature for this proposition.[80] Economic presence in an electronic commerce context could be determined by reference to a regular and systematic direction of activities in a country. Determining whether activities amount to taxable nexus under this approach might depend on whether the activities of non-resident vendors were 'purposefully directed' at source-country customers, and according to Harris, this could be determined by asking the following three questions:

> Did the taxpayer 'purposefully avail' itself of the benefits of a taxing state? Did the taxpayer's conduct and operations in the taxing State rise to a level where it should have reasonably anticipated being haled into court? Were the taxpayer's in-state activities a continuous and systematic part of its general business in the state?[81]

These considerations draw from the experience with the level and nature of the connections providing the nexus necessary to authorise a state's authority to tax out-of-state mail order firms under the US state sales and use taxes and local income taxes and this experience may be useful if source-country entitlement is based on economic presence.

Proceeding with the analysis based on a business having an economic presence in an electronic commerce environment, McLure observes that since company taxes are usually based on accounting profits rather than economic profits (which includes the normal return to capital), it can therefore be argued that entitlement to tax a company's profits should exist any time such a company avails itself of the productive resources or the market of a country–that is, if it has an economic presence in the country.[82] Therefore, if entitlement is based on economic presence, the case for the

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79 See, eg, McLure, above n 5, 6:6 (supporting the proposition that the entitlement theory is conducive to taxation of corporations that lack a physical presence).

80 See, eg, Avi-Yonah, above n 10, 507 (advocating a change from physical presence to a gross income threshold for the purposes of determining source-tax nexus); Michael Lambooij, 'Rethinking Corporate Residence (Speech)', 6 June 1997, <http://www.lovotax.nl/lovotax/tax/document.html?doc_id=175>; Ernst & Young LLP, 'Logging on to Cyberspace Tax Policy: An Interactive Services Association Task Force White Paper' (1997) *Internet Services Association*, <http://www.isa.net/about/releases/taxwhpap.html>; Steven J Forte, 'A Cyberspace Perspective: Use Tax Collection on Internet Purchases: Should the Mail Order Industry Serve as a Model?' (1997) *John Marshall Journal of Computer & Information Law* 203 (suggesting economic presence replace physical presence for determining tax nexus).

81 As quoted in Luc Hinnekens, 'Looking for an Appropriate Jurisdictional Framework for Source-State Taxation of International Electronic Commerce in the Twenty-first Century' (1998) *Intertax* 26(6-7) 192, 198.

82 McLure, above n 5, 6:4.

taxation of remote vendors (even in the absence of a physical presence in source countries) would seem strong.[83]

In summary, the line of reasoning based on the entitlement theory and economic presence supports the taxation at source of income that arises from international electronic commerce transactions. At the same time, an important qualification to the argument presented is that economic presence would need to be *significant* before a business should be subject to tax in a source country.[84] There are many ways this could be achieved in an electronic commerce scenario. For example, liability for income tax could be made subject to a *de minimis* threshold test to avoid innumerable cases of limited liability in which only a little income is generated. For present purposes, the point being made is that source country taxation of profits that arise from international electronic commerce transactions *can* be justified pursuant to the entitlement theory – the mechanics of *how* source may need to be (re)defined to accommodate the characteristics of electronic commerce is a secondary consideration to theoretically establishing the proposition for the continuation of source-based taxation in an electronic commerce context.

E. Pragmatic Considerations, the Prospect of Double Taxation and Impediments to International Trade

The final rationale for source-based taxation is pragmatic: a source country is unlikely to forgo taxing income that arises within its boundaries. In his writings on the work of the League of Nations, Mitchell Carroll observed that taxation based on the source principle is widely applied, reflecting the desire of governments (particularly in developing countries) to tax foreigners.[85] Thomas S Adams, has expressed the pragmatic considerations underlying a source-country's right to tax in these words: 'Every state insists upon taxing the non-resident alien who derives income from

83 Ibid (adding that this argument would be valid whether such a vendor was selling tangible products delivered by traditional means, or intangible products or services provided over the Internet).

84 This qualification is grounded as much in common sense as it is in principle as it would not be sensible, both on administrative and compliance cost grounds, for source countries to levy an income tax on *all* vendors that have an economic presence, no matter how small their scale of activities were.

85 Mitchell B Carroll, *Prevention of International Double Taxation and Fiscal Evasion* (1939) 17 ('Governments are dominated by the desire to tax the foreigner, or in other words … taxes based on the idea of origin are … still very widely applied…'). See also, David L Forst, 'The Continuing Vitality of Source-Based Taxation in the Electronic Age' (1997) 15 *Tax Notes International* 1455 (citing the League of Nations: 'A survey of the whole field of recent taxation show how completely the Governments are dominated by the desire to tax the foreigner. It seems to be clearly instinctive that in laying down general principles to treat "origin" as of first importance and "residence" as of secondary importance').

source [sic] within that country, and rightly so, at least inevitably so.'[86] Vogel has expressed similar sentiments, observing that 'no country which levies an income tax (and very few do not fall into this category today) forgoes taxing domestic source income, irrespective of who has derived it.'[87] Apart from these statements, as a practical matter, since source countries typically have the first opportunity to collect taxes on payments derived from within its borders, it is difficult to prevent these countries from taxing these payments. Thus, even if other bases for taxation may be preferred on economic or theoretical grounds, they are unlikely to be followed in practice, especially in the case of business income that is derived from large markets, where there may be little fear that the non-resident business will abandon the market because of the imposition of taxation by the source jurisdiction.[88] Also, in these cases, the presence of substantial assets and/or intermediaries such as agents that act on behalf of non-resident businesses has made source taxation enforceable.

In an electronic commerce environment, it can be expected that source countries will also seek to tax payments arising from transactions arising within their borders. By the same token, the application of source-based taxation in an electronic commerce environment may be more difficult than in a traditional setting due to the reduced need for intermediaries, as well as by virtue of the fact that businesses do not need to maintain substantial physical presences (and therefore assets) in customer markets. However, these matters go to expedience or administrative considerations rather than being based on policy or principle. Therefore, while these factors may make the practical enforcement of source taxation difficult, it is argued that source countries will nevertheless persist with trying to tax these transactions, perhaps by using intermediaries, such as payment providers or Internet Service Providers, as their collection agents.

The literature supports the proposition that source countries *will* seek to continue taxing income that arises from electronic commerce transactions on pragmatic grounds. For example, Doernberg *et al* have expressed the situation as follows:

> The growth of electronic commerce may signal an economic realignment of the role of source and resident countries compared with their roles in traditional commerce … To the extent that electronic commerce replaces traditional commercial patterns, the tax balance between countries may be threatened … Any change in the balance of taxing authority between country R [the residence country] and country S [the source country] under existing international tax principles may lead countries–particularly those likely to be source countries (i.e., country S)–to call for new international tax principles or at

86 Avi-Yonah, above n 10, 521 (citing Graetz and O'Hear, above n 6, 1037 (n 46) (quoting Thomas S Adams, 'Interstate and International Double Taxation' (1929) 22 *National Tax Association Proc* 193, 197)).

87 Vogel–Part I, above n 7, 217.

88 Ibid (observing at the same time that in respect of portfolio investment, 'even large source countries like the United States have tended to abandon it for fear of driving away mobile capital'. This may suggest that business income is a better candidate for source-based taxation than portfolio income).

> least for a reinterpretation of existing tax principles in a manner that will restore the preexisting tax equilibrium.[89]

Therefore, the political and practical reality is likely to be that source countries will not readily agree to see a part of their tax base disappear and therefore to the extent that such countries perceive they are not properly being able to participate in the tax base generated by electronic commerce, they may resort to creative, unilateral measures to attempt to tax some of these payments. If this occurs, it could conceivably lead to double tax and could thereby constitute an impediment to international trade. Such a result would also be in contravention of the OECD's tax framework conditions that were agreed to at the Ottawa conference in 1998 which provides that 'any arrangements for applying international tax principles should be structured … to avoid double taxation and unintentional non taxation.'[90]

Despite the literature arguably supporting the proposition that source-based taxation of international electronic commerce taxations can be justified on pragmatic grounds, some may question whether the prospect of countries enacting unilateral measures constitutes a serious possibility. The response to this is that the prospect has already eventuated, in a decision involving the treaty between India and the United States and issued by India's Authority for Advance Rulings ('AAR').[91]

Under this decision, which involved the case of American Express travel-related services, India's AAR asserted that foreign companies engaged in the credit card and traveller's cheque business that received payments from an Indian company for gaining access to the foreign corporation's computer system/central processing unit in the US earned royalty income which was taxable in India under the applicable treaty between India and the US. The essence of this case turned on the proper characterisation of payments made to access a computer database and hardware in another country (the US) from another (India). The AAR concluded that the payment was for the 'right to use' software and therefore constituted a royalty under Article 12 of the applicable treaty.

The converse argument was that the payment was for services rendered, thereby giving rise to business profits rather than royalty income, which would only be taxed in the US in the absence of a permanent establishment in India.[92] Under this view, the characterisation of what was acquired would be regarded as the 'output' of

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89 Doernberg *et al*, above n 56, 342-3.

90 OECD Taxation Framework Conditions, above n 67, Annex 1, 228.

91 P No 30 of 1999 (238 ITR 296). This decision has been discussed in several sources, including, eg, Indian Electronic Commerce Report, above n 19, 228; 'Indian AAR Issues Landmark Ruling on E-Commerce Taxation under US-India Tax Treaty' (1999) *Tax Notes International* 11-14; Richard L Doernberg, 'International Tax Issues: The Taxation of Business Profits' (Paper presented at the International Fiscal Association Asia Regional Conference on E-Commerce and International Taxation, Mumbai, India, November 2000) 8.

92 The OECD MC dealt with independent personal services income separately in Article 14, however, this Article was deleted from the OECD MC on 29 April 2000, on the basis of an OECD report entitled *Issues Related to Article 14 of the OECD Model Tax Convention*. This report

processed data rather than any 'rights' in the processing of the data. Paragraph 14 of the Commentary to Article 12 of the OECD MC supports this argument as the Indian company that accessed the US database acquired no rights in the software itself; rather it merely paid for the processing of the data that it sent to the US computer. Moreover, the OECD Final Treaty Characterisation Report[93] supports the view that the payments in this example should be characterised as business profits rather than royalties.[94]

The ultimate result of this decision is that it could lead to double tax if one country (the United States in the case) treats the payment as being for services while another country (India in the example) regards the payment as being royalty income and subjects it to withholding tax. Further, if the US does not recognise the taxing authority of India, it may be unwilling to relieve double taxation by granting a tax credit for any withholding tax imposed by India, and in any event, even if a credit was permitted, it could be limited by the US.

This decision is also significant in the context of whether source countries should be able to tax electronic commerce transactions, as it may indicate a concern of countries like India if they perceive that they are not properly sharing in the tax base arising from electronic commerce, they will not be bound to OECD principles but rather will resort to unilateral and creative measures to attempt to tax some of these payments, notwithstanding that such measures may not conform to existing principles of international income allocation as contained in the OECD MC. And while it may be too early to tell which countries will be winners and which will be losers in electronic commerce, or even which countries will be source or residence countries, or net exporters or importers of capital, the *perceptions* that countries maintain of their relative positions cannot be ignored in the meantime.[95]

Outcomes such as those made possible by this decision are undesirable, not only because of the double tax possibilities that may arise from it, but also the impediments to international trade that could result because of it. These are both strong reasons, therefore, to allow source countries to share in the revenues which are generated from

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was adopted by the Committee on Fiscal Affairs on 27 January 2000. The effect of the deletion of Article 14 is that income derived from professional services or other activities of an independent character is now dealt with under Article 7 of the OECD MC as business profits.

93 OECD, TAG on Treaty Characterisation of Electronic Commerce Payments, *Tax Treaty Characterisation Issues Arising from E-Commerce* (1 February 2001), < http://www.oecd.org/daf/fa/e_com/ec_2_TREATY_CHAR_Eng.pdf> ('OECD Final Treaty Characterisation Report').

94 Ibid. Categories 9-10 of the OECD Final Treaty Characterisation Report illustrate that payments made to an application service provider (the US company in the case) for access to software hosted on the provider's computer should be classified as business profits and not royalties. Also, Categories 15-16 of the report treat payments for data retrieval as business profits rather than royalties.

95 Doernberg, above n 91, 9 ('To the extent that countries perceive that they are not sharing in the electronic commerce bounty, they may through creative, self-help attempt to tax some of the base-eroding payments').

electronic commerce transactions, even though this basis of taxation may be founded in pragmatic considerations rather than being underpinned by pure theoretical reasons.

II Conclusions

This paper has examined the fundamental tax policy principles that underlie source-based taxation. These principles include benefit theory, neutrality considerations (eg, capital-import neutrality), principles of equity (eg, inter-nation equity), the concept of entitlement, and finally pragmatic considerations, including the prospect of double taxation and likely impediments to international trade. After analysing the basis for each of these principles and how they justify source-based taxation in a traditional context, it has been argued that they remain applicable in an electronic commerce environment, thereby establishing that source-based taxation of electronic commerce transactions *is* theoretically justifiable. It therefore follows that source-based taxation *should* continue to apply in an electronic commerce context.