

The Need to Reconceptualize the Permanent

Establishment Threshold

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1. INTRODUCTION

This article argues that the way source is defined under the permanent establishment threshold for purposes of the current OECD Model Tax Convention)¹ is no longer valid and needs to be

¹ The current OECD Model is used to illustrate treaty considerations as this Model is one of

reconceptualized in light of the changes brought about by globalization and the related developments in electronic commerce.

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Before examining *how* source can be redefined, it is important to question whether source-based taxation remains theoretically valid in today's globalized business world. The article first undertakes an analysis of this issue. The article then addresses the central issue of the need to reconceptualize the permanent establishment threshold as currently defined. The current definition of permanent establishment in the OECD Model relies on the existence of either a physical presence (e.g. a factory) or a representative presence (e.g. an agent) before source-based taxation applies. Globalization, epitomized by the advent of electronic commerce, allows *substantial* business activities to take place in a source state *without* either physical or human intermediaries, such as brokers, distributors or representatives, making it more difficult to find a permanent establishment based on its traditional formulation under the OECD Model.

[next 2 paras. combined] [ok]

Indeed, in relation to the reduced need for human intervention, the literature (e.g. the writings of Profs. Klaus Vogel and Arvid Skaar) strongly supports the proposition that human intervention is *not* necessary for a finding of a permanent establishment in the source state. The OECD agrees with this view -- advocating that it would seem illogical to conclude that individuals are necessary to have a permanent establishment when no individuals are in fact necessary to generate the income. Therefore, rather than relying on a physical or representative presence before a permanent establishment arises, this article suggests that a different threshold may need to be considered. The article undertakes an analysis of three possible approaches -- the base-erosion approach, the virtual permanent establishment approach, and the refundable withholding approach. Each proposal has advantages and disadvantages, and they are examined and analysed in the article.

The article concludes **[omit words here] [ok]** that the permanent establishment concept *does need* to be reconceptualized in light of the changes brought about by globalization and the related developments in electronic commerce. This reconceptualization may involve a consideration of not only qualitative proposals (e.g. the virtual permanent establishment model advocated by Prof. Luc

the most important and influential treaties **and is the one [ok]** on which most bilateral tax treaties

Hinneken), but also quantitative proposals (e.g. the refundable withholding approach that is analysed below) as such proposals could offer bright-line rules for determining the source-country tax nexus, thereby offering the advantages of clarity and certainty.

2. THEORETICAL FOUNDATIONS AND RATIONALE FOR SOURCE-BASED TAXATION

This part analyses the theoretical foundations and rationale for source-based taxation² and argues that these principles remain valid in an electronic commerce environment. The analysis here is not concerned with how source is defined, but rather at establishing the first argument of the article, that source-based taxation *is* theoretically justifiable for income arising from international transactions conducted in an electronic commerce environment.

Some may argue that, from an economic perspective, if the source state's only contribution is its customer base or its telecommunications infrastructure, only the residence state should be able to exercise income-taxing authority because all the wealth is created there. In response, it is argued that such income *should* continue to be taxed by source states on the basis that the theoretical principles underpinning source-based taxation remain valid notwithstanding the changes brought about by globalization and electronic commerce.

These principles include the benefit theory, neutrality considerations (e.g. capital-import neutrality), principles of equity (e.g. inter-nation equity), the concept of entitlement and, finally, pragmatic considerations, including the prospect of double taxation and the likely impediments to international trade. It is argued that *all* of these principles remain applicable in an electronic commerce environment, thereby establishing the first argument of this article that the source-based

are based.

² 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); Arnold, Brian J., "Controlled Foreign Corporation Rules, Harmful Tax Competition, and International Taxation", in *2000 World Tax Conference Report* (Toronto: Canadian Tax Foundation, 2000), at 17:1. Both residence-based and source-based taxation can be justified in terms of tax policy principles, though this part of the article is concerned with the theoretical justification for source-based taxation and its application to electronic commerce transactions.

taxation of electronic commerce transactions *is* theoretically justifiable. It therefore follows that source-based taxation *should* continue to apply in an electronic commerce context.

2.1. Benefit theory

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. Taxes are therefore regarded as the price paid for all state services by all taxpayers taken together, and countries obtain their right to tax based on the services (benefits) provided. In a broad sense, these costs may be thought of as representing the price paid for a civilized society, thereby justifying the imposition of tax as compensation to the governments bearing the costs.

The benefits that may be provided by source countries can be either general or specific. Obvious examples of general benefits are education (which relates to the availability and level of labour) and police, fire and defence protection. **[shorten text to avoid repetition] [ok]** Specific benefits include a conducive and operational legal infrastructure for the proper functioning of business, along with specific government policies, such as keeping exchange rates stable and interest rates low, thereby providing economic stability and business and consumer confidence.³ Most of these general and specific benefits are equally (if not more) relevant in an electronic commerce context. **[use "benefit theory" throughout] [ok]**

In further considering the applicability of the benefit theory to justify source-based taxation in an electronic commerce context, a question that needs to be addressed is whether source countries should be limited taxing the income **only of those non-resident businesses that [ok]** have a physical presence⁴ in the source country. That is, in an electronic commerce context, the issue that

³ See e.g. Avi-Yonah, Reuven S., "International Taxation of Electronic Commerce", 52 *Tax Law Review* 507 (Spring 1997), at 520 (arguing that benefits such as these justify source-based corporate taxation because the source country's government bears some of the costs necessary for earning the income and should therefore be compensated for incurring them).

⁴ The term "physical presence" is used intentionally here instead of the treaty concept "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 and is analysed **later in this article [could we cross-reference here to the section and omit the rest of this sentence ??] [ok]** when discussing the issue of whether the way source is defined for active

needs to be analysed is whether the benefit theory is compatible only with having a physical presence in the source country. This is important because electronic commerce affords businesses the facility to earn profits from interacting with source countries *without* having to maintain a physical presence in the source country.

Charles McLure argued that, in a traditional context, taxation based on the benefit theory suggests that a physical presence is *probably* needed to establish a tax nexus for source-based taxation.⁵

This is because many of the services described earlier (e.g. police and fire protection) that benefit businesses which provide tangible goods and services are only available and relevant if the businesses maintain a physical presence in the source country. An important issue raised by electronic commerce is **the place where [ok]** income should be regarded as being generated if the entire value of what is sold is created in the residence country but the customers who determine that value are in the source country. In such cases, from an economic perspective, the source country's only contribution is often 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 which would justify source-based taxation under the benefit theory.

This argument can, however, be challenged on two grounds. First, Prof. Skaar provides support for the view that, even if a business does *not* have a physical presence in the source country, the business 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, ... **that requires [add bold text] [ok]** all enterprises which obtain such benefits from a country to render a corresponding contribution to this society,

business income needs to be reconceptualized because of the characteristics of electronic commerce that are relevant from a tax perspective. For present purposes, the main issue is whether the principles that underlie source-based taxation (including the benefit theory) are applicable in an electronic commerce context.

⁵ McLure, Jr., Charles E., "Source-Based Taxation and Alternatives to the Concept of Permanent Establishment", in *2000 World Tax Conference Report*, supra note 2, at 6:5.

whether or not they have a [permanent establishment].⁶ (**emphasis in original**)?? [**no – emphasis added**]

Second, despite possible claims by non-resident businesses without a physical presence in the source country that they therefore derive no benefits from that country, it is argued that source countries *do* provide significant benefits to companies that carry on business activities with those countries, even in the absence of a physical presence. Apart from Prof. Skaar's analysis noted above, non-resident companies without a physical presence in the source country nevertheless benefit from that country's legal system inasmuch as they rely on it to enforce payment for transactions, uphold intellectual property rights (e.g. trademarks), and maintain a pro-competitive and conducive business environment. Indeed, the protection of intellectual property rights (e.g. in the case of computer software) is critical to vendors of intangible products and digitized services, and the protection of these rights arises independently of the need to maintain a physical presence in the source country. Likewise, vendors of digitized content (including music and computer games) do not have a market in source countries that do not have a suitable telecommunications infrastructure or whose population lacks competency in computers. The provision of these benefits therefore adds weight to the case for source-based taxation under the benefit theory, *even* in the absence of a physical presence in the source country.⁷ Further, source countries need to provide waste disposal for packaging materials, consumer protection laws, and an infrastructure on which delivery vehicles can travel (in the case of physically delivered electronic commerce products),⁸

⁶ Skaar, Arvid A., *Permanent Establishment: Erosion of a Tax Treaty Principle* (1991), at 559-560 (framing his concept of the benefit theory in what he referred to as the "equivalence principle", which he argued requires all enterprises that obtain benefits from a country to render a corresponding contribution to that country, whether or not they have a physical presence there).

⁷ McLure, *supra* note 5, at 6:13 (footnote 28). In 2001, India released a report on electronic commerce which 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), at www.laws4india.com/indiantaxlaws/notification/ecomcontent.asp ("Indian Electronic Commerce Report"), cited in Hardesty, David, "India to Go Its Own Way?", 13 February 2002, at www.ecommercetax.com/doc/021002.htm.

⁸ McLure, *supra* note 5, at 6:6 (observing that "mail order sales of tangible products may [likewise] place demands on public services").

and the provision of these benefits strengthens the case for the source-based taxation of electronic commerce transactions.

Therefore, in an electronic commerce context, since benefits are provided to non-resident vendors even though they may lack a physical presence in the source country, it is clearly arguable that the costs of providing these benefits justify the source country's right to tax the resultant income (or at least part of it) under the benefit theory. In other words, it may be argued that the benefit theory continues to justify source-based taxation even in an electronic commerce context if non-resident vendors may conduct business in a source country without the need to maintain a physical presence in that country.

2.2. Neutrality

The principle of neutrality in an international context is normally considered within two dimensions of neutrality: capital-export neutrality (CEN) and capital-import 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 largely been influenced by the writings of Prof. Vogel.⁹ For convenience, the ensuing analysis is conducted separately under the headings of CEN/CIN and inter-nation neutrality, reflecting the way the subject has developed in the literature.

2.2.1. Capital-export and capital-import neutrality

Richard Musgrave has been credited as being the first to distinguish between capital-export and capital-import neutrality.¹⁰ 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

⁹ Vogel, Klaus, "Worldwide vs. source taxation of income -- A review and re-evaluation of arguments (Part II)", *Intertax* 310 (No. 10, 1988), at 313 ("Vogel-Part II"). See also, Vogel, Klaus, *Taxation of Cross-Border Income, Harmonization, and Tax Neutrality under European Community Law: An Institutional Approach* (1994), at 21.

... Import neutrality means that capital funds originating in various countries should compete at equal terms in the capital market of any country.¹¹

Prof. 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.¹²

Apart from considerations of international competitiveness suggesting **source-based taxation ??** [please compare against original] [ok] under the principle of capital-import neutrality, the preference for capital-export neutrality that has traditionally been evident in the literature¹³ has been challenged. 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-

¹⁰ Vogel–Part II, supra note 9, at 311.

¹¹ Id. (citing Musgrave, Richard, "Criteria for Foreign Tax Credit", in *Taxation and Operations Abroad, Symposium* (1960), at 84-85).

¹² Id.

¹³ See e.g. McLure, Jr., Charles E., "Substituting Consumption-Based Direct Taxation for Income Taxes as the International Norm", 45 *National Tax Journal* 145 (1992), at 146-147 and 153 (footnote 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, **which is [add bold text] [ok]** considered to be a less significant goal); and Vogel–Part II, supra note 9, at 311 (observing that Peggy Musgrave argued **that capital-export neutrality should have priority [ok]** 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"). Prof. Vogel also referred to other commentators who supported this view, including Richard Musgrave and Bernard Snoy, with Snoy stating: "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"; id. (citing Snoy, Bernard, *Taxes on Direct Investment Income in the EEC, A Legal and Economic Analysis* (1975), at 37, and noting that further support for capital-export neutrality can be found in Sato, M. and Richard Bird, "International Aspects of the Taxation of Corporations and Shareholders", 22 *IMF Staff Papers* 408 (1975) ("only capital-export neutrality accords with the objective of world efficiency")).

based taxation.¹⁴

[change wording in this para. to distinguish it from preceding para.] [ok – I deleted the first sentence as it was repetitive]

Apart from these considerations, however, a similar conclusion may be reached from an economic perspective. Norman Ture's analysis shows that export neutrality can distort relative prices.¹⁵ This supports import neutrality, as do the arguments put forward by Otto Gandenberger, who concluded that a residence-based system is non-neutral and therefore inefficient.¹⁶ Others, including Barry Bracewell-Milnes and J.D. Foster reached similar conclusions, strengthening the arguments in favour of capital-import neutrality and therefore source-based taxation.¹⁷ Hence, if the distinction between export and import neutrality is to be maintained, it is argued that preference should be accorded to import neutrality, thereby favouring source-based taxation. Finally, for the reasons noted earlier, including considerations of international competitiveness, it is further contended that this analysis is equally (if not more) applicable in an electronic commerce context.

2.2.2. Inter-nation neutrality

According to Prof. Vogel, 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

¹⁴ It is beyond the scope of this article to examine these challenges. For a detailed discussion, see Pinto, Dale, *E-Commerce and Source-Based Income Taxation* (2003), at 27-29.

¹⁵ Vogel, supra note 9, at 24.

¹⁶ Vogel, Klaus, "Worldwide vs. source taxation of income -- A review and re-evaluation of arguments (Part I)", *Intertax* 216 (Nos. 8/9, 1988), at 222 ("Vogel-Part I") (citing Gandenberger, Otto, "Kapitalexportneutralität versus Kapitalimportneutralität. **Allokative Überlegungen zu einer Grundfrage der internationalen Besteuerung. Aufsätze zur Wirtschaftspolitik**" ?? [in my copy of Vogel-Part I, the part in bold is not in the title], *7 Aussätze zur Wirtschaftspolitik (Forschungsinstitut für Wirtschaftspolitik an der Universität Mainz, 1983).*?? [please check -- this is what my copy shows] [yes – your cite is correct – please change accordingly]

¹⁷ Id. at 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").

same time, as the relation of benefits and burdens between countries is not the same, Prof. Vogel created a concept 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 argued 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 he concluded that only source-based taxation can comport with the principle of inter-nation neutrality:

Inter-nations neutrality then means that 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.¹⁸ **(emphasis in original) [ok]**

In considering the applicability of Prof. 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, infrastructure and direct subsidies, as well as the level of public health, public education (which impacts on the supply and quality of labour) and information.¹⁹ These benefits are no less relevant in an electronic commerce setting, and indeed some benefits, such as the protection afforded to intellectual property rights and the benefits flowing from secure financial systems, may assume greater importance than in a traditional context.

In terms of transaction costs, R.C.O. Matthews observed 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

¹⁸ Vogel—Part II, *supra* note 9, at 314.

¹⁹ *Id.* at 313. See also the discussion of benefits in 2.1.

are the costs of executing a contract".²⁰ Prof. Vogel suggested that transaction costs are determined by the total legal environment of an enterprise and should include not only the costs relating to a contract (or product), but also the general costs of transactions which are incurred by a business, including the cost of information, the costs of legal protection, public security, **efficiency of administrative agencies and the services they provide ?? [is this a "cost" ?? please check sentence] [ok – yes it is a cost and it is correct]**, and the costs associated with a stable business and monetary environment.²¹ Again, many of these transaction costs, including especially legal costs, information costs and the costs of stable business and monetary environment, are equally applicable in an electronic commerce context; hence, the ensuing analysis should also apply 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 the foreign countries where the investments are made.²² By contrast, capital-import neutrality (which supports source-based taxation) is attainable as foreigners are subject to the same transaction and production costs in the source country as local enterprises and, if no additional burdens are imposed by the residence country on foreign investors, competition between local and foreign enterprises in the source country is equal, unobstructed and therefore neutral.²³ Therefore, in light of the preceding analysis, it is argued that the source-based taxation of international electronic commerce transactions can also be justified by the principles of tax neutrality.

2.3. Equity

²⁰ Vogel, supra note 9, at 26 (footnote 44) (citing Matthews, R.C.O., "The Economics of Institutions and the Sources of Growth", 96 *Economic Journal* 903 (1990)).

²¹ Id.

²² Id. at 27 ("[The residence] state has no influence whatsoever on transaction costs and on other state-induced costs incurred by the foreign investment.")

²³ Id. at 28 (Prof. Vogel noted, however, that, in order for a source-taxation system to be truly neutral, it is not taxation alone, but the aggregate of state-induced costs and benefits, which must fall equally on investments by residents and foreigners).

In a tax context, the equity considerations that refer to the position of individual taxpayers (individual or taxpayer equity) are normally distinguished from those that refer to the gain and loss of the residence and source countries (inter-nation equity). Prof. Vogel credited Peggy Musgrave as being the first person to make this distinction.²⁴ Consistent with this distinction, the analysis below is conducted separately under the headings of individual and inter-nation equity.

2.3.1. Individual equity

Some contend that considerations of individual equity favour *only* source-based taxation **because [ok]** "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 country's tax policy decisions".²⁵ More specifically, Prof. Vogel made this case on grounds of legitimation, equality, integrity and redistribution which, he contended, support exclusive taxation of foreign direct investment income in the source country.²⁶ These arguments are summarized below as they are germane to establishing the rationale for source-based taxation on grounds of individual equity.

In terms of legitimation, Prof. Vogel contended that a tax claim can be considered equitable only if the transaction or event, by the state in question, is legitimate -- that is, can be justified. He then used the benefit theory²⁷ to support his conclusion that **source-country ?? [should this be "source-based" ??] [should be source-based]** taxation is preferable on grounds of legitimation. While legitimation looks to the relationship between a taxpayer and a state, equality looks to the **relationship between taxpayers [ok]**, and Prof. Vogel argued that taxpayers who receive foreign

²⁴ Vogel, Klaus, "Worldwide vs. source taxation of income -- A review and re-evaluation of arguments (Part III)", *Intertax* 393 (No. 11, 1988), at 394 ("Vogel-Part III").

²⁵ Vogel-Part I, supra note 16, at 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).

²⁶ Vogel-Part III, supra note 24, at 394. What follows on this point is adapted from this source.

²⁷ For the benefit theory, see 2.1.

income must be compared not only to similarly situated taxpayers in their residence country, but also to competitors in the source country. Extending the analysis, if the tax rates are lower in the source country than in the residence country, taxation in the residence country at its higher rates is contrary to achieving equality in the source country, even if the residence country grants a credit for foreign taxes. In addition, even if a case can be made on equality grounds for taxing foreign income at the same rates as domestic income, it can be regarded as a convincing conclusion only with regard to that part of the foreign income that was 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".²⁸ Therefore, equality considerations are fully consistent *only* with 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, Prof. Vogel put forward considerations of integrity and redistribution to strengthen his arguments for source-based taxation on individual equity grounds.²⁹ It is contended that the preceding arguments supporting source-based taxation on individual equity grounds are no less relevant in an electronic commerce context. Further, in an electronic commerce context, tax equity may also mean that taxpayers engaged in traditional commerce should be treated the same as those engaged in electronic commerce, **although this consideration could also relate [ok]** to tax neutrality.

2.3.2. Inter-nation equity

In addition to individual equity, inter-nation equity needs to be considered in an international context. Under the principle of inter-nation equity, each country should receive an equitable share

²⁸ Vogel–Part III, *supra* note 24, at 396.

²⁹ *Id.* at 397. The arguments based on integrity and redistribution are not detailed here as they are not considered central to the present discussion.

of the tax revenue from cross-border transactions.³⁰ An equitable division of the tax revenue depends on (a) the allocation of the tax base between the source and residence countries, and (b) the tax rate in the source country.³¹

Prof. Vogel argued that inter-nation equity tends to strongly favour taxation by the source country.³² This is because traditionally it has been the source country that provided most or all of the benefits relevant to production and, without the source country's economic opportunities (i.e. market), the income would normally not have been generated. At the same time, however, Prof. Vogel accepted that a certain integration of the seller's activities into the source country's economy is necessary before the source country's taxing rights arise.³³ This has traditionally been evidenced by the existence of a permanent establishment or by satisfying the "trading within" concept in common law countries. As electronic commerce allows vendors to sell products to consumers in source countries without such integration or physical presence in those countries, it calls into question the source country's taxing rights over income arising from electronic commerce transactions. However, even if such integration has not occurred, Prof. Vogel argued 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 sales income at least to some extent as providing the goods does. There is no valid objection, therefore, against a claim of the sales state to tax part of the sales income.³⁴

This line of reasoning therefore supports the continued taxation in the source country of income arising from international electronic commerce transactions. Indeed, over time, **source [ok]**

³⁰ Kaufman, Nancy H., "Fairness and the Taxation of International Income", 29 *Law and Policy in International Business* 145 (1998).

³¹ Doernberg, Richard, et al., *Electronic Commerce and Multijurisdictional Taxation* (2001), at 69 (citing Musgrave, Peggy, *United States Taxation of Foreign Investment Income* (1969), Chap. VII).

³² Vogel—Part III, *supra* note 24, at 398.

³³ *Id.* at 401.

countries have asserted their right to tax the income received from sales to their residents, reasoning that this income would not have been earned but for the market the source countries provide. An argument of this nature seems to be especially strong in cases involving customized or made-to-order products because such products would simply not be made without the market provided. Similar considerations 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 framework conditions that should govern the taxation of electronic commerce transactions is the principle of inter-nation equity:

... [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 ...³⁵

2.4. Entitlement

Another rationale for source-based taxation is **[omit words] [ok]** the concept of "entitlement" -- the view that the source country is entitled to tax income arising within its geographic borders even if the income accrues to non-resident taxpayers. The entitlement view of taxation is usually associated with Peggy Musgrave, who contended that the source country is entitled to tax income originating within its borders because it is the source country as the "place of income-generating activity",³⁶ rather than the country where the income-producer resides (i.e. the residence country), that economically contributes to the production of income, and the source country should therefore be compensated for its contribution. Peggy Musgrave further argued that, according to the entitlement theory, source countries are entitled to tax income originating within their borders since the countries where consumers reside provide services that are complementary to the consumption

³⁴ Id. See also Indian Electronic Commerce Report, *supra* note 7.

³⁵ OECD, "Electronic Commerce: Taxation Framework Conditions", in OECD, *Taxation and Electronic Commerce: Implementing the Ottawa Taxation Framework Conditions* (2001), Annex 1, at 228 ("OECD Taxation Framework Conditions").

³⁶ Doernberg, Richard and Luc Hinnekens, *Electronic Commerce and International Taxation* (1999), at 306 (footnote 641) (citing Musgrave, Richard and Peggy Musgrave, "Inter-Nation

of their residents.³⁷

In considering whether the entitlement theory justifies the taxation of income from electronic commerce transactions in source countries, the issue of whether the entitlement theory allows the source country to tax in the absence of a physical presence needs to be addressed, as electronic commerce allows the possibility for business profits to be derived in source countries without maintaining a physical presence in them. 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 them if **the right to tax [ok]** is based on economic presence rather than on physical presence.³⁸ Given that physical presence can be largely insignificant for an electronic commerce transaction, economic presence may be a better indicator on which the source-country tax nexus may be based, and there is a body of literature supporting this proposition.³⁹ Economic presence in an electronic commerce context could be determined by reference to a regular and systematic **direction ?? [is "direction" the right word here ??] [yes it is correct]** of activities in a country. Determining whether activities amount to a tax nexus under this approach might depend on whether the activities of non-resident vendors were "purposefully directed" at source-country customers and, according to M.A. Harris, this could be determined by asking the following three questions:

Equity", in *Modern Fiscal Issues: Essays in Honor of Carl S. Shoup* (1972), at 71).

³⁷ Musgrave, Peggy B., "Interjurisdictional Coordination of Taxes on Capital Income", in Cnossen, Sijbren (ed.), *Tax Coordination in the European Community* (1987), at 198; Musgrave, Peggy B., "Principles for Dividing the State Corporate Tax Base", in McLure, Jr., Charles E. (ed.), *The State Corporation Income Tax: Issues in Worldwide Unitary Combination* (1984), at 230.

³⁸ See e.g. McLure, *supra* note 5, at 6:6 (supporting the proposition that the entitlement theory is conducive to the taxation of corporations that lack a physical presence).

³⁹ See e.g. Avi-Yonah, *supra* note 3, at 507 (advocating a change from physical presence to a gross income threshold for purposes of determining the source-country tax nexus); Lambooij, Michael, "Rethinking Corporate **Residence**" (speech) [ok], 6 June 1997, at 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", *Internet Services Association* (1997), at www.isa.net/about/releases/taxwhpap.html; and Forte, Steven J., "Use Tax Collection on Internet Purchases: Should the Mail Order Industry Serve as a Model?", 15 *John Marshall Journal of Computer & Information Law* 203 (Winter 1997) (suggesting that economic presence should replace physical presence for determining the tax nexus). **[last article checked at HLS] [ok]**

1) Did the taxpayer "purposefully avail" itself of the benefits of a taxing state? 2) 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? 3) Were the taxpayer's in-state activities a continuous and systematic part of its general business in the state?⁴⁰

These considerations draw from the experience with the level and nature of the connections providing the nexus necessary to authorize a state 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 the source country's entitlement to tax is based on economic presence.

Proceeding with the analysis based on a business having an economic presence in an electronic commerce environment, Charles McLure observed that, since company taxes are usually based on accounting profits rather than economic profits (which include the normal return to capital), it can be argued that the entitlement to tax a company's profits should exist any time the company avails itself of the productive resources or the market of a country -- that is, if the company has an economic presence in the country.⁴¹ Therefore, if the entitlement to tax is based on economic presence, the case for taxing remote vendors (even in the absence of a physical presence in the source country) seems strong.⁴²

In summary, the line of reasoning based on the entitlement theory and economic presence supports **source-based taxation [deleted 'the' before source-based taxation]** of income arising from international electronic commerce transactions. At the same time, an important qualification to the argument presented is that the economic presence needs to be *significant* before a business is

⁴⁰ As quoted in Hinnekens, Luc, "Looking for an Appropriate Jurisdictional Framework for Source-State Taxation of International Electronic Commerce in the Twenty-first Century", 26 *Intertax* 192 (No. 6/7, 1998), at 198.

⁴¹ McLure, *supra* note 5, at 6:4.

⁴² *Id.* (adding that this argument would be valid whether a remote vendor sold tangible products delivered by traditional means or intangible products or services provided over the Internet).

subject to tax in the source country.⁴³ There are many ways this could be achieved in an electronic commerce scenario. For example, liability to the income tax could be made subject to a *de minimis* threshold test to avoid innumerable cases of limited liability in which only **a small amount of [ok]** income is generated. For present purposes, the point is that the source-country taxation of profits arising from international electronic commerce transactions *can* be justified by 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.

2.5. Pragmatic considerations

The final rationale for source-based taxation is pragmatic: a source country is unlikely to forgo taxing income arising 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.⁴⁴ Thomas S. Adams 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 source [sic] within that country, and rightly so, at least inevitably so."⁴⁵ Prof. Vogel expressed similar sentiments, observing that "no country which levies an income tax (and very few do not fall into

⁴³ This qualification is grounded as much in common sense as in principle because it would not be sensible, on grounds of either administrative or compliance costs, for source countries to levy an income tax on *all* vendors that have an economic presence, no matter how small the scale of their activities was.

⁴⁴ Carroll, Mitchell B., *Prevention of International Double Taxation and Fiscal Evasion* (1939), at 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 Forst, David L., "The Continuing Vitality of Source-Based Taxation in the Electronic Age", 15 *Tax Notes International* 1455 (1997) (citing the League of Nations: "A survey of the whole field of recent taxation shows 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").

⁴⁵ Avi-Yonah, *supra* note 3, at 521 (citing Graetz, Michael J. and Michael M. O'Hear, "The 'Original Intent' of US International Taxation", 46 *Duke Law Journal* 1021 (1997), at 1036 (footnote 46), quoting Adams, Thomas S., "Interstate and International Double Taxation", 22

this category today) forgoes taxing domestic source income, irrespective of who has derived it".⁴⁶ Apart from these statements, as a practical matter, since source countries typically have the first opportunity to collect tax 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 derived from large markets, where there may be little fear that a non-resident business will abandon the market because of the tax levied by the source jurisdiction.⁴⁷ In these cases, the presence of substantial assets and/or intermediaries such as agents acting on behalf of non-resident businesses has also 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 within their borders. By the same token, applying source-based taxation in an electronic commerce environment may be more difficult than in a traditional setting due to the reduced need for intermediaries and also because businesses do not need to maintain a substantial physical presence (and therefore assets) in customer markets. However, these matters go to expedience or administrative considerations rather than to 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 in 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 arising from electronic commerce transactions on pragmatic grounds.⁴⁸ Therefore, the political and

National Tax Association Proc 193 (1929), at 197).

⁴⁶ Vogel—Part I, *supra* note 16, at 217.

⁴⁷ *Id.* (observing at the same time that, in respect of portfolio investment, "even large source countries like the United States have tended to abandon **it [taxation] ?? please check** for fear of driving away mobile capital". This may suggest that business income is a better candidate for source-based taxation than portfolio income).

⁴⁸ See e.g. Doernberg et al., *supra* note 31, at 342-343. The prospect has already eventuated in a decision involving the India-United States treaty which was issued by India's Authority for Advance Rulings (AAR) **P [what do this "P" stand for ??] [delete – typo]** No. 30 of 1999 (238

practical reality is likely to be that source countries will not readily agree to see part of their tax base disappear; thus, to the extent source countries perceive that they are not able to participate properly in the tax base generated by electronic commerce, they may resort to creative, unilateral measures to attempt to tax some of the payments **arising from transactions that they perceive take place within their borders.**[add bold text – added the words ‘that they perceive take place’] If this occurs, it could conceivably lead to double taxation and thereby constitute an impediment to international trade. This result would also be in contravention of the OECD's taxation framework conditions that were agreed to at the Ottawa conference in 1998, which provide that "any arrangements for applying international tax principles should be structured ... to avoid double taxation and unintentional non taxation".⁴⁹

2.6. Summary

This part has examined the fundamental tax policy principles that underlie source-based taxation. These principles include the benefit theory, neutrality considerations (e.g. capital-import neutrality), principles of equity (e.g. inter-nation equity), the concept of entitlement, and pragmatic considerations, such as the prospect of double taxation and the 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 was argued that they remain applicable in an electronic commerce environment, thereby establishing the first argument of this article that the 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.

3. DEFINITION OF SOURCE UNDER THE PERMANENT ESTABLISHMENT THRESHOLD

Having established the first argument of this article, this part focuses on the need to reconceptualize

ITR 296). This decision has been discussed in several publications, including e.g. Indian Electronic Commerce Report, *supra* note 7, at 228; **Pandit, S. and S. Goradia [ok]**, "Indian AAR Issues Landmark Ruling on E-Commerce Taxation under US-India Tax Treaty", 19 *Tax Notes International* 11 (July 1999); and Doernberg, Richard L., "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), at 8.

the way source is defined under the permanent establishment threshold for purposes of the OECD Model.

Under the OECD Model, the existence of a permanent establishment is the *minimum* connection required for the source-based taxation of active business profits. Art. 5 of the OECD Model defines "permanent establishment" as "a fixed place of business through which the business of the enterprise is wholly or partly carried on". Under this definition, therefore, it is *insufficient* for business to be merely "carried on" abroad.⁵⁰ Rather, the taxpayer "must have established a specific connection to the other country, i.e., a 'home' abroad",⁵¹ as this provides evidence of the economic bonds⁵² (i.e. economic allegiance) between the enterprise and the other country. If this connection exists, the source country can tax the profits that are attributable to such an establishment so long as business is conducted through it.⁵³

The existing concept of permanent establishment, as found in treaties based on the OECD Model, focuses on the existence of a business presence in the sense of either a physical presence of the

⁴⁹ OECD Taxation Framework Conditions, *supra* note 35, Annex 1, at 228.

⁵⁰ It is generally accepted law that, for a trade or business to exist or for a tax nexus to be present, there must be more than a mere solicitation for orders; Hickey, Julian J.B., "The Fiscal Challenge of E-commerce", [2000] *British Tax Review* 91 (No. 2), at 97. Thus, in *Grainger v. Gough* [1896] AC 325, at 335, the court held that "there is a broad distinction between trading *with* a country and carrying on a trade *within* a country" (**emphasis in original**).^{??[ok]} Only the latter creates a tax nexus. The court also said (at 336) that soliciting orders does not amount to a trade, whether the solicitation is conducted by agents, circulars or advertisements.

⁵¹ Skaar, Arvid A., "Erosion of the Concept of Permanent Establishment: Electronic Commerce", in *International Studies in Taxation Law and Economics* (Kluwer, 1999), at 309 (also noting that the taxpayer's "home" will be qualified in different ways depending on the legal authority for the taxing power).

⁵² Vogel, Klaus, *Klaus Vogel on Double Taxation Conventions* (3rd ed., 1997), at 280 (observing that the permanent establishment rule is "designed to ensure that business activities will not be taxed by a State unless and until they have created significant economic bonds between the enterprise and that State").

⁵³ Art. 7 of the OECD Model. In the absence of such a permanent establishment, the source country cannot tax the income (other than on a limited withholding basis if the income is passive, non-business income such as royalties), which is then generally subject to tax where the business is

enterprise (fixed place of business) or a representative presence (agent). In both cases, there is an exclusion from permanent establishment status if the activities are considered to be preparatory or auxiliary.

This definition reflects the fact that international business activities carried on by corporations have hitherto involved the use of fixed physical or representative premises in each jurisdiction, generally to effect the delivery of goods to consumers in that jurisdiction.⁵⁴ This is evident from the specifically enumerated categories of fixed places of business in Art. 5 of the OECD Model (including a branch, an office and a factory), all of which imply the existence of a fixed physical place from which the corporation's business is actually carried on.

In traditional commerce, the reliance on a physical presence is sensible, and the permanent establishment threshold can therefore be applied with relative coherence and certainty so that business profits are attributed only to the more substantial and long-term **presences [I would use singular, not plural, here] [no – plural please]** of a corporation in a jurisdiction, not to a more fleeting, temporary or ephemeral **presences [ditto]** that does not satisfy the required threshold.⁵⁵ As electronic commerce **enables [ok]** an enterprise to trade in another country without maintaining a physical presence there, it allows the enterprise to participate in the economic life of another country to a substantial extent and potentially earn business profits **without establishing [ok]** a physical presence in that country. **Because of the way [ok]** source is currently defined under the permanent establishment threshold, such profits may not be taxed by source countries in an electronic commerce context unless a computer server through which core activities are conducted is maintained in the **source country (where the profits are earned).[ok]**

It is submitted that **[words omitted] [ok]** taxing business profits in source countries on the basis of the location of infrastructure such as a server is an unsatisfactory and unstable basis for attributing a tax nexus for several reasons. First, the location of infrastructure such as a server often bears little relationship to the location of the essential economic activity that electronic commerce comprises --

resident for tax purposes.

⁵⁴ Turner, Geoffrey S., "Permanent Establishments and Interprovincial Income Allocation: Reflections on the Advisory Report on Electronic Commerce", *Mondaq [should this be "Monday" ??] [no Mondaq is correct]Business Briefing*, 15 June 1998, at 7.

the production and consumption of information.⁵⁶ In this regard, the US Treasury noted that "[c]omputer 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".⁵⁷ Second, even if the location of a server were relevant to determining taxing jurisdiction, the server could be readily moved (without affecting the underlying transaction) [**"either" deleted ??**] [ok] at regular intervals **between different servers in different countries [how does this fit ?? please check sentence] [reads ok]**, and mirror sites could be established to direct customers to different servers depending on the level of traffic at any time. Actions such as these could frustrate the attempts of tax authorities to find a stable physical presence on which to base taxation under the permanent establishment threshold. Many, including Prof. Skaar, have therefore observed that a finding that a permanent establishment exists may easily be avoided by moving operations to a server in another country before the conditions of being "fixed" under the permanent establishment test are satisfied.⁵⁸

Even if a server in a source country is not moved to avoid a finding of a permanent establishment, "the profit attributable to the marketing and sales functions (typically incurred in the source country) declines relative to the production or manufacturing function that might take place in the residence state".⁵⁹ This is because electronic commerce facilitates a reduced investment in office space and distribution facilities, as well as a reduced sales and marketing staff, which means that the proportion of a company's profit allocated to the source country may decline, while the profit attributable to other countries could increase. Also, the possibilities afforded by electronic commerce for functions to be spread or disaggregated between servers, combined with server arrays, **make it difficult as practical matter to determine whether activities are core or**

⁵⁵ Id.

⁵⁶ Hellerstein, Walter, "Transaction Taxes and Electronic Commerce: Designing State Taxes That Work in an Interstate Environment", 50 *National Tax Journal* 593 (1997).

⁵⁷ United States Department of the Treasury, Office of Tax Policy, *Selected Tax Policy Implications of Global Electronic Commerce* (22 November 1996), at [7.2.3.1]; available at www.ustreas.gov/taxpolicy/internet.html ("US Treasury Report").

⁵⁸ Skaar, *supra* note 6, at 319.

preparatory. [ok] This may also allow electronic commerce transactions to be disaggregated into different functions which, by themselves, may be considered only preparatory in nature, but when linked via the Internet may constitute "a viable business that [may] not be subject to tax in any jurisdiction".⁶⁰ These possibilities provide further reasons why a server may not be a stable physical presence on which **the right to tax is [ok]** based, and they further expose the vulnerabilities of trying to apply the existing way source is defined under the treaty formulation of a permanent establishment to transactions conducted in an electronic commerce environment.

In conclusion and based on the foregoing analysis, it is contended that the way source is defined for business profits under the permanent establishment threshold may need to be reconceptualized in light of electronic commerce transactions. It was previously argued in this article that theoretically the taxation of business profits is justifiable in the absence of a physical presence, yet trying to deal with electronic commerce transactions in the context of the conventional formulation of the permanent establishment threshold seems to be inadequate as these rules depend on a finding of some kind of physical presence at a specific geographical location for a certain period of time. Therefore, the permanent establishment principle, which emerged as a tax concept at the end of the **last century?? [the 20th century ??] [use 20th]**, may no longer represent an appropriate instrument for the taxation of business profits -- a view advocated by Prof. Skaar:

The 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 economic connection to the soil, its [permanent establishment], is no longer a reliable evidence of economic allegiance.⁶¹

⁵⁹ Doernberg and Hinnekens, *supra* note 36, at 152.

⁶⁰ Cockfield, Arthur J., "Balancing National Interests in the Taxation of Electronic Commerce Business Profits", 74 *Tulane Law Review* 133 (1999), at 215. **See also [ok]** Australian Taxation Office, Electronic Commerce Project Team, *Tax and the Internet -- Volume 1* (1997), at [7.5.4] **[delete ("First Australian Report") -- not cited again] [ok]**. This is subject to the proviso noted earlier that the combined activities of an enterprise remain preparatory or auxiliary only so long as the overall activities of the enterprise remain preparatory; Art. 5(4)(f) of the OECD Model.

⁶¹ Skaar, *supra* note 6, at 573.

While the way source is defined under the permanent establishment threshold has been entrenched in international tax law for well over 100 years and countries have become accustomed to it as representing the threshold for the source-based taxation of business transactions, it is suggested that **the permanent establishment principle?? source?? [the original has "it"]** is not an immutable concept and therefore may need to be changed in the context of changes in international business. Support for this proposition can be found in the literature, including the writings of Prof. Skaar, who observed that "a [permanent establishment] is merely a piece of *evidence* of economic allegiance, not the reason for source-state taxation".⁶² **[this was quoted earlier (see text accompanying fn. 6) -- I would suggest we paraphrase the point here, not quote again] [ok] modified wording follows.** As noted above, Prof. Hinnekens noted that there is nothing sacred about the legacy of the permanent establishment principle as a fixed place of business.⁶³ Similarly, Prof. Doernberg et al. observed that there is nothing sacred about the permanent establishment concept, which, according to them, simply denotes "a threshold that business activities in the source country must have reached in order to entitle that country to tax the pertinent income. It is not unreasonable for this threshold to be adjusted for changes in the nature of business and in the way business is carried on".⁶⁴

Finally, apart from the conceptual and theoretical reasons which supported the adoption of the permanent establishment threshold, it must also be remembered that the adoption and relative success of this threshold can, at least partly, be explained by the fact that it has thus far offered the advantage of ensuring that taxes can actually be enforced and collected, as the records and assets that are normally associated with a permanent establishment have traditionally provided a relatively stable basis for determining and collecting the tax due.⁶⁵ However, even from an administrative perspective, the characteristics of electronic commerce, including its mobility, its reduced need for a physical presence and its intangible nature, could **["it is submitted" deleted - used below] [ok]**

⁶² Id. at 559.

⁶³ Hinnekens, *supra* note 40, at 197.

⁶⁴ Doernberg et al., *supra* note 31, at 79.

⁶⁵ Sasseville, Jacques, "The Future of the Treaty Rules for Taxing Business Profits", in *2000 World Tax Conference Report*, *supra* note 2, at 5:11.

place increasing pressure on the ability to rely on the permanent establishment threshold to tax business profits. In this regard, Profs. Doernberg and Hinnekens noted:

[E]nforcement of any taxing authority by the source state may be virtually impossible. There may be no assets to seize in the case of non-payment and no way of preventing access to the entrepreneur's web site. Moreover, the use of anonymous payment systems may make it even more difficult to trace how much commercial activity is taking place in a source state.⁶⁶

Therefore, from both from a theoretical and practical perspective, it is submitted that the way source is defined under the permanent establishment threshold may need to be reconceptualized to adequately accommodate electronic commerce transactions. Possible reconceptualizations of **source under this threshold ?? [please check against original] [ok]** are analysed in the next part.

4. RECONCEPTUALIZING SOURCE UNDER THE PERMANENT ESTABLISHMENT THRESHOLD

This part describes the following three approaches **to reconceptualizing source [ok]** under the permanent establishment threshold: - the base-erosion approach;
-the virtual permanent establishment approach; and
-the refundable withholding approach.

The ensuing analysis explains each approach and then examines the advantages and disadvantages of each proposal.

4.1. Base-erosion approach

The base-erosion approach -- a withholding approach -- has been advocated by Prof. Doernberg

⁶⁶ Doernberg and Hinnekens, *supra* note 36, at 341. See also US Treasury Report, *supra* note 57, at [7.1.5] (observing that it might be difficult to link an item of income with a specific geographical location for an electronic commerce transaction).

and is referred to in the literature as either the "single-rate withholding approach" or the "base-erosion approach", **which is how this article refers to it.?? [I would delete the bold text -- it is obvious] [ok]** The base-erosion approach seeks to address two main concerns created by electronic commerce, described by Prof. Doernberg as follows:

First, electronic commerce importing countries are concerned that they may lose some of their existing tax base and/or will not be able to share in any new tax base generated by electronic commerce transactions. Second, taxpayers and governments are concerned about the likelihood of double taxation because of inconsistencies in the application of existing tax principles to income generated by electronic commerce.⁶⁷

The base-erosion approach has four essential features which, when taken together, are designed to overcome the concerns mentioned above. First, the base-erosion approach is intended to operate within the existing international tax regime, including maintaining the permanent establishment principle. As noted earlier, however, preserving the permanent establishment **principle/concept [add "principle", "concept" ??]** in its current form and seeking to apply it to electronic commerce transactions may allow tax revenue to be shifted from source countries to residence countries if non-resident businesses operate in source countries without a physical presence. Consequently, while the base-erosion approach seeks to maintain the permanent establishment principle, it also seeks to modify its application to allow source and residence countries to share the tax base generated by electronic commerce transactions. In this way, the approach seeks to preserve the long-standing permanent establishment principle while, at the same time, making some adjustments "to recognize the claims of [source] countries that are concerned that existing OECD principles are too heavily weighted toward residence-based taxation".⁶⁸

Second, it is intended **that a source country be permitted to withhold tax at a single rate [word order] [ok]** on *any* payment that has the effect of "eroding" the country's tax base. A payment would be considered as eroding the source country's tax base if it was *either* deductible by a source-

⁶⁷ Doernberg, Richard L., "Electronic Commerce and International Tax Sharing", 16 *Tax Notes International* 1013 (1998).

⁶⁸ Doernberg, *supra* note 48, at 10.

country purchaser *or* formed part of **his** [cannot use "it" here since "it" in this sentence refers to "payment"] [ok] cost of goods sold (as this would decrease the gain on the sale of goods). If either of these conditions applies, withholding would occur under the base-erosion approach *irrespective* of the category of the income. This feature is an important element of Prof. Doernberg's approach, and it is intended to respond to the concern regarding the characterization problems that are likely to intensify in electronic commerce transactions, as the test for withholding would be independent of the characterization of the income in the transaction. There are two notable exceptions to withholding under the base-erosion approach. First, dividends would not be subject to withholding because they are not deductible and would therefore not be viewed as eroding the source country's tax base. Second, payments made by consumers of source countries would not be subject to withholding because consumers do not generally deduct the costs of their consumption.

Regarding the rate of withholding, this in many ways is a political question which needs to be determined by negotiation, consensus and quantitative information relating to how much tax could be collected from such a withholding measure. These considerations aside, any chosen rate should be low in order to accommodate the commonly expressed concern that, from an economic perspective, a gross-based tax may conceal a much higher net rate of tax. Also, since the tax base under Prof. Doernberg's approach is more comprehensive than is currently the case for withholding tax systems, a low rate of tax seems appropriate.

The third feature of the base-erosion approach is that **the withholding tax** [add bold text] [ok] is intended to be creditable in the residence country, as the approach is premised on *allocating* the tax base from electronic commerce between source and residence countries, rather than increasing the overall level of taxation. This feature is designed not only to achieve an allocation of the tax base between residence and source countries, but also to operate as a mechanism to avoid double taxation.

The final significant feature of the base-erosion approach is the inclusion of a mechanism to allow vendors from residence countries to file on a net basis in source countries. This feature is necessary to overcome the potential excessive tax burden that may be associated with **a gross-based tax** [ok] under the proposal, along with concerns of double taxation, such as those expressed in the previous paragraph.

In summary, it may be seen that the base-erosion approach seeks to respond to concerns regarding the way source is presently defined for both active business profits and passive income. In relation to active business profits, the base-erosion approach seeks to preserve the permanent establishment threshold, while supplementing it with a new test for tax nexus in source countries which is based on a withholding tax that would apply to any base-eroding payment made by source-country businesses ["taxpayers" deleted ??] [no – retain taxpayers] to residence-country businesses.

Regarding passive income, the base-erosion approach is directed at avoiding the double taxation that may arise when countries adopt different characterizations of **the income arising from ??** [add bold text ??] [ok] electronic commerce transactions. **The approach ?? [the original has "it"]** [ok] also represents a possible policy response to the perceived imbalance in allocating the tax revenue generated by electronic commerce to source and residence countries. Further, it represents a compromise approach, and there are corresponding advantages for tax administrations as well as residence and source countries. For residence countries, the full tax will be collected on dividends as they are not subject to withholding due to their non-deductibility. Residence countries will also be able to tax the income arising from transactions with consumers in source countries if there is no permanent establishment in such countries (because the approach excludes such payments from withholding). Source countries also benefit as they can withhold tax on any base-eroding payment made by businesses **to persons in** [ok] residence countries. Relief from double taxation could be accommodated by allowing a credit, and distortions and excessive tax burdens may be accommodated by allowing for a net-basis filing election in source countries. However, difficulties with this approach are also evident, including the risk of capital flight and excessive credits that may arise from applying the credit mechanism. These difficulties would have to be effectively overcome to ensure that **the approach** [ok] can operate in a way that is acceptable to most countries. This may be achieved either through modifications to the approach or through supplementary measures directed at overcoming the policy challenges identified.

4.2. Virtual permanent establishment approach

The virtual permanent establishment approach is a policy approach that has been advocated by

Prof. Hinnekens.⁶⁹ This approach seeks to relax the permanent establishment principle by adopting a threshold for source-based taxation that is *lower* than that of a traditional permanent establishment. It achieves this by creating a tax nexus in source countries even in the absence of a fixed place of business in them. This effectively means that the tax nexus operates as a permanent establishment "fiction" by allowing tax jurisdiction on the basis of a *virtual* permanent establishment in the source country.

While the virtual permanent establishment approach may seem to be radical, Prof. Skaar has suggested that perhaps the most radical suggestion in reconceptualizing the permanent establishment concept is to completely abandon it as the leading condition for tax jurisdiction and to introduce a system of source-state taxation of business profits.⁷⁰ At the same time, he acknowledged that it is not likely that industrialized countries as a group will agree to changes of this nature and that history suggests that the most practical solution to reconceptualizing the permanent establishment concept is to leave its development to case law and bilateral treaty practice.⁷¹ To support this process, Prof. Skaar suggested that source countries "may seek to include [permanent establishment] fictions in their bilateral treaties for industries where high mobility, impermanence, and the lack of physical location are predominant".⁷² Prof. Skaar's writings therefore provide support for Prof. Hinnekens' proposed virtual permanent establishment approach, which seeks to create such a fiction in determining the source-country tax nexus.

Specifically, the proposal has two main elements. First, a lower threshold for a permanent establishment is intended to apply in the case of electronic commerce transactions, and this is achieved by deleting the requirement for the existence of a "fixed place of business" in the source country from the current formulation of source under the permanent establishment threshold. Second, core or mainstream business activities are subject to source-country taxation under the

⁶⁹ Hinnekens, *supra* note 40.

⁷⁰ Skaar, *supra* note 6, at 573.

⁷¹ *Id.* at 574 (adding that "[i]n the course of this process, the need for amendments in the [permanent establishment] concept will have to labor its way to subjective recognition through interpretation by national courts and tax authorities").

approach, while ancillary activities are not. This is similar to the present exclusion for preparatory or auxiliary activities in Art. 5(4) of the OECD Model, though the proposed exclusion requires the development of suitable guidance and appropriate criteria **in order to distinguish [ok]** core activities from ancillary activities in an electronic commerce context.⁷³ Modified in this way, Prof. Hinnekens argued that the traditional permanent establishment concept *can* be redesigned to accommodate electronic commerce transactions in a way that taxes these transactions consistent with the principles of economic allegiance and equivalence.⁷⁴ Such an approach could also **[shorten here] [as is]** represent a compromise between the interests of electronic commerce exporting and importing countries,⁷⁵ thereby achieving the sharing of revenue between these countries.

Indeed, the theoretical basis for the possible reconceptualization of source under the virtual permanent establishment approach may be justified by reference to Prof. Skaar's writings, which provide support for adopting an approach that seeks to tax businesses in source countries even in the absence of a fixed place of business in those countries:

It seems that an enterprise which does not need to invest in immovable facilities, or other

⁷² Id.

⁷³ In the Commentary (Paras. 42.7 to 42.9) on Art. 5 of the OECD Model, the OECD has provided some guidance on the activities that may be considered core (i.e. an essential and significant part of the business activity of the enterprise as a whole) and activities that may be considered preparatory or auxiliary in an electronic commerce context. Para. 42.7 lists the following activities as being preparatory:

- (i) providing a communications link between suppliers and customers;
- (ii) advertising goods or services;
- (iii) relaying information through a mirror server for security and efficiency purposes;
- (iv) gathering market data for the enterprise; and
- (v) supplying information.

A detailed analysis of the issue of core activities, on the one hand, and preparatory activities, on the other, is beyond the scope of this article.

⁷⁴ Hinnekens, *supra* note 40, at 197.

⁷⁵ Id. (arguing that "the new test of source taxation [would need to be] acceptable to international business as well as to tax authorities as a compromise between the interests of importing and exporting states").

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].*⁷⁶ (emphasis added) **[the emphasized part of this quote was quoted in the text accompanying footnote 6 -- I think we should not repeat that part of the quote. What do you think ??] [ok]**

[break up long sentence]

These words provide theoretical support for the virtual permanent establishment approach, and the proposal seeks to provide an effective jurisdictional framework for taxing electronic commerce transactions in the face of a reduced need for a physical presence in source countries. **Despite this, [ok]**the likely problems in trying to establish an internationally acceptable standard for determining the tax nexus under this approach loom as a major factor which detracts from its successful implementation. These problems are exacerbated by the likely difficulties that will be encountered in attributing profits to a virtual permanent establishment and, although **the problem of attributing profits [ok]** is not necessarily unique to electronic commerce, the problem may nevertheless become exacerbated by transactions that take place in an electronic commerce environment. **[could we use another word here ?? there are many "problems" here] [ok wording modified]**. Finally, while the approach seeks to reconceptualize how source is defined for active business profits, its implementation is unlikely to overcome the problems associated with how source is defined for passive income, including the possible greater incidence of the recharacterization of income and the consequent possible risks of double or unintentional non-taxation that may arise in an electronic commerce context.

4.3. Refundable withholding approach

As an alternative to the two approaches described above, this section puts forward a third proposal - the refundable withholding approach -- which represents an attempt to reconceptualize the way

⁷⁶ Skaar, *supra* note 6, at 559-660.

source is defined for active business income by **proposing [avoid "putting forward" again] [ok]** an alternative to the permanent establishment threshold for determining the source-country tax nexus. This approach also represents an attempt to simplify the way source is defined for passive income by seeking to apply withholding at a standard rate to *all* income covered by the proposal irrespective of the character of the income. Therefore, the approach **[omit words] [ok]** simultaneously presents a possible reconceptualization of the way source is defined for *both* active and passive income. The refundable withholding approach draws upon elements from other proposals (e.g. withholding), but, as will be observed, it also includes other elements to establish the source-country tax nexus. It therefore represents a hybrid approach to reconceptualizing the way source is currently defined for both active and passive income.

The refundable withholding approach is designed to establish a jurisdictional framework for the source-based taxation of electronic commerce transactions by introducing a system of withholding to be applied by source countries at a uniform rate to *all* international electronic commerce transactions generating withholding income (see definition below), which will be refundable if the *total* gross sales of a business in a source country for the relevant period (e.g. a financial year) remain below a *de minimis* threshold.

While many are critical of systems based on withholding,⁷⁷ given the characteristics of electronic commerce, the greater use of withholding taxes by source countries may be justified.⁷⁸ The literature on electronic commerce provides support for tax systems based on withholding, and Prof. Doernberg's base-erosion withholding approach represents a leading example of such support, which was examined in 4.1. In addition to Prof. Doernberg, others, including Prof. Avi-Yonah, have proposed withholding tax approaches for the source taxation of electronic commerce transactions, albeit Prof. Avi-Yonah's proposed approach suggests applying withholding at the

⁷⁷ See e.g. Katz, Stanley I., "International Taxation of Electronic Commerce: Evolution not Revolution", 52 *Tax Law Review* 655 (Summer 1997). Some of the criticisms that Katz levels at withholding systems are analysed when the advantages and disadvantages of the refundable withholding approach are considered later in this section.

⁷⁸ McLure, *supra* note 5, at 6:8 (advocating that, in light of electronic commerce, it may be appropriate for source countries to consider the use of withholding taxes); Avi-Yonah, *supra* note 3, at 507.

corporate tax rate in the source country, while Prof. Doernberg's approach advocates a low rate of withholding tax.⁷⁹ Leaving aside the theoretical support for a greater use of withholding mechanisms to collect tax from electronic commerce transactions, in a practical context, countries such as India are already seeking to rely to a greater extent on withholding approaches in determining how to tax electronic commerce transactions.⁸⁰ Therefore, though many may criticize the approaches based on withholding, it is likely that, from both a conceptual and practical perspective, withholding mechanisms are likely to be increasingly resorted to by countries trying to accommodate the taxation of electronic commerce transactions.

Basing the source-country tax nexus on total gross sales above a *de minimis* threshold would, to many, seem to be a novel, if not unique, proposal. It is submitted, however, that such a threshold for nexus may be necessary to take into account the challenges that electronic commerce provides to established tax principles, such as the permanent establishment threshold, which rely on a physical presence that could become more elusive (or even absent) in an electronic commerce context. In support of the proposal, a search of the literature also reveals that suggestions for dollar-based thresholds to determine the nexus for taxation are not without precedent and have been made, for example, in the US state context by Prof. Hellerstein and others, who have searched for mechanisms to simplify and streamline the disparate systems of state sales taxes which operate in the United States.⁸¹ Prof. Avi-Yonah developed a similar approach that resembles a destination-based VAT by proposing a tax system that seeks to levy a withholding tax at the corporate tax rate on the income in source countries which exceeds a specified threshold.⁸² Therefore, in principle at

⁷⁹ Id. For reasons considered in detail later, it is strongly suggested that if a system of withholding is implemented, it should adopt a low rate rather than **[omit words] [ok]** a high rate, such as the corporate tax rate that may apply in source countries.

⁸⁰ For example, India's AAR decision (supra note 48) and the Indian Electronic Commerce Report (supra note 7) both advocated a greater reliance on withholding mechanisms to collect tax in an electronic commerce context.

⁸¹ Hellerstein, Walter, "State Taxation of Electronic Commerce", 52 *Tax Law Review* 425 (1997), at 497 ("implementation of any uniform regime might well be facilitated by the adoption of de minimis safe harbor rules For example, the obligation of a vendor to determine its customer's billing address might be limited to vendors with more than, say, \$250,000 of sales").

⁸² Avi-Yonah, supra note 3, at 532-541.

least, such a proposal is not necessarily without foundation.

The refundable withholding approach could operate as follows. All international transactions involving goods or services that are either provided electronically (e.g. computer software) or purchased via electronic means (e.g. flowers purchased over the Internet) would be treated as "withholding income", which would then be subject to a uniform rate of withholding **tax [ok]** by source countries irrespective of the category of income involved. The only exception to withholding would be in relation to passive dividend or interest income, which will continue to be treated under existing rules, i.e. such income is generally taxed by residence countries, though consistent with current practice, dividend and interest income may continue to be taxed on a withholding basis by source countries that withhold tax on such income. The taxation of passive dividend and interest income on a residence basis may be justified on a number of grounds, including Prof. Avi-Yonah's formulation of the benefit principle which, according to him, justifies the proposition that "the residence jurisdiction [should have] the primary right to tax passive (investment) income, while the source jurisdiction [should have] the primary right to tax active (business) income".⁸³ This treatment may also be justified on theoretical and practical grounds. From a theoretical perspective, it is arguably sensible to generally tax passive dividend and interest income on a residence basis since individuals derive primarily investment (passive) income, while companies generally derive business (active) income; therefore, source taxation may be more appropriate in this situation. However, on a practical level, source countries have the first opportunity to tax income such as dividends and interest, and some countries thereby exercise the right to withhold tax from this income. At the same time, many large source countries, including the United States, have tended to abandon the source-based taxation of such income, probably for fear of discouraging mobile capital.⁸⁴

Subject to the exception from withholding for passive dividend and interest income discussed above, at the end of the relevant period, if a seller's total gross sales into a jurisdiction remained below a *de minimis* threshold, the seller would *not* be subject to tax in the source country, but

⁸³ Id. at 507.

⁸⁴ Id. (referring to Sec. 871(h) of the US Internal Revenue Code, which repealed the tax on interest derived by non-residents from certain portfolio debt investments in the United States).

would need to file a return there to obtain a refund of the withheld amounts. Conversely, if the seller's total gross sales into the jurisdiction for the period exceeded the *de minimis* threshold, the seller *would be* subject to source-country taxation, and the amounts withheld would generally not be refunded. At the same time, sellers whose operations exceed the *de minimis* threshold would be able to elect to file a return in the source country and be taxed on a net basis.⁸⁵ This is because withholding under the proposal applies to gross income; however, income from active business operations should generally not be subject to tax on a gross basis⁸⁶ as this may have distortionary outcomes, including the possibility of a gross tax being imposed in the absence of any net income.⁸⁷ Therefore, the ability to file on a net basis must be provided in order to minimize impacts such as these.

The advantages of this approach include the prospect that the system is operationally possible with the use of new technologies to assist with the collection, distribution and refund of the taxes withheld under the approach. The system is also designed to avoid the difficult issues regarding the characterization of income that could become more problematic in an electronic commerce context. Finally, as the system can be unilaterally enacted by countries, it would not require a revision of the extensive and entrenched bilateral double taxation treaty network that exists between countries.

Despite these advantages, it is recognized that the approach is not without difficulties. The first concern that needs to be considered is whether the proposed system is consistent with the principle of neutrality. It could be argued that the proposed system is *not* neutral because, under the proposal, withholding applies only with respect to cross-border sales of electronic commerce goods and services that involve foreign sellers; withholding does not apply to similar sales made by local

⁸⁵ It is recognized that the decision to file on a net basis would have compliance costs, which businesses would need to take into account in deciding whether to file on a net basis.

⁸⁶ Unless it can be established that gross income approximates net income -- arguably a remote possibility unless the income is of a type that has few corresponding deductions or expenses.

⁸⁷ Alternatively, a gross-based tax could result in prohibitively **high tax rates on net income.?? [please check] [correct]**

vendors. Also, as withholding is proposed to apply to *all* cross-border electronic transactions,⁸⁸ this may be more unfavourable to small businesses as compared to large businesses because small businesses whose total gross sales fall below the *de minimis* threshold would have to wait until the end of the relevant period to file their return to receive a refund of the amounts withheld. At the same time, large businesses that choose to file on a net basis in source countries would also have to wait until the end of the relevant period to have their position reconciled. In other words, the proposal creates a possible timing problem for receiving a **refund**,~~[omit words]~~ **[ok]** which may be more acute for small businesses.

Another concern relates to the feature of withholding under the proposal as there are several problems with any withholding-based system, which are briefly summarized. First, withholding taxes based on gross receipts could be distortionary where it is not reasonably certain that the substantial part of the gross receipts consists of net income. Withholding taxes could also operate as tariffs, especially if they are not creditable in residence countries. Further, **taxpayers would incur the compliance costs** ~~[delete 'the']~~ associated with filing returns to obtain a refund of the amounts withheld, and tax authorities would incur administrative costs to ensure that the system is enforceable. Finally, from an economic perspective, productive resources may be wasted by taxpayers trying to avoid such taxes. While all of these concerns are valid criticisms of any withholding-based system, it is submitted that the effects could be minimized if the proposal advanced here is implemented as intended --that is, if the tax withheld is creditable in residence countries and is levied at a low rate, with net filing in source countries being permitted. And while it is recognized that even these features will not eliminate the concerns expressed, the features could certainly operate to minimize their impact.

The final concern regarding the proposal relates to the fact that, as electronic commerce transactions would effectively be taxed based on their ultimate destination (i.e. the country of consumption), it could be argued that the system more closely resembles a consumption tax than an **[I would delete "direct"]** **[ok]** income tax, and this could lead to a number of problems. Stanley Katz, for example, argued that since there are fundamental differences between a consumption tax

⁸⁸ Subject to the ~~[delete "possible" ??]~~ **[ok]** exception for passive dividend and interest income noted earlier.

system and international income taxation, the adaptation of a consumption tax system may not "provide a rationale for taxing [the] income of foreign producers on a destination basis".⁸⁹ Further, as income is usually associated with production rather than consumption, allocating income tax revenues to countries where consumption occurs may be inconsistent with this association. Against this line of reasoning, however, Prof. Avi-Yonah has argued that "the issue of which tax base to choose (income or consumption) is different from the question of which jurisdiction should get the revenues (production or consumption)".⁹⁰ On this basis, it could therefore be argued that it is not necessarily illogical to allocate income tax revenues to countries in which consumption takes place -- **the same way that it is acceptable to [ok]** allocate an origin-based VAT (or goods and services tax) to the production country.

5. CONCLUSIONS

This article has argued that, although source-based taxation remains theoretically valid in today's globalized world, the *way* source is defined under the permanent establishment threshold needs to be reconceptualized in light of the changes brought about by globalization and the related developments in electronic commerce. Three possible approaches to this reconceptualization were examined (see 4.) and, despite the potential difficulties associated with each approach, **it is submitted [ok]** that the perfect should not be the enemy of the good and each approach does offer some advantages.

~~In sum, it is submitted [can we avoid repeating this phrase ?? see above]~~ that the The proposed approaches outlined in this article could provide a more stable and appropriate basis for the source-based taxation of international electronic commerce transactions than the current international tax system. These approaches seek to take into account the possibility that substantial business profits are earned from **source [ok]** countries without the need to maintain a physical presence in them. In short, the proposals attempt to respond to the concerns expressed by Prof. Skaar, and it is instructive to conclude this article by returning to the following extract from his writings:

⁸⁹ Katz, *supra* note 77, at 668 (criticizing Prof. Avi-Yonah's proposed destination-based tax system designed to be applied by source countries by withholding at the corporate tax rate).

⁹⁰ Avi-Yonah, *supra* note 3, at 539.

Changes in communications and technology have created new industries where the performance of extensive and profitable business activities does not require substantial machinery or equipment, or establishment at one specific geographical point for a long period of time. The conclusion is that the effects of the [permanent establishment] concept in international fiscal law have changed, in particular during the last few decades. Rather than protecting the tax base in the source state, the [permanent establishment] principle today has become instrumental in ensuring avoidance of source-state taxation for some economically important business operations ... [and] the 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.⁹¹

⁹¹ Skaar, *supra* note 6, at 559 and 573.