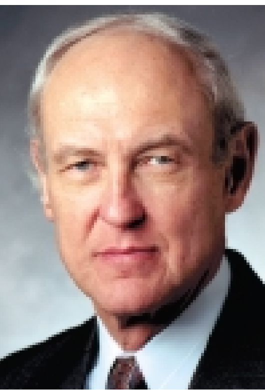

Alternatives to the Concept of Permanent Establishment**

Charles E. McLure, Jr.*

Introduction

The question, "What are the alternatives to the concept of permanent establishment?" could be interpreted in a variety of ways, among them:

- What are the alternatives to source-based income taxation, in which the concept of permanent establishment (PE) plays a central role?
- What are the alternatives to the concept of PE, if the objective is to implement source-based income taxation?
- What are the alternatives to the definition of a PE found in the OECD Model Tax Treaty?

Source-based taxation could be rendered obsolete by e-commerce

I limit my discussion to the first two or these.[1]

It is not at all clear how electronic commerce should be defined for the purpose of this discussion. The Organisation for Economic Co-operation and Development (OECD) has defined electronic commerce as "business occurring over networks which use non-proprietary protocols that are established through an open standard setting process such as the Internet."[2] Virtually all international commerce involving business-to-business transactions – the vast majority of all international trade – will soon fall within this definition. Yet limiting the definition to sales of tangible products and digital content downloaded from the Internet is too narrow. Fortunately, for present purposes a precise definition is not needed.

Why it matters

The advent of electronic commerce has caused some to question the continued viability of source-based taxation. The U. S. Treasury, in its 1996 report entitled *Selected Tax Policy Implications of Global Electronic Commerce,* suggested:

The growth of new communications technologies and electronic commerce will likely require that principles of residence-based taxation assume even greater importance. In the world of cyberspace, it is often difficult, if not impossible, to apply traditional concepts to link an item of income with a specific geographical location. Therefore, source-based taxation could lose its rationale and be rendered obsolete by electronic commerce.[3]

This proposal is not likely to be popular with other countries, which are much less active in electronic commerce than the United States. Besides, residence-based taxation is not free of problems in a world of electronic commerce.

Even if this fear – or is it a hope? – that continued source-based taxation is not a viable alternative turns out to be exaggerated, electronic commerce raises the spectre of increasing amounts of sales being made by firms that lack a permanent establishment in market nations, as indicated by the traditional tests. The problem may be described as follows:

"The growth of electronic commerce may signal an economic realignment of the role of source and resident countries compared to their role in tradi-

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[1] This discussion draws heavily on Reuven S. Avi-Yonah, "International Taxation of Electronic Commerce (1997), *Tax Law Review,* vol. 52, no. 3, 507–55.

[2] Organisation for Economic Co-operation and Development, *The Economic and Social Impact of Electronic Commerce: Preliminary Findings and Research Agenda* (Paris: OECD, 1999) p. 28.

[3] U. S. Department of the Treasury, *Selected Tax Policy Implications of Global Electronic Commerce* (1996), available at http://www.ustreas.gov/taxpolicy/internet.html.

tional commerce. A typical traditional commercial transaction might involve R Corp., a country R company, producing goods in country R and marketing and selling goods through a country S permanent establishment or subsidiary. In this scenario, country S might tax income attributable to the permanent establishment or subsidiary, and country R might tax any income attributable to the production process. Countries have relied on this basic division of tax jurisdiction for most of the 20th century. To the extent that electronic commerce replaces traditional commercial patterns, the tax balance between countries is threatened. Through the use of the Internet, R Corp., which still may produce its goods in country R, now can market and execute sales in country S without the need for a presence in country S. Even if R Corp. must maintain a presence in country S, it is likely that the presence will be much more limited and that the income attributable to such a presence will likewise be limited."

Furthermore:

"Any change in the balance of taxing authority between country R and country S under existing international tax principles may lead countries – particularly those likely to be source countries (i.e., country S) – to call for new international tax principles or at least for a reinterpretation of existing tax principles in a manner that will restore the pre-existing tax equilibrium."[4]

The rule that source countries could tax only business income attributed to a permanent establishment was intended to limit the amount of income that source countries could tax. In a sense, then, the traditional debate is being turned on its head: reliance on the concept of permanent establishment may need to be rethought to protect the revenue of source (market) nations.

Source vs. residence-based taxation

To assess whether the position of the U.S. Treasury would represent good policy, it is useful to start with first principles – to ask what are the conceptual and theoretical underpinnings for taxation based on source and on residence. Given the proposal to shift from source-based taxation, it makes sense to focus primarily on the case for source-based taxation. With this conceptual discussion as background, we can then ask whether pragmatism forces compromise with those principles. It is useful to distinguish between the taxation of individuals and the taxation of corporations in applying the principles.

The case for residence-based taxation

The case for residence-based taxation is relatively clear. Residence-based taxation is implied by the desire to tax individuals on the basis of *ability to pay.* Taxation would be levied on the total world-wide income of individuals, presumably at graduated rates. Note several points. First, a tax on total world-wide income must be imposed by countries of residence; it makes no sense even to contemplate source-based taxation of total income. Second, ability-to-pay taxation is meaningful only in the context of taxation of individuals. Ability-to-pay cannot be used to justify residence-based taxation of corporations.

Residence-based taxation achieves capital-export neutrality

Residence-based taxation achieves *capital-export neutrality* – neutrality toward the choice of where to invest, which in turn produces world-wide efficiency in the allocation of capital. To the extent that the benefit principle is used to justify taxation by the country of residence, it is also relevant primarily for individuals, who consume far more public services than do corporations. Benefit-related taxation of corporations should be primarily source-based, as corporate residence, *per se,* probably involves few governmental costs for the home country.

The case for source-based taxation

The case for source-based taxation is less obvious, but may be just as compelling. One justification for source-based taxation relies loosely on the *benefit principle of* taxation: the view that the country where income originates should be compensated for the cost of providing public services. Besides such obvious services as defence and police and fire protection, there is the legal infrastructure that is necessary for the functioning of business. T.S. Adams, the U.S. Treasury official most directly responsible for the U.S. position that is reflected in the forerunner of the OECD Model Treaty, said, "A large part of the cost of government is traceable to the neces-

[4] Richard L. Doernberg and Luc Hinnekens, *Electronic Commerce and International Commerce* (The Hague: Kluwer Law International for the International Fiscal Association, 1999), pp. 300 and 301.

sity of maintaining a suitable business environment."[5] More generally, business is seen to benefit from the existence of a civilised society and thus should help pay the "price we pay for a civilised society." As noted above, this type of benefit to corporations is likely to be greatest in source countries.

A tax justified by the benefit principle would generally only cover the cost of providing public services for corporations, which would be relatively small. A second rationale for source-based taxation, and one that might justify greater taxation of corporate income, is based on the somewhat squishy concept of "*entitlement*" – the view that the source country is entitled to share in income created within its borders.[6] The entitlement theory seems most persuasive in the case of taxes on natural resources, especially in countries where resources are privately owned and their exploitation results in economic rents (profits that are extraordinary, in the sense of exceeding the normal return to capital). One commonly finds words such as "heritage" and "patrimony" being used to justify taxation of natural resources.

The benefit principle and the entitlement theory argue for source-based taxation

The entitlement theory may be equally applicable in industries where profits are extraordinary for other reasons, as when there is market power. (Thus extraordinary profits and the right to tax them may exist in the case of Coca Cola, but not in the case of commodities such as wheat.) But, since the base of the corporate income tax commonly resembles accounting profits, rather than economic profits (that is, it includes the normal return to capital), one can argue that entitlement to corporate tax revenue exists any time a firm avails itself of the productive resources or the market of a nation – that is, if it has an economic presence in the nation. Of course, common sense requires that the economic presence be significant before a firm is subjected to income taxation.

It is useful to compare and contrast the benefit and entitlement theories. The benefit argument concentrates on benefits of services the government of the taxing nation provides to business. Under the entitlement theory, public services are more-or-less irrelevant, as entitlement is based on economic benefits, for example, the benefits of exploiting a market. Limiting taxation to profitable corporations and using profits as the tax base thus seems more sensible under the entitlement theory. Moreover, the entitlement theory seems to support a higher level of corporate taxation than does the benefit principle.

The final argument for source-based taxation is pragmatic: source countries are not likely to want to forego taxation of income earned within their boundaries, regardless how outsiders feel about their entitlement to tax it.

Source-based taxation assures that all those who invest in a given country compete on an equal footing. The result, capital import neutrality, has considerable appeal to business, but little to economists, who instead endorse capital-export neutrality.[7]

Reconciling source and residence-based taxation

Taxation of a given flow of income by both source and residence countries generally produces double taxation, in the absence of steps to prevent double taxation. Two methods are commonly used to avoid international double taxation of business income: exemption of foreign-source income and foreign tax credits (FTCs).[8] Both are implemented by residence countries and accord priority to source-based taxation; that is, they reduce residence-based taxation, while leaving source-based taxation intact. Both require measurement of foreign-source income, and thus the attribution of income to its geographic source and nexus rules, the former because only foreign-source income is exempt and the latter because FTCs are generally limited to the amount of tax that would be due on the foreign-source income in the residence country.

The administrative dimension

Whether source-based taxation is administratively feasible trumps conceptual arguments. Countries may simply not be able to implement taxes on

[5] Thomas S. Adams, "The Taxation of Business," (1917) vol. 11 *Proceedings of the National Tax Association,* p. 186, quoted in Michael J. Graetz and Michael M. O'Hear, "The 'Original Intent' of U.S. International Taxation," *Duke Law Journal,* vol. 46, no.5, 1036.
[6] The entitlement view is commonly associated with Peggy Musgrave; see, for example, Peggy Musgrave, "Principles for Dividing the State Corporate Tax Base," in Charles E. McLure, Jr., editor, *The State Corporation Income Tax: Issues in Worldwide Unitary Combination* (Stanford, Calif.: Hoover Institution Press, 1984), pp. 228–46, and references provided there.

[7] In general capital-export neutrality and capital-import neutrality are mutually compatible only if tax rates (and the definition of income) are identical in source and residence countries.
[8] Deduction for source-based taxes does not eliminate double taxation; it only reduces it.

income originating within their boundaries, no matter how compelling the arguments for doing so. But administrative concerns do not cut only one way; under certain conditions implementing residence-based taxation is also problematical. (See the discussion of problems of residence-based taxation below.)

The role of physical presence in source-based taxation

Assuming that the objective is to implement source-based taxation of corporate income, should source countries be allowed to tax income of foreign multinationals only if they have a physical presence in the country? In attempting to answer this question, it is useful to distinguish three types of products (tangible products, intangibles, and services) and two (partially sequential) states of the world:

- The "pre-digital world," in which virtually all international economic relations involve local vendors, physical assets, tangible products, and services that require a physical presence for their delivery, and
- The "digital world," in which there are remote vendors, important intangible assets, intangible products, and digitised services that can be provided at a distance, as well as the attributes of the pre-digital world.

Benefit principle. In the pre-digital world the argument for source-based taxation based on the benefit principle suggests that a physical presence should probably be required to establish nexus for source-based income taxation. It seems that in this world most of the public services that benefit business firms providing tangible products and services do so only if the firm has a physical presence in the country. Consider, for example, police and fire protection. Do they benefit firms that lack a physical presence in the taxing nation? Probably not.

The situation seems to be different in the digital world. Most obviously, protection of intellectual property is crucial to vendors of intangible products and digitised services and does not depend on whether the seller has a physical presence in the taxing nation. Also, mail-order sales of tangible products may place demands on public services. Thus, in the digital world perhaps a physical presence should not be required to justify source-based taxation under the benefit principle.

Entitlement. The entitlement theory seems to be somewhat more conducive than the benefit principle to taxation of corporations that lack a physical presence. If entitlement is based on economic presence, the case for taxation of income of remote vendors seems strong, even though the vendor does not have a physical presence in the taxing nation. This is true whether the vendor is selling tangible products delivered by conventional means or intangible products or services provided over the Internet. These statements should, however, be qualified; liability for income tax should be subject to a de minimis test; because of the compliance costs involved, it would not make sense to levy income tax on all vendors that have an economic presence, no matter how small their sales.

In the digital world a physical presence is not required under the benefit principle and the entitlement theory

Administrative considerations. Administration and compliance are simpler if the taxpayer has a physical presence in the taxing nation than if it does not.

"[S]ource countries that are seeking to tax income from electronic commerce have to consider how they might enforce any taxing authority they claim. In many cases, an enterprise may not have any physical presence in the country seeking to tax. In such a case, enforcement 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."[9]

Synthesis

The Table summarises the above discussion. In the pre-digital world it makes sense under the benefit theory of taxation to predicate source-based taxation on the existence of a physical presence in the taxing nation. The entitlement theory suggests that source-based taxation may be appropriate, even in the absence of a physical presence. In the digital world both principles justify source-based taxation, even if there is no physical presence.

[9] Doernberg and Hinnekens, *op. cit.*, p. 341.

Implications of Taxing Theories for the Role of Physical Presence

Theory of Taxation	Pre-digital World	Digital World
Benefit principle	Generally required	Perhaps not required
Entitlement	Perhaps not required	Probably not required

Conceptual arguments notwithstanding, the practical difficulty of taxing the income of firms that lack a physical presence remains; taxation may be difficult to implement ("be rendered obsolete," in the words of the U.S. Treasury Department) where there is no physical presence. As noted earlier, the latter consideration has led some, including the U.S. Treasury Department, to conclude that continued heavy reliance on source-based taxation is not appropriate – that there should be a multinational shift to greater reliance on residence-based taxation.

Problems of residence-based taxation

A shift to residence-based taxation would be self-serving and politically unrealistic

The suggestion that there should be a shift to greater reliance on residence-based taxation seems to be technically naive, as well as self-serving and perhaps politically unrealistic. That it is self-serving and perhaps politically unrealistic is obvious. The United States is, by far, the world's largest exporter of electronic commerce. Other nations can be expected to resist an explicit shift to residence-based taxation, which would run against the tide of historical development in this area, as well as international opinion.

What, then, are the difficulties of implementing residence-based taxation? First, in a world of rapid and inexpensive interactive communication, the place of effective management, the test of residence employed in much of the world, can easily be divorced from the place where production occurs. The place of residence can be manipulated to place residence in a tax haven, where there will be little or no taxation. Strengthened CFC legislation (laws dealing with the taxation of controlled foreign corporations) may be able to combat shifting of operations to subsidiaries located in tax havens, but it will not affect newly created enterprises operating from tax havens.

Nor does the problem end with tax havens. Some "real" countries (e.g., Belgium and the Netherlands) have enacted legislation that is intended to attract home offices. CFC legislation probably would not even affect the transfer of residence to those countries.

Second, unless all nations abandon source-based taxation, there will remain a need to determine the source of income, in order to implement exemptions for foreign income or limitations on foreign tax credits, which ordinarily are available only to the extent of domestic taxation of foreign-source income for which credit is sought.

Salvaging source-based taxation

The U.S. Treasury Department's position takes as given and immutable the existing international rules for determining the source of income. In addition to the use of a PE to determine jurisdiction to tax, it accepts the current distinctions between types of income (income from sales, income from the provision of services, and royalties) and difference in the taxation of each. A more flexible attitude might have revealed less need to abandon source-based rules.

Continued reliance on source-based taxation requires attention to at least three questions: a supplement to the PE test of nexus, distinctions between types of income, and rules for dividing income among nations. In addition, it may be appropriate to consider the use of withholding taxes by source countries. The discussion of the first and last of these issues (supplementing the PE test and withholding tax)concentrates on electronic commerce where the seller does not have a PE in the taxing nation; the discussion of the other two is more generally applicable.[10]

A supplement to the PE test. The discussion of the entitlement view suggests that earning more than a de minimis amount of income in the taxing nation should be enough to subject a firm to the nation's income tax, even if there is no PE. Although this test would ideally be based on net income, administrative considerations suggest that the test must be based on gross income or gross receipts; basing

[10] This discussion draws heavily on the substantially more comprehensive discussion in Avi-Yonah, *op. cit.*, pp. 531–550.

the test on net income would make the de minimis rule pointless, as it would theoretically force all firms making sales in the nation to calculate income attributable to the nation to determine whether they have taxable nexus.

Characterization of income. Electronic commerce blurs the distinctions between types of income: income from sales, income from the provision of services, and royalties from the licensing of intangibles. It thus makes sense to eliminate these distinctions, which have no economic foundation. "In an economic sense, income is income. ... Distinctions between different types of income are artificial."[11]

Division of income. Traditionally the division of income among countries has relied on separate accounting and arm's length prices. The growing importance of intangible assets, which often have no market price, has made application of the traditional methods of determining arm's length prices (comparable uncontrolled prices, cost plus, and resale value) more and more difficult.[12] Electronic commerce will aggravate this tendency, by increasing the degree of economic integration between related entities, increasing the number of transactions that need to be valued, and reducing the availability of comparable market prices.

"The speed, frequency, and integration of exchanges over the Internet and the development of private networks within MNEs will require an innovative approach in applying a separate transaction analysis. In terms of comparability, it becomes more difficult to determine what the transaction actually is, and even greater difficulties apply to finding a third party transaction about which enough is known to conclude that it is comparable. And transactions can be hard to discover and trace, particularly those which take place in private networks. The OECD guidelines direct a functional analysis to assess comparability, but with electronic commerce and private networks, it can be difficult to know who is doing what. Transfer pricing will increase in complexity, particularly if the MNE is purposefully attempting to shift income among related parties."[13]

[11] *Ibid.*, p. 335.
[12] See Charles E. McLure, Jr., "U.S. Federal Use of Formula Apportionment to Tax Income from Intangibles" (1997), *Tax Notes International,* vol. 14, no. 10, 859–71, and literature cited there.
[13] Frances M. Horner and Jeffrey Owens, "Tax and the Web: New Technology, Old Problems," (1996), *Bulletin for International Fiscal Documentation,* vol. 50, no. 11/12, 520.

It may thus be desirable – or inevitable, even if not desirable, in principle – to turn to increased use of formulas to divide income of multinational enterprises (MNEs).

The use of formulas is not without problems, however.[14]

A withholding tax on international payments. The possibility of an expanded use of withholding taxes raises important questions, like that of the appropriate rate. The use of the corporate tax rate could subject sales to enormous withholding taxes that could not be credited in the country of residence. The problem is not that the withholding tax would not be non-creditable, *per se;* this proposal makes sense only if there is agreement (ideally multilateral, but more likely bilateral, as is the practice in this area) that residence countries will allow foreign tax credits for it. The problem is that if the withholding tax on gross income is levied at the corporate rate, it will almost always exceed the tax that is due on net income in the residence country.

Source-based taxation would require: a supplement to the PE test, distinction between types of income, rules for dividing income among countries

Where the withholding tax exceeds income tax that would be due under the normal income tax of the source country, it should be possible for a firm to complete an ordinary income tax declaration in the source country, even if it lacks a permanent establishment there, in order to obtain refund of excess taxes withheld. This would alleviate the problem of excess foreign tax credits, but at the cost of forcing many firms with a de minimis presence in the source country to file tax returns. As always in choosing withholding rates to be levied on gross income, there must be a compromise between the risk of collecting too little revenue and the risk of forcing filing by those who should not file – in this case, because they earn little net income in the taxing nation.

Concluding remarks

If it is thought desirable to change international standards for jurisdiction to levy income tax, it would be most efficient to make the changes in a multilateral context; besides being enormously

[14] For an analysis of the pros and cons of formula apportionment see Charles McLure, Jr. and Joann m. Weiner, "Deciding Whether the European Union Should Adopt Formula Apportionment of Company Income," in Sijbren Cnossen, ed., *Taxing Capital Income in the European Union: Issues and Options for Reform* (Oxford University Press, 2000), pp. 243–92.

time-consuming, re-negotiation of bilateral tax treaties would leave gaps and overlaps in taxation during the period when the rules are in flux. While the reforms discussed above (supplementing the PE concept, eliminating distinctions between types of income, use of formulas, and withholding) could be introduced unilaterally or bilaterally, multilateral introduction would be more likely to avoid inconsistencies. Moreover, solution to the administrative problems created by electronic commerce is likely to require international co-operation, both to prevent tax evasion and to prevent harmful tax competition (for example, from tax havens) that facilitates legal tax avoidance.

Desired are multilateral negotiations of an international tax treaty to deal with e-commerce

Unlike the situation in the case of trade and tariffs, no international agency is charged with responsibility for multilateral negotiation of international tax treaties; there is no "GATT for taxes" and no World Tax Organisation. Although many double taxation treaties are patterned after the OECD Model Treaty, virtually all are bilateral agreements.[15]

The OECD is at the centre of international discussions of the changes needed to deal with the tax implications of electronic commerce. It will be interesting to watch the progress of discussions at the OECD on the need to revise the OECD Model Treaty to deal with fundamental changes in commercial relationships brought about by e-commerce. It may be even more interesting to see whether it is concluded that there is a need for a more comprehensive and formal forum for discussion of these and similar matters — that is, whether something like a World Tax Organisation is needed.

[15] The relatively few multilateral agreements between members of the European Union are the only significant exception to this generalisation.