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The Jurisdiction to Tax Highly Virtual Enterprises

Thesis submitted in fulfilment of the requirements for the degree of Doctor of Philosophy (Ph.D.)

2016

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Summary of methods used and major findings

Research for this thesis commenced in September 2011, with earlier preliminary research taking place from October 2010. The onus for undertaking this research was a belief that the challenges to international tax law posed by electronic commerce – which had gone largely unchecked – would soon need to be addressed by policymakers. It was anticipated that the financial crises of 2008-2011, and the resulting loss of government revenue – would precipitate an impetus to, at last, address these issues. This prediction has proved to be a correct one.

This research for this thesis was primarily undertaken at Trinity College, Dublin between September 2011 and September 2015. Further significant research was intermittently undertaken at the University of Glasgow, the University of Edinburgh, and the University of Cambridge, and from October-December 2014 at the China-EU School of Law at the China University of Political Science and Law, Beijing.

This thesis commences with a broad conceptual overview of the subject area. It identifies the jurisdictional challenges that have arisen in international taxation, and catalogues the efforts that have hitherto been made to address these challenges. This thesis proceeds to consider the economic and legal basis for existing jurisdictional rules – the concept of taxation at source, and the permanent establishment threshold – as well as proposing a revised jurisdictional standard which would better address the challenge of highly virtual enterprises. Finally, this thesis considers other threshold standards that have been proposed, or that already exist.

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Many of the practical aspects of this thesis are the product of the author's past work in the Scottish Parliament – which provided invaluable experience in how policy is made, as well as on the conduct of intergovernmental affairs. For this experience, as well as for their enduring support, the author wishes to thank Ms. Pauline McNeill, Cllr. Frank McAveety, and Mr. William Bain.

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All errors and omissions are that of the author.

Stuart MacLennan
28 September 2015

Table of Contents

Summary of methods used and major findings v

Acknowledgements vi

Table of Contents ix

List of Tables xiii

Chapter 1: Introduction 1

1.1 Conspectus 1

1.2 Scope of inquiry 3

1.3 Methodological considerations 6

1.4 Methodological limitations 9

1.5 Overview of thesis 13

Chapter 2: The Jurisdiction to Tax 1

2.1 Introduction 1

2.2 The normal operation of international law 1

2.3 Fiscal sovereignty and the jurisdiction to tax 9

2.4 Double taxation as a product of the normal operation of international law 11

2.4.1 Territorial basis to tax 11

2.4.2 Personal basis to tax 12

2.4.3 The normal operation of international law 13

2.5 Delimiting jurisdiction 16

2.5.1 Origins of the principles of double taxation elimination 22

2.5.2 Inter-war years: efforts of the League of Nations and others 24

2.5.3 The OECD Model 29

2.6 Conclusion 31

Chapter 3: Jurisdiction and the Internet 33

3.1.1 Defining the Internet 35

3.2 Nature of the Internet 35

3.3 Allocating legal authority on the Internet 38

3.3.1 Drawing a new border: David Post's Approach 39

3.3.2 Old-fashioned sovereignty and the Internet 42

3.4 Rethinking Internet jurisdiction 52

3.5 Conclusion 55

Chapter 4: Addressing the challenges of new business models 57
4.1 Introduction 57
4.2 New business models 59
4.2.1 Catalogue model 60
4.2.2 Online conclusion/offline delivery model 61
4.2.3 Online conclusion and delivery model 62
4.2.4 Online intermediaries 62
4.2.5 Online service provision 63
4.2.6 Internet Service Providers 64
4.2.7 Advertising 64
4.3 Highly virtual enterprises 67
4.4 The challenge of the digital economy 68
4.5 Efforts at addressing the challenges of the new economy 71
4.5.1 Internet Tax Freedom Act 72
4.5.2 OECD efforts 76
4.5.3 Criticism of the OECD Approach 96
4.6 EU VAT on e-Services Directive 101
4.6.1 Supplies of electronic services within the European Union 102
4.6.2 Administration and collection of VAT from outwith the European Union 104
4.7 Conclusion 106
Chapter 5: The Concept of Source 109
5.1 Introduction 109
5.2 Conspectus 109
5.2.1 Illustrative example 110
5.2.2 Methods for alleviating double taxation of foreign source income 112
5.2.3 Exemption method 116
5.3 The source of income 117
5.3.1 Defining source 117
5.3.2 Knowing the source of income 122
5.4 Legitimation 123
5.4.1 Benefit theory vs. sacrifice theory 124
5.4.2 Value-creating activity 133
5.4.3 Access to Markets 140
5.4.4 Inter-nation equity 142
5.4.5 Capital import neutrality and capital export neutrality 145
5.5 Classifying income 148

5.6 Alternatives to taxation at source 152
5.7 Global Value Chains 157
5.7.1 Integration of Business Functions 157
5.7.2 The source of income from intangibles 167
5.8 The enduring importance of source 174

Chapter 6: Permanent Establishment 181
6.1 Introduction 181
6.2 Permanent Establishment 182
6.3 Constitution of a fixed place of business 186
6.3.1 'Enterprise' 186
6.3.2 'Place of business' 189
6.3.3 'Fixed' 191
6.3.4 'Through which the business of the enterprise is carried on' 196
6.4 Reconceptualising Internet taxation 197
6.4.1 Servers as Permanent Establishments 199
6.4.2 Practical difficulties in taxing servers 217
6.4.3 Virtual Permanent Establishments 228
6.5 A pragmatic standard 238
6.6 Conclusion 239

Chapter 7: Purposeful direction – a qualitative standard 241
7.1 A (more) qualitative standard 243
7.1.1 Subjectivity vs. objectivity 245
7.1.2 Consistency with conceptual basis to tax 247
7.2 Jurisdiction to Tax between U.S. States 249
7.3 Proposed new Model Articles 261
7.3.1 Qualitative criteria for determining jurisdiction 264
7.3.2 Draft articles 268
7.4 Support for a more qualitative standard 273
7.5 Necessary features for a substantive standard to work in practice 282
7.5.1 Characteristics of effective dispute resolution 284
7.5.2 Interpretation of tax treaty rules 286
7.5.3 Essential features of effective dispute resolution 294
7.6 BEPS agenda 297
7.7 Conclusion 300

Chapter 8: Alternative Threshold Standards 303
8.1 Introduction 303
8.2 India's 'business connection' standard 303

8.3 Diverted Profits Tax 307
8.3.1 Commencement and enforcement 311
8.3.2 Compatibility with OECD Model 315
8.3.3 Compatibility with European Union Law 325
8.4 Base Erosion Approach 334
8.5 Quantitative economic presence test 337
8.6 Residence-based taxation 341
Chapter 9: Conclusions 347
Bibliography 357

List of Tables

Table 5-1 - effects of different approaches to alleviation of double taxation

Table 5-2 – active and passive income articles in OECD Model Convention

Table 5-3 – allocation of active and passive income to source and residence in OECD Model

Table 6-1: Differing tax treatment of fixed place of business and dependent agent permanent establishments

Chapter 1: Introduction

1.1 Conspectus

Double taxation arises as a consequence of the overlap of jurisdiction to tax. International law seeks to allocate that jurisdiction to tax through a network of bi-lateral Double Taxation Conventions, the majority of which are based upon the OECD Model Convention. The emergence of Highly Virtual Enterprises has challenged both the conceptual basis for, and practical operation of the prevailing jurisdictional threshold standard in international tax law – permanent establishment.

More broadly, the Internet has challenged conventional approaches to allocation of jurisdiction generally. Fears about the Internet being a lawless new frontier precipitated a rash of different approaches, many of which appeared to have little regard to the fundamental nature of the Internet – which is that it is ultimately merely a communications medium. In any case, many of the fears about the Internet failed to come to light, with the technology actually proving far easier to regulate than was anticipated. Nonetheless, there remains a need for consistent universal rules as to the allocation of jurisdiction over the Internet. This thesis identifies an approach to such allocation that reflects the nature of the Internet as a communications medium, which

informs subsequent discourse as to how jurisdiction to tax highly virtual enterprises ought to be determined.

This thesis then considers the conceptual bases for the allocation of jurisdiction to tax, generally, and finds that the benefit principle is the only sound basis for allocation of jurisdiction to tax in international law. As such, the principle of taxation at source ought to be adhered to.

This thesis critiques the use of the permanent establishment standard to determine jurisdiction to tax over highly virtual enterprises. It considers, in particular, the physicality requirement inherent in a standard that hinges upon the existence of a fixed place of business, and its suitability in the context of the new economy.

It is submitted that whatever the practical virtues of the permanent establishment standard – the link between the conceptual bases for allocation of jurisdiction and the permanent establishment standard is tenuous, and weakened further by the advent of highly virtual enterprises. This thesis considers alternative jurisdictional standards, and proposes that a subjective assessment of an enterprise's activities in within a state would be more conceptually sound than a standard based upon a bright-line physical presence test. While a subjective standard might not presently be feasible, as states move towards including mandatory arbitration clauses in their bilateral treaties, a more subjective threshold standard might be operable in the near future.

Finally, this thesis considers some alternative jurisdictional threshold standards, either extant or proposed. While this thesis does not specifically endorse any of these standards, some of them represent an improvement upon the *status quo*, as well as illustrating that there is no sacred reason for strict adherence to the permanent establishment jurisdictional threshold.

1.2 Scope of inquiry

As its title suggests, this thesis is a study of the jurisdiction to tax highly virtual enterprises in international law. Its focus is primarily on the OECD Model Convention, and the treaties based thereupon. Though this thesis is not a study of jurisdiction as a matter of domestic law, many states' domestic rules are designed to mirror those provided for by the OECD Model. Furthermore, there appears to be at least some evidence that domestic approaches to international tax rules influence the development of those international rules.[1] Consideration of domestic applications of treaty rules is therefore informative.

Questions as to the jurisdiction to tax can be divided into a first and a second order. The first order question is what in this thesis is referred to as the 'jurisdiction question'. The jurisdiction question is concerned with the level of contact an enterprise

[1] See, for example, the German Pipeline Case, discussed *infra* at 4.5.2.3.2.

ought to have with a state before that state exercises its jurisdiction to tax the profits of that enterprise.

Once the first order question – the jurisdiction question – has been addressed and it has been found that an enterprise does indeed have sufficient jurisdictional links with a state in order to be subject to taxation within that state, it then becomes necessary to address the second order question – which is how the profits of that enterprise ought to be accounted for such that an appropriate share of those profits is allocated to that enterprise's establishments within that state. For the purposes of this thesis, this question is referred to as the 'allocation question'. Furthermore, the schedular nature of the allocation of jurisdiction under tax treaties means that questions of jurisdictional appropriateness will arise in both the characterisation of income and in the allocation of profits. Though this thesis is primarily concerned with the question of jurisdiction, that some cursory consideration of questions of allocation and characterisation takes place at the fringes is inevitable.

This thesis is not a schematic of the jurisdiction to tax. Such a study has been done quite conclusively by Martha.[2] Nor is this thesis concerned with the taxation of electronic commerce, generally – excellent studies of which have been done by Subhajit Basu,[3] and Dale Pinto,[5] among others.

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[2] Rutsel Silvestre J. Martha, *The jurisdiction to tax in international law* (Kluwer Law and Taxation 1989).

[3] Subhajit Basu, *Global perspectives on E-commerce taxation law* (Ashgate 2007).

Furthermore, though this thesis is primarily concerned with the jurisdictional standards that exist in international law for the taxation of highly virtual enterprises, it is not a doctrinal study of such. The jurisdiction of states to tax the profits of enterprises is founded in Articles 5 and 7 of the OECD Model Convention, which have been detailed extensively by Klaus Vogel[7] and Phillip Baker.[9]

This thesis is focuses primarily upon the taxation of business profits. In particular, the profits of highly virtual enterprises. Taxation of other sources of income, consumption, or other gains is therefore not examined in this thesis.

Existing literature in this field tends to focus upon electronic commerce. The growth of electronic commerce is the predominant jurisdictional challenged posed by the advent of the Internet. However, the term electronic commerce suggests a focus upon transactions, and not the parties that make them. This thesis is primarily concerned with jurisdiction over online enterprises, and not merely online transactions. Furthermore, this thesis seeks not to be bound to consequences that arise solely as a consequence of certain new methods of buying and selling goods and services. Jurisdictional challenges also arise as a consequence of the manner in which enterprises can organise themselves across traditional jurisdictional bounds, the facilitation of vastly

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[5] Dale Pinto, *E-commerce and source-based income taxation* (IBFD 2003).

[7] Ekkehart Reimer, Alexander Rust and Klaus Vogel, *Klaus Vogel on double taxation conventions* (Fourth edition. edn, Kluwer Law International 2015).

[9] Philip Baker, *Double taxation conventions : a manual on the OECD Model Tax Convention on Income and on Capital* (New edn, London : Sweet & Maxwell, 2001- 2001).

increased internal trade, the proliferation of online advertising, as well as the jurisdictional difficulties associated with cloud computing. Consequently, this thesis considers the jurisdictional challenges in taxing highly virtual enterprises, and not simply their transactions.

Though there exists some contemporary disquiet over the allocation of jurisdiction over other sources of income, such as investment income and royalties, these challenges exist largely independently of the challenges that arise as a consequence of the emergence of the new economy. Other aspects of jurisdiction to tax, such as jurisdiction to levy consumption taxes, appear to have been addressed quite adequately by states – in particular in the European Union.

1.3 Methodological considerations

This thesis seeks to provide an evaluative overview of the subject matter. That is to say, as Kelsen might put it, the purpose of this thesis is to determine what the law ought to be, rather than what the law is.[11] Nonetheless, such an evaluative critique of the subject matter necessitates an element of doctrinal study, in order to assess the subject matter relative to certain defined qualities.

The starting point for such an evaluative study is, therefore the identification of criteria against which the subject matter can be assessed. This thesis does so in two

[11] Hans Kelsen, *General theory of norms* (Clarendon 1991).

orders. The first, is to determine on what basis the jurisdiction to tax should be allocated. In order to determine this, the evaluative criteria selected by this thesis fall, broadly speaking, into two categories. The first such category is democratic. It is submitted that rules should reflect democratic will, and that international rules should therefore, at the very least, reflect the will of democratically selected actors.[13] In order to determine that will, a variety of sources were consulted – in particular newspaper articles and opinion pieces, as well as official statements, documents and legislative reports. Through this research, it is apparent that the democratic will with respect to the allocation of the jurisdiction to tax is that taxes should be paid where profits are earned. That is to say, the public preference appears to be for taxation at source. However, there is an inherent danger in relying solely upon public opinion, or indeed the opinion of representatives of the public, in that it can often be the case that their numerous wants can conflict with each other.[15] While the proposition that taxes should be paid where profits are earned is a popular refrain, it may well prove that progressive taxation based upon worldwide income is equally popular – the tension between the two not being apparent to the individual(s) questioned.

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[13] A necessity not least by virtue of the fact that tax laws in both domestic and international contexts are made by political actors. On the process of policymaking, see Martin Feldstein, 'On the theory of tax reform' (1976) 6 Journal of Public Economics 77.

[15] John Prebble, 'Why is Tax Law Incomprehensible?' (1994) 4 British Tax Review 380.

This thesis therefore sought to corroborate this criterion with a second, economic criterion. The basis for this criterion is taxation as a *quid pro quo* – from the perspective of both the taxpayer and the state. From the perspective of a non-resident taxpayer, the jurisdiction of a state to tax can be justified on the basis of certain benefits received from the state. From the perspective of the state, the jurisdiction to tax non-resident taxpayers can be justified as a fair return upon their investment in, among other things, infrastructure. This seems logical – as it is the approach that would most likely maximise economic efficiency.[17] On both these bases, it is apparent that the principle of taxation at source should be used to allocate jurisdiction amongst states. Therefore, in determining the first-order criteria, this thesis primarily took a socio-legal approach.[19]

Having selected a basis upon which jurisdiction to tax should be allocated, the second order question therefore seeks to identify whether or not existing rules reflect the principles outlined in answer to the first question. If the answer to that question is

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[17] Capital-importing states are unlikely to invest heavily in infrastructure when the beneficiaries of such investment are not required to pay tax on the increased profits arising from that public investment. Similarly, those capital-exporting states are unlikely to make much effort to facilitate economic development within their own jurisdictional bounds if they are assured that their treasuries will be the primary beneficiaries of other states' investments. For a further discussion on this matter, see chapter 5.

[19] On the merits of adopting an inter-disciplinary approach to tax research, see Margaret Lamb and Andrew Lymer, *Interdisciplinary research in taxation : research approaches and bibliographic survey* (Institute of Chartered Accountants in England and Wales, Centre for Business Performance 1999); S. R. James and Christopher Nobes, *The economics of taxation : principles, policy and practice* (9th ed. edn, Fiscal Publications 2009), more generally M. Murray and C. Descanctis, *Legal Research Methods* (West Academic 2015), M. McConville and W.H. Chui, *Research Methods for Law* (Edinburgh University Press 2007).

in the negative, it therefore follows that an assessment of alternative jurisdictional rules is desirable. This second inquiry is evaluative in nature.

1.4 Methodological limitations

The author encountered a number of methodological difficulties, many of which are inherent in a study of the subject matter of this thesis.

The first such difficulty is a product of the nature of the jurisprudence of international taxation law – or rather, the lack thereof. Unlike the majority of fields of legal study, the interpretation of Double Taxation Conventions does not take place in a court. As a consequence, there is very little judge-made jurisprudence to which recourse can be made in order to provide answers to questions such as those posed by this thesis. Furthermore, the primary interpretive aid to the OECD Model Convention is its accompanying Commentary. While the Commentary is considered to be highly authoritative, it is not an objective interpretation, and states have placed numerous reservations upon it.[21] Furthermore, because the Commentary can only reflect broad consensus, it is an inherently conservative document, that skirts many of the more contentious questions. In interpreting tax treaties, it is therefore necessary to consult the law and practice of contracting states, judgements of domestic courts, a litany of

[21] Baker, *supra* note 6.

policy documents and reports; as well as secondary sources. This inevitably leads to less certain conclusions.

The second such difficulty stems from the secrecy that is inherent in tax accounting and collection, as well as dispute settlement. Companies don't generally like sharing more information about their corporate structures and accounting practices, beyond that which they are lawfully required to publicly disclose. Not necessarily in order to conceal information from tax authorities – although that may also be an objective. However, companies – especially those that trade on an ethical brand – generally do not wish to be seen to be engaging in practices designed to minimise their tax liability.[23]

Similarly, though revenue authorities provide information in the form of manuals and statements of practice – they too are less than keen to reveal details of their practices, or of their settlements with corporations. This can be explained, in large part, by public reaction to the leaked details of HMRC's settlement with Vodafone – with

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[23] See, for example, the recent *furore* over Starbucks' tax arrangements, Vanessa Houlder, 'Skimping tax can still leave a bitter taste for coffee companies' *Financial Times* (London, 16 June 2015) <http://www.ft.com/intl/cms/s/0/4daf995e-10dc-11e5-9bf8-00144feabdc0.html#axzz3n7CNUxXT> accessed 16 June 2015, Phillipa Foster, 'Avoiding tax may be legal, but can it ever be ethical?' *The Guardian* (London, 23 April 2013) <http://www.theguardian.com/sustainable-business/avoiding-tax-legal-but-ever-ethical> accessed 12 June 2015, Helia Ebrahimi, 'Starbucks, Amazon and Google accused of being 'immoral'' *The Daily Telegraph* (London, 12 November 2012) <http://www.telegraph.co.uk/finance/personalfinance/tax/9673358/Starbucks-Amazon-and-Google-accused-of-being-immoral.html> accessed 12 June 2015, 'Free shopping guide to Coffee shops, from Ethical Consumer' (*Ethical Consumer*) <http://www.ethicalconsumer.org/buyersguides/drink/coffeeshops.aspx> accessed 16 June 2015.

HMRC perceived to have cut an overly-generous deal with a large corporation at a time when the exchequer was short on revenue.[25] It is also unlikely that revenue authorities would be keen for details of favourable settlements they might have been forced to make to be known to other companies, who then would expect similarly favourable treatment.[27]

Furthermore, where disputes arise under tax treaties, dispute settlement is typically done by reference to the Mutual Agreement Procedure – a process of engagement between states' respective revenue authorities, from which even the taxpayer themselves are largely excluded. Though arbitration clauses increasingly feature in new or updated Double Tax Conventions, such processes are also typically done in secret – with no judgement ever being published.

The consequence of the above factors is an area of law, which, in practice, takes place entirely in secret. It is therefore necessary to piece together details about corporate structures and practices from what little information is made public, together with details from secondary sources.

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[25] Vanessa Houlder and Daniel Thomas, 'Vodafone agrees multimillion pound deal with HMRC for royalties' *Financial Times* (London, 19 August 2013) <http://www.ft.com/intl/cms/s/0/3f3e05cc-08eb-11e3-ad07-00144feabdc0.html> accessed 12 June 2015, 'MPs attack HMRC's 'cosy' deals with big business' (*BBC*, 20 December 2011) <http://www.bbc.com/news/business-16253205> accessed 12 June 2015.

[27] The question of the justness, or otherwise, of such deals in the administration and collection of taxes is a question for an entirely different thesis.

The author is fortunate to have at his disposal the resources of the Library of Trinity College, Dublin. As the Trinity College Library is a legal deposit library under both the Copyright and Related Rights Act 2000 of Ireland, and of the Deposit Libraries Act 2003 of the United Kingdom – the Library has an unparalleled collection of works across all disciplines published in both Ireland and the United Kingdom. However, as this study is primarily international in its focus, some resources published outside of Ireland and the United Kingdom proved more difficult to source.

Particularly conspicuous by their absence from Trinity College Library were a number of works from two publishers – Wolters Kluwer, and the International Bureau of Fiscal Documentation (IBFD) – both of which are based in the Netherlands. A number of steps were taken in order to mitigate this difficulty, including frequent visits to the library of the University of Glasgow, in particular, as well as visits to the libraries of the University of Edinburgh and the University of Cambridge. Inter-library loans were also used where it appeared unlikely that the author would be visiting a library that holds the required item or items. While these steps allowed the author to avail of identified but otherwise unavailable resources, the inability to casually browse the resources of these publishers means, inevitably, that some relevant material has likely been overlooked.

1.5 Overview of thesis

Chapter 2 considers the jurisdiction to tax in international law, generally. It considers the emergence of the problem of double taxation, and the efforts taken to alleviate that problem. It demonstrates that double taxation is a natural consequence of the normal operation of international law. It concludes that it is the efforts of states at mitigating the effects of double taxation that have led to opportunities for avoidance and an unjust allocation of the jurisdiction to tax.

Chapter 3 considers the challenge of determining jurisdiction over activity that takes place over the Internet. It outlines the flaws in many early attempts at allocating jurisdiction over online acts, and identifies the approaches which, it is submitted, better reflect the 'real world' activities which underpin online acts. The jurisdictional approach favoured by chapter 3 frames much of the subsequent consideration of the jurisdiction to tax highly virtual enterprises – in particular in chapters 5, 6, and 7.

Chapter 4 outlines the new business models that have emerged as a consequence of the advent of the Internet, and the efforts that have been made to address the difficulties of taxing highly virtual enterprises. It critiques the conservative approach taken by the OECD, and its misapplication of offline analogs to online environments. It contrasts this approach with that taken by the European Union in adapting its system of Value Added Tax (VAT) to the new economy, which has proved to be largely

successful. It concludes that further effort is required in order to adequately address the jurisdictional challenges posed by highly virtual enterprises.

Chapter 5 seeks to synthesise a conceptual basis for the jurisdiction to tax. It argues that the justification for the allocation of jurisdiction to tax in international law is the benefit principle, which therefore necessitates the taxation of business profits at source. Chapter 5 then seeks to track the source of income of multi-national enterprises (MNEs), in particular those which have arisen as a consequence of, or adapted their operations to the Internet. Chapter 5 concludes that the benefit principle, and source taxation, remain the conceptual basis for the jurisdiction to tax, notwithstanding the challenges posed by the new economy.

Chapter 6 examines the predominant jurisdictional standard in international tax law – the permanent establishment standard. It considers the present extent of the permanent establishment standard – including its application to certain elements of online commerce, including servers. It considers, in particular, the physicality requirement of the permanent establishment standard; its suitability to highly virtual enterprises; and its compatibility with the conceptual base provided by chapter 5. It concludes that the permanent establishment standard, while once a reasonable proxy for participation in the economic life of a state, no longer reflects the economic realities of modern commerce. It makes the case for reform to existing jurisdictional standards, in particular to accommodate the growth of highly virtual enterprises.

Chapter 7 details the reforms to the allocation of jurisdiction to tax preferred by this thesis. It proposes a new standard for determining jurisdiction to tax business profits: purposeful direction. Chapter 7 proposes that an enterprise should be subject to a state's jurisdiction to tax where is has purposefully directed its activities towards that state. It considers the operation of such a standard in the United States, and concludes that it better reflects the conceptual basis underpinning the jurisdiction to tax. Chapter 7 further considers the institutional infrastructure that would be necessary for a subjective jurisdictional standard to work in practice. It concludes that though the lack of adequate dispute resolution in international tax law precludes the adoption of such a standard at present, the increasing proliferation of mandatory arbitration in tax treaties may provide the intuitional framework necessary for the adoption of such a standard in the future.

Finally, chapter 8 outlines some of the alternative approaches to the allocation of jurisdiction to tax, either extant or proposed. While this thesis does not advocate the adoption of any of these standards on a broad scale, these standards nonetheless demonstrate, to varying degrees, the operability of alternative jurisdictional threshold standards.

Chapter 2: The Jurisdiction to Tax

2.1 Introduction

Double taxation is the consequence of the normal operation of international law. This chapter considers the relationship between state sovereignty and the jurisdiction of states to levy and enforce tax laws over persons, property, and events located within its territory and elsewhere. It briefly outlines the origins of state intervention to inhibit the normal operation of international law, by allocating jurisdiction to tax certain acts or persons to single states – which is ultimately where many contemporary problems in international taxation find their genesis.

2.2 The normal operation of international law

'Jurisdiction' is concerned with the limits of the legal competence of a state or other actor with legal personality in international law to make, apply, and enforce rules of law upon the conduct of persons. This exercise of authority can be done by any branch of government, and at any level. Even the most perfunctory administrative tasks performed at the lowest level of government is an exercise of the lawful authority of the state.

Jurisdiction and sovereignty are somewhat circular in their relationship with each other – in that jurisdiction is both an aspect and a product of a state's sovereignty.

Jurisdiction is an aspect of a state's sovereignty, in that the competence to regulate persons or events is a necessary prerequisite of sovereignty. However, jurisdiction is also a product of a state's sovereignty, insofar as it is the manifestation of a state's regulatory supremacy over persons or events. Jurisdiction and sovereignty are, however, separable – insofar as it is possible for non-sovereign actors to exercise jurisdiction. Such exercises of jurisdiction by non-sovereign actors are usually the product of an alienation of jurisdiction by sovereign actors – such as, for example, the jurisdiction of the International Court of Justice.

In 1968 the Council of Europe produced a *Model Plan for the Classification of Documents concerning State Practice in the Field of Public International Law.*[29] The Council of Europe's Model Plan delimited the treatment of different categories of jurisdiction. The Model Plan outlines five bases for the jurisdiction of states: the territorial principle; the personal principle; the protective principle; universality principle; and 'other base'. It also outlines three types of jurisdiction: jurisdiction to prescribe; jurisdiction to adjudicate; and jurisdiction to enforce.

These bases broadly reflect the aspects of sovereignty outlined by Oppenheim,[31] and are broadly accepted.[33] Of particular relevance to the current discourse are the

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[29] Council of Europe, *Model Plan for the Classification of Documents concerning State Practice in the Field of Public International Law* (Resolution (68) 17, 1968).

[31] Robert Yewdall Jennings, Sir Arthur Watts and Lassa Oppenheim, *Oppenheim's International Law: Peace* (Longman 1992)

territorial and personal jurisdictional bases – the overlap of which is the primary cause of double taxation.

The competence of states to exercise their jurisdiction over persons, actions, and territory is a product of their sovereignty in international law. However, though this sovereignty is derived from states' sovereignty in a constitutional sense, the two senses of sovereignty – constitutional and international – have developed distinctive meanings, which oughtn't be confused. The internal competence of a state to levy, say, an income tax, is distinct from the external competence of a state to, for example, tax the overseas income of its residents. A state may well be internally competent to prescribe, adjudicate, and enforce tax laws extraterritorially; however its external competence to do so might nonetheless be limited by the confines of international law.

2.2.1.1 Sovereignty in constitutional law

In its constitutional sense, the concept of sovereignty moved from the Roman concept of *imperium*, through to its investiture in a monarch and subsequent detachment from an individual and transfer to the populous. Like so many elements of constitutional law it can be said to be evolutionary rather than revolutionary.[35]

Though contemporary jurisprudence on the concept of sovereignty finds its origins principally in the works of Thomas Hobbes and Jeremy Bentham, among

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[33] Christopher Stalker, 'Jurisdiction' in Malcolm D. Davis (ed), *Intenational Law* (4th edition edn, OUP 2014).

[35] Sir William Wade, 'Sovereignty-Revolution or Evolution?' (1996) 112 Law Quarterly Review 568.

others, their theories on sovereignty were perhaps best extracted and compounded in the lectures of John Austin,[37] and summarised by Harrison as

> the source of all positive law is that definite sovereign authority which exists in every independent political community, and therein exercise *de facto* the supreme power, being itself unlimited, as a matter of fact, by any limits of positive law.[39]

Conceptually there can be little doubt that sovereignty in a constitutional sense is supreme authority. From a jurist's perspective sovereignty is the ultimate source of law within any legal order. Whether derived from Parliament, as is the case in the United Kingdom,[41] or the people as in Ireland,[43] sovereignty founds executive authority, legislative competence, and jurisdiction.

While within a domestic legal order sovereignty may mean omnipotence it does not, in reality, mean omnipresence. Formulations of sovereignty that describe it as being 'unlimited' appear very much to be of their time. Jennings' oft quoted example of the UK Parliament enacting that smoking in the streets of Paris is an offence being

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[37] See John Austin and Sarah Austin, *The province of jurisprudence determined*, vol 2 (J. Murray 1861)

[39] Frederic Harrison and Augustus Henry Fraser Lefroy, *On Jurisprudence and the Conflict of Laws. [Reprinted from the Fortnightly Review and revised.] ... With annotations by A. H. F. Lefroy* (Clarendon Press 1919).

[41] See generally Albert Venn Dicey, *Introduction to the study of the law of the constitution* (10th edn, Macmillan 1959).

[43] 'All powers of government, legislative, executive and judicial, derive, under God, from the people, whose right it is to designate the rulers of the State and, in final appeal, to decide all questions of national policy, according to the requirements of the common good.', Article 6.1., Bunreacht na hÉireann.

perfectly valid,[45] as it may well be regarded by a UK court, runs contrary to basic principles of international law. Similarly, the emergence of an international legal order, particularly within Europe, has placed limits on Parliamentary Sovereignty in the United Kingdom and elsewhere.[47]

For authority to be supreme it must, necessarily, enjoy exclusivity. However international law is composed of multiple sovereigns that are equally supreme. The equality of sovereign states is a fundamental principle of international law. Territoriality is only one aspect of sovereignty in international law and, as is discussed below, different aspects of sovereignty can overlap. As sovereignty in international law is not, therefore, exclusive it cannot, by definition, be supreme. Therefore, for the purposes of international law, an alternative definition of sovereignty is required.

The global legal community is composed of two co-existent legal orders: the domestic legal order with which constitutional lawyers are principally concerned; and the order that exists between sovereign nation states with which international lawyers are engaged. This thesis argues that the concept of sovereignty in international law should therefore be distinguished from sovereignty in constitutional law.

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[45] Sir Ivor Jennings, *The Law and the Constitution* (5th edn, University of London Press 1959), p.170

[47] See *R v. Secretary of State for Transport ex p Factortame Ltd* [1990] UKHL 7.

2.2.1.2 Sovereignty in international law

The fundamental purpose of sovereignty in constitutional jurisprudence is to determine the ultimate source of legal authority. While there is little doubt that one of the purposes of sovereignty in international law is to determine the source of law that is not its sole function. Nor, it can be argued, is sovereignty the sole source of authority in international law.

Sovereignty, in a constitutional sense, is the product jurists' endeavours to find the sole source of law within a particular legal order. The fact that it is supreme necessitates that it must be the sole source of law within a jurisdiction.

International law, however, is composed of multiple sovereigns. Positive international law flows from individual sovereign actors who are, themselves, supreme. The Role of sovereignty in international law finds its genesis in the 1648 Treaty of Westphalia[49] – so called 'Westphalian sovereignty'. The text of the treaty does not define or explain what it intends to mean by 'sovereignty'. However it is through this treaty that the principle of sovereignty makes the leap from being solely a concept of constitutional jurisprudence to forming the foundations of an international legal order. From this, the concept of the nation state and the co-existence of multiple legal orders emerged. It was this conception of sovereignty that necessitated the creation of an

[49] 'The Treaty of Westphalia, between the Holy Roman Emperor and the King of France and Their Respective Allies, Oct 24, 1648' <http://avalon.law.yale.edu/17th_century/westphal.asp> accessed 20 October 2012.

international legal order. And if the world was to consist of multiple and equally sovereign nation states then it was perhaps inevitable that a legal order would emerge with the purpose of regulating the interaction of these nation states.

Over the centuries that followed the role of sovereignty in the international order grew increasingly significant. In the late 19th and early 20th centuries international law moved beyond a system of core principles and developed a body of positive law.

The role of sovereignty in international law was considered by the Permanent Court of Arbitration in the *Netherlands v. USA, Island of Palmas case:*

> [s]overeignty in the relations between States signifies independence. Independence in regard to a portion of the globe is the right to exercise therein, to the exclusion of any other State, the functions of a State. The development of the national organization of States during the last few centuries and, as a corollary, the development of international law, have established this principle of the exclusive competence of the State in regard to its own territory in such a way as to make it the point of departure in settling most questions that concern international relations.[51]

This formulation of sovereignty in international law confirmed the validity of the concept of 'Westphalian Sovereignty' – that the nation state enjoyed the sole and supreme authority to function as such within its own territorial bounds.

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[51] *Netherlands v. USA (Island of Palmas)* (1928) II RIAA 829.

However internal territorial supremacy, as Oppenheim opined, is only one aspect of sovereignty in international law. He also argued that sovereignty is comprised of both external and personal elements as well:

> [i]nasmuch as it excludes dependence upon any other authority, and in particular from the authority of another state, sovereignty is *independence.* It is *external* independence with regard to the liberty of action outside is borders in the intercourse with the intercourse with other States which a State enjoys. It is *internal* independence with regard to the liberty of action of a State inside its borders. As comprising the power of a State to exercise supreme authority over all persons and things within its territory, sovereignty is *territorial* supremacy (*dominium, territorial sovereignty).* As comprising the power of a State to exercise supreme authority overs its citizens at home and abroad, sovereignty is *personal* supremacy (*imperium, political sovereignty).*[53]

If, therefore, the fundamental purpose of international law is to regulate the interaction of multiple sovereign actors it must, necessarily, demarcate the sphere of each nation state's supremacy.

The territorial limit of a nation's sovereignty is that portion of the world over which the relevant sovereign body exercises exclusive legal authority. The personal sovereignty of a state is exercised over its citizens, subjects or nationals regardless of where they are situated in the world, as well as those aliens who are domiciled or resident within its territory. Functional sovereignty is an altogether newer concept and

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[53] L. Oppenheim, *International law: a treatise.*, vol 1: Peace. (H. Lauterpacht ed, 8th ed. / Ed. by H. Lauterpacht. edn, Longman 1974), p.286.

is a legal construct made largely necessary by international trade. Functional sovereignty can be seen as certain legal constructs designed to solve problems of international law where sovereignty is unknown, unclear, or non-existent.[55]

2.3 Fiscal sovereignty and the jurisdiction to tax

The competence of states to levy and collect taxes is derived from states' sovereignty. In recent years, it has become increasingly common to hear a state's autonomy over matters of revenue and expenditure referred to as 'fiscal sovereignty'. This suggests, therefore, that fiscal sovereignty is a species of sovereignty possessed of unique characteristics.

Knechtle defines fiscal sovereignty as the 'sum total of international and national conflict rules and of substantive rules which are applied to international fiscal facts.'[57] This, it could be argued, is an unsatisfactory definition for a number of reasons.

First, in its international legal sense sovereignty is a product of customary international legal norms. It is not merely the source of all law (though it could be argued that it is the source of all positive international law). Sovereignty in international law provides those who have it with a set of rights within the

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[55] Such as rules relating to sovereignty over ships or aircraft in flight over the high seas. See Willem Riphagen, 'Some Reflections on "Functional Sovereignty"' (1975) 6 Netherlands Yearbook of International Law 121.

[57] Arnold Knechtle, *Basic problems in international fiscal law* (Kluwer 1979).

international legal order, crucially that it shall be treated equally to all other sovereign nations. Knechtle's definition is, therefore, inherently circular. Sovereignty in international law is the product of international legal norms, therefore sovereignty, and all that comes with it, can be seen as being, of itself, one of the 'international rules' to which Knechtle refers in his definition.

Second, it follows that his definition presupposes that fiscal sovereignty is a concept distinct from sovereignty. However, it is arguable that revenue is a necessary component of all sovereign states. As Pak describes

> [f]iscal authority is an essential constituent to any government since it provides the revenue for national cost and expenditure that enables a nation to maintain the existence and operation of the government benefit its citizens [sic] and compete with foreign countries. Because taxes are one feature of national cost and expenditure, taxation has traditionally been viewed as the nation-states' sovereignty to levy and collect taxes from all entities within their jurisdiction.[59]

Therefore fiscal authority is an essential attribute of state sovereignty, in the same way as territorial integrity and legal jurisdiction.

It is worth noting, however, that Knechtle's definition of fiscal sovereignty would be satisfactory in a constitutional sense. Insofar as sovereignty in a constitutional sense denotes supremacy as the source of all law, fiscal sovereignty, as a corollary, is the source of all those rules that apply to fiscal facts.

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[59] Insop Pak, 'International finance and state sovereignty: global governance in the international tax regime' (2004) 10 Ann Surv Int'l & Comp L 165.

There appears, in reality, to be little that distinguishes fiscal sovereignty international law from sovereignty as it is more broadly defined.

2.4 Double taxation as a product of the normal operation of international law

States are possessed of sovereignty over territory and over persons. Where persons and territory are co-located, jurisdictional conflicts do not arise. However, where a national of one state is located within the territory of another, that person may well be subject to the jurisdiction of two sovereigns, simultaneously. Therefore, double taxation is a consequence of two conflicting jurisdictional bases to tax: territorial; and personal.

2.4.1 Territorial basis to tax

The territorial principle is 'a corollary of the sovereignty of a State over its territory.'[61] That sovereignty entails the right of that state to prescribe whatever laws it wishes over the territory of the state. It is both internal and external supremacy over affairs as they are conducted within the state's sovereign territory. This supremacy extends over persons and property located, and acts that take place, within the territory of the sovereign state. This therefore grants a state a broad competence to levy taxes upon

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[61] Stalker, *supra* note 18, p.316.

persons and property situated within the territory of that state, as well as upon transactions that take place within it.

2.4.2 Personal basis to tax

A purely territorial view of sovereignty then as it applies to fiscal matters sovereignty would appear to extend far beyond the territorial reach to which national sovereignty would conventionally extend. Sovereign states reserve the right to tax not only those fiscal acts which take place within their territory but also those extra-territorial fiscal acts of their respective nationals. While this extension of a nation's fiscal jurisdiction might *prima facie* seem to extend beyond the scope of a state's sovereignty in a rudimentary territorial sense, such an extension of jurisdiction would usually still fall within the scope of a state's personal sovereignty as Oppenheim would describe it.

The application of sovereignty to international taxation was described by Martha as the 'most fundamental and basic test in matters of international taxation [...]. A State may only fiscally attach those facts that are subject to its supremacy (sovereignty); either personal, territorial, or functional.'[63] There appears to be very little difference between this conception of fiscal sovereignty and what we understand to be meant by 'sovereignty'.

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[63] Martha, *supra* note 2, p.43.

However, as is discussed above, sovereignty has more than a territorial application, it has a personal and a functional application too. The extension of fiscal jurisdiction beyond a nation's borders is, therefore, not unusual or necessarily incompatible with international law. Many states have laws purporting to affect the conduct of their nationals overseas.

2.4.3 The normal operation of international law

The very reason for the existence of double taxation conventions is because of the effects of nations asserting exercising their far-reaching fiscal sovereignty. While this global reach of national sovereignty as it applies fits well with Jennings' conception of sovereignty, seemingly boundless tax laws (or indeed, any laws for that matter) runs contrary to the most basic principles of international law. The role that international public law plays in demarking the boundaries of national sovereignty therefore has to be considered.

Through the thousands of double taxation treaties that are presently in force around the world, international law provides a solution to the problematic nature of international taxation. However, the problematic nature of international taxation is, of itself, a product of international law. An examination of the relationship between revenue and international law is therefore required in order to determine the cause of the problems which double taxation treaties are designed to solve. In doing so, it

becomes possible to assess the effectiveness of double taxation treaties by reference to their original purposes.

The normative framework[65] for dealing with international taxation developed while the contemporary legal order was still in its infancy. The community of nations has expanded far beyond the 'community of civilized nations' whom the international legal order once exclusively served. Nations that were once net-exporters of capital have become net-importers of capital. There has developed an increasing recognition of the bias of the international order in favour of the developed world. Crucially, the world has become inter-connected like never before, and a normative framework has begun to emerge for the application of the international legal order to the Internet. An appreciation of that framework is therefore necessary when assessing the impact of the Internet on the effectiveness of international taxation law.

Taxation is an assertion of a state's authority. The power to tax is derived from a state's sovereignty; its ability to enforce its power to tax is an aspect of its jurisdiction.

In a constitutional sense revenue provides the state with the means to pursue its domestic goals. Despite the wide variance in the domestic ambitions of nation states, states universally require revenue to achieve those aims.

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[65] For a discussion on the extent to which certain elements of international taxation law have become customary legal norms see Reuven S. Avi-Yonah, *International tax as international law : an analysis of the international tax regime* (Cambridge University Press 2007).

Revenue also plays a crucial, though often unrecognised, role in international law. Revenue is essential for the maintenance of the nation state. It allows a state to do the things that it requires to do in order to maintain its status as a sovereign actor in the world order. While it is correct, it is argued, that international law limits the power of sovereign states to collect revenue it is not the case that the relationship between international law and revenue is unidirectional – it is reciprocal. Revenue provides the means for the maintenance of the nation state, and the maintenance of sovereign states is one of the fundamental aims of international law.[67]

Sovereignty, it can be said, is a concept possessed of multiple personalities. In an etymological sense the French form, *souveraineté*, derived from the Latin *superanus*[69] meaning supreme power. The Oxford English Dictionary defines 'sovereignty' as

> [t]he quality or condition of being sovereign.
>
> 1. Supremacy or pre-eminence in respect of excellence or efficacy.
>
> 2. Supremacy in respect of power, domination, or rank; supreme dominion, authority, or rule.
>
> 3. a. The position, rank, or power of a supreme ruler or monarch; royal authority or dominion.
>
> b. The supreme controlling power in communities not under monarchical government; absolute and independent authority.

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[67] See Pak, *supra* note 31.

[69] While the word 'sovereignty' may be derived from Latin the Romans would likely not recognize our conception of sovereignty as such. *Imperium* – 'the power to command' – bears a closer conceptual resemblance to that which we now call 'sovereignty'.

4. A territory under the rule of a sovereign, or existing as an independent state.[71]

The Stanford Encyclopaedia of Philosophy proposes as a compound that most definitions of sovereignty are some variant of 'supreme authority within a territory'.[73] However such definitions of sovereignty, while quite correct in a constitutional sense, are not necessarily adequate when discussing sovereignty in the concept of international law.

It is an unfortunate coincidence of language that that which we call 'sovereignty' in constitutional law and that which we call 'sovereignty' in international law share a common nomenclature. Though the two concepts are not intrinsically unrelated – they both find their genesis in that which was once known as the law of nations – they have developed into distinct concepts within their respective spheres.

2.5 Delimiting jurisdiction

Sovereignty, for the most part, is a formal attribute, though not exclusively so. Sovereignty is often conceptually, mistakenly as Raustiala argues, confused with

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[71] OED, 'sovereignty, n.' (*OUP*, December 2011) <http://www.oed.com/view/Entry/185343> accessed 30 November 2014.

[73] Dan Philpot, 'Sovereignty' (*Stanford Encyclopedia of Philosophy (Summer 2010 Edition), Edward N. Zalta (ed.)*) <http://plato.stanford.edu/archives/sum2010/entries/sovereignty/> accessed 25 June 2013.

authority or power.[75] Conflating sovereignty with power would logically lead one to the conclusion that there exists a rank-order of sovereign states: that the United States is more sovereign than the United Kingdom which, in turn, is more sovereign than Ireland, *etc.* If sovereignty and power are to be considered as being synonymous then it could also be argued that Google or British Petroleum rank (presumably fairly highly) on that scale. Authority is, in fact, an aspect of sovereignty.

It is in the expression of that authority that we find the concept of jurisdiction. If, as it is argued, that fiscal sovereignty is merely an aspect of sovereignty, that which has been termed 'fiscal jurisdiction' can be seen as the exercise of a state's fiscal sovereignty.

In describing the relationship between jurisdiction and sovereignty Frederick Mann proposed that

> [j]urisdiction... is concerned with what has been described as one of the fundamental functions of public international law, viz. the function of regulating and delimiting the respective competences of States [...]
>
> It may be that, as a matter of international law, the jurisdiction of a state extends to the limits of the State, that jurisdiction is co-extensive with sovereignty, that it reaches as far, but no further, than sovereignty.[77]

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[75] Kal Raustiala, *Does the constitution follow the flag? The evolution of territoriality in American law* (Oxford University Press 2009).

[77] Frederick A Mann, 'The Doctrine of Jurisdiction in International Law' [1964] Recueil des Cours 111, pp.15-16.

Martha considers extensively the role of international law in determining the limits of fiscal jurisdiction:

> If... international law imposes no limit on the (fiscal) jurisdiction of States, the concept of legal coexistence of States without contradiction would be logically impossible. The contradiction vanishes if one contents that international law necessarily demarcates the extent of (fiscal) jurisdiction of States. Once international law has determined the spheres of validity of national fiscal orders, the positive regulation of fiscal obligations and rights of individuals is attributed to such national legal orders. In that sense only, is it true that international law does not regulate fiscal matters positively. In that sense, international law definitely allocates fiscal jurisdiction to states, by determining spheres of validity of the national orders.[79]

Similarly, Ryser contends that as fiscal jurisdiction is an attribute of national sovereignty, the bounds fiscal jurisdiction naturally correlates with those of sovereignty. Although, he somewhat unsatisfactorily does not postulate on the extent of that correlation:

> [t]here is a relationship between the extent of tax jurisdiction and the limits of state sovereignty. But where are they? Are they defined in a precise and restricted manner?[81]

A consideration of the exercise of jurisdiction is therefore useful for proving the limits of fiscal sovereignty. The jurisdiction to tax is ultimately limited by two

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[79] Martha, *supra* note 2.

[81] Walter Ryser, 'Extraterritorialité et Droit Fiscal' (1984) 39 Außenwirtschaft 119.

principles: the limits of the taxing body's sovereignty, and the principles of international law.

The role of international law in delimiting the jurisdiction of states was considered by the Permanent Court of International Justice in the *Nationality Decrees issued in Tunis and Morocco* case, which postulated that

> [i]t may well happen that, in a matter which... is not, in principle, regulated by international law, the right of a state to use its discretion is nevertheless restricted by obligations which it may have undertaken towards other States. In such a case, jurisdiction which, in principle, belongs solely to the State, is limited by rules of international law.[83]

Though the judgment itself does not define 'obligations' it can be inferred from context that it includes both treaty obligations and customary international legal norms.

The *S.S. Lotus* case considered the question of concurrent jurisdiction. This case concerned the collision of two ships – one French, one Turkish – on the high seas, and whether or not Turkey could exercise its jurisdiction extra-territorially on the basis that the victims of a crime were Turkish citizens. In its judgement the PCIJ considered the territorial nature of jurisdiction:

> [t]he first and foremost restriction imposed by international law upon a state is that – failing the existence of a permissive rule to the contrary – it may not exercise its power in any form in the territory of another state.[85]

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[83] *Dispute between France and Great Britain as to the Nationality Decrees issued in Tunis and Morocco (French Zone)* (1923) PCIJ, Series B, No 4, pp. 23-24.

[85] *The Case of the S.S. 'Lotus'* (1927) PCIJ, Series A, No 10, p.18.

In its consideration of the case the PCIJ concluded that there is no rule of international law that necessarily prohibits a state from exercising its jurisdiction *within its own territory* regarding acts which occurred beyond its territory, provided that the extension of its jurisdiction was founded by its sovereignty. The judgment also explicitly recognises that sovereignty and jurisdiction are limited by international law:

> [a]ll that can be required of a state is that it should not overstep the limits which international law places upon its jurisdiction; within these limits its title to exercise its jurisdiction rests in its sovereignty.[87]

The US Supreme Court in *Burnet v. Brooks*[89] considered the extent of American fiscal jurisdiction. In delivering the judgement of the court Mr Chief Justice Hughes considered the multiple grounds on which governments can found fiscal jurisdiction and the high likelihood that such jurisdiction would overlap:

> [a]s jurisdiction may exist in more than one government, that is, jurisdiction based on distinct grounds – the citizenship of the owner, his domicile, the source of income, the situs of the property – efforts have been made to preclude multiple taxation through the negotiation of appropriate international conventions. These endeavors, however, have proceeded upon express or implied recognition, and not denial, of the sovereign taxing power as exerted by governments in the exercise of jurisdiction upon any one of these grounds.

From his judgement we can conclude that Mr Chief Justice Hughes saw nothing inherent in international law which delimits the sovereignty of nations over fiscal

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[87] *Ibid*, p.19.

[89] *Burnet v. Brooks* (1933) 288 US 378, 53 S Ct 457.

matters where jurisdiction is founded upon the grounds he cited. However, his recognition of the co-existence of the sovereign taxing power of other nations would imply a degree of exclusivity of sovereign taxing power insofar as concerns each of the grounds for jurisdiction, but not necessarily where two different grounds (e.g. citizenship and *situs*) overlap.

Martin Norr proposes that 'no rules of international law exist to limit the extent of a country's tax jurisdiction.'[91] He does so on the basis that 'there is no case in which any national court has condemned double taxation as a violation of international law.'[93] However this bold assertion is, arguably, a logical fallacy. First, it is not correct to state that no rule of international law exists simply because no positive law has been enforced by any domestic court. Second, as Norr himself acknowledges there are different kinds of jurisdiction (territorial, personal, *etc.*) Double taxation occurs either where aspects of jurisdiction overlap (such as the personal jurisdiction over a citizen overlapping with the territorial jurisdiction of that person's *situs*) or else where someone is subject to more than one nation's jurisdiction (such as a dual citizen). In neither case is the existence of concurrent jurisdiction, nor the double taxation that potentially arises therefrom, a violation of international law. The very fact that double taxation does not necessarily violate international law does not prove that international

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[91] Martin Norr, 'Jurisdiction on tax and international income' (1961) 17 Tax L Rev 431.

[93] Ibid.

law does not limit a nation's jurisdiction to tax. Certainly there exists a body of jurisprudence that shows international law limits the jurisdiction of nation states. There is very little to suggest that fiscal jurisdiction is exceptional.

Nation states therefore principally exercise jurisdiction over fiscal acts on two grounds: those acts which occur within the territory of that state; and, those acts that are done worldwide by persons who are either citizens of that nation state (such as the United States does), or those who are domiciled in that state (as is more commonly the case). The consequence of this broad jurisdiction is that multiple states are frequently entitled to exercise jurisdiction over the same fact, resulting in double taxation. In order to avoid such occurrences it is therefore necessary for states to enter into Double Taxation Treaties.

2.5.1 Origins of the principles of double taxation elimination

At an international level the early efforts to come to agreement over the elimination of double taxation were undertaken by the League of Nations as is discussed below. However the concept of alleviating double taxation first emerged in the United States almost ten years prior to the work of the League. While the United States acting to ensure levels of taxation remain low is hardly surprising in a contemporary setting, their initial policy of offering relief on taxation paid abroad appears wildly at variance with the approach they have pursued in recent decades.

The federal government of the United States first affirmed its right to 'collect taxes on incomes, from whatever source derived'[95] through the sixteenth amendment to their constitution. Following its enactment in 1913 the Congress enacted the Revenue Act 1913, creating a comprehensive federal income tax over all income earned by and US citizen, regardless of their locus, and by every resident in the United States:

> [t]hat there shall be levied, assessed, collected and paid annually upon the entire net income arising or accruing from all sources in the preceding calendar year to every citizen of the United States, whether residing at home or abroad, and to every person residing in the United States, though not a citizen thereof.[97]

Insofar as international taxation was concerned the only concession offered by US tax law at that time was a deduction from gross income of 'the amount of income, the tax upon which has been paid or withheld for payment at the source of the income'.[99] This would naturally include foreign governments.

This remained the practice until the Revenue Act of 1918 when the United States became the first jurisdiction in the world to provide a credit against federal income tax for taxes paid to foreign governments on income earned abroad. The taxes of citizens of the United States were to be credited with

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[95] Amendment XVI, Constitution of the United States of America.

[97] § II, Revenue Act 1913, ch. 16.

[99] Ibid.

> [t]he amount of any income, war-profits and excess profits taxes paid during the taxable year to any foreign country, upon income derived from sources therein.[101]

Similarly, resident aliens were to be afforded a credit against US federal income tax in consideration of taxes paid in their jurisdiction of domicile on the condition that that jurisdiction allowed a similar credit to American citizens living within said jurisdiction.[103] This recognition of the primacy of the taxing jurisdiction of source is significant considering the United States' contemporary preference for residence-based taxation, discussed below. Graetz and O'Hear propose the appointment of T.S. Adams as tax advisor to the US Treasury Department as being responsible for the United States' early support for source-based taxation.

2.5.2 Inter-war years: efforts of the League of Nations and others

While the work on the OECD Model Convention stemmed from its predecessor organisation, the Organisation for European Economic Co-operation (OEEC), the concept of having model articles regarding double taxation finds its origins in the League of Nations.

While the growth of cross-border trade had seen a considerable increase in double taxation in the decades leading up to the First World War it was not at that

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[101] § 222(a)(1) Revenue Act 1918 ch. 18..

[103] § 222(a)(3) *Ibid.*

time an overly burdensome concern. However the cost of war and the subsequent budgetary shortfalls forced states (in Europe in particular) to levy taxes at rates considerably higher than had previously been seen. The increasing tax burdens imposed by both foreign nations in which an enterprise was doing business as well as in the home country resulted in traders losing practically of the income from their foreign ventures.[105]

In 1920, the International Financial Conference at Brussels agreed that the League of Nations should consider the issue of double taxation. The Financial Committee (of the League of Nations) therefore appointed a panel of four economists: Professors Bruins of the Commercial University, Rotterdam, Einaudi of Turin University, Seligman of Columbia University, and Sir Josiah Stamp, of the University of London to consider the issues surrounding international double taxation and to report back.

Their report[107] identified four principles which could be used in the attribution of taxation revenues: political allegiance or nationality; temporary residence; domicile or permanent residence; and location of wealth. When considering the development of

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[105] Mitchell B Carroll, 'The Development of International Tax Law: Franco-American Treaty on Double Taxation-Draft Convention on Allocation of Business Income' [1935] American Journal of International Law 586.

[107] M. Bruins, et al., *Report on double taxation, League of Nations Economic and Financial Commission* (League of Nations, 1923, EFS 73 F 19).

the various League of Nations drafts the origins of certain contemporary principles in international taxation becomes clear.

The panel's report of 1923 considered whether *source* or *residence* should be the determining factor in founding jurisdiction to tax. This report proposed a test of economic allegiance as being a solution, proposing that consideration should be given to the acquisition of wealth, the location of wealth, the enforceability of wealth, and residence and/or domicile. In their considerations as to how these principles would apply in practice they concluded that for most corporeal wealth, whether moveable or immovable, and incorporeal immovable wealth (giving consideration in particular to mortgages as they relate to property taxes and death duties) jurisdiction to tax would be founded at source; for incorporeal moveable wealth jurisdiction to tax should be founded at residence.

Meanwhile, in 1922 the Financial Committee constituted a committee to examine the administrative and practical questions associated with double taxation and tax evasion. Their report and resolutions were submitted to the Financial Committee in 1925.[109] This document shifted away from the practice of dividing wealth into categories and instead focused on types of taxes. They proposed that the basic principles

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[109] Committee of Technical Experts on Double Taxation and Tax Evasion, *Report and Resolutions, League of Nations Economic and Financial Commission* (League of Nations, C 115 M 55 1925 II (F 212), 1925).

of international taxation should see schedular (or impersonal) taxes being imposed at source, while personal taxes should be collected in the jurisdiction of domicile.

Following the 1925 report the Committee expanded from seven members to fourteen. They agreed upon a series of resolutions and submitted them alongside a general report to the Financial Committee in 1925. The culmination of this committee's work came in 1927 when it submitted to the Financial Committee a report complete with a 'draft of a bilateral convention for the prevention of double taxation.'[111]

The committee considered at length whether a multilateral or bilateral approach to resolving double taxation issues would be the most appropriate. While recognising the obvious attractiveness of a collective agreement on double taxation the committee concluded that it simply was not practically possible:

> [i]t would certainly be desirable that the States should conclude collective conventions, or even a single convention embodying all others. Nevertheless, the Committee did not feel justified in recommending the adoption of this course. In the matter of double taxation in particular, the fiscal systems of the various countries are so fundamentally different that it seems at present practically impossible to draft a collective convention, unless it were worded in such general terms as to be of no practical value.
>
> The committee envisaged that model articles would create a degree of uniformity in international fiscal law, with the natural evolution of that law being the consolidation and possibly the codification of double taxation treaties.

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[111] League of Nations, *Double taxation and tax evasion. Report and resolutions submitted by the technical experts on double taxation and tax evasion* (1927).

It was in this draft that the principle of permanent establishment finds its origins. Though it contains somewhat arcane examples the resemblance with the modern conception of permanent establishment is quite apparent:

> [i]ncome from any industrial, commercial or agricultural undertaking and from any other trades or professions shall be taxable in the State in which the persons controlling the undertaking or engaged in the trade or profession possess permanent establishments.
>
> The real centres of management, affiliated companies, branches, factories, agencies, warehouses, offices, depots, shall be regarded as permanent establishments. The fact that an undertaking has business dealings with a foreign country through a *bona fide* agent of an independent status (broker, commission agent, etc.), shall not be held to mean that the undertaking in question has a permanent establishment in that country[113].

The draft article also contains an early formulation of the arm's length principle in international taxation:

> [s]hould the undertaking possess permanent establishments in both Contracting States, each of the two states shall tax the portion of the income produced in its territory.
>
> In the absence of accounts showing this income separately and in proper form, the competent administrations of the two Contracting States shall come to an arrangement as to the rules for apportionment.[115]

While the Fiscal Committee of the League of Nations continued to develop policy in this area various European nations as well as the United States began to press

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[113] Article 5, Draft of a Bilateral Convention for the Prevention of Double Taxation, Committee of Technical Experts on Double Taxation and Tax Evasion, Committee of Technical Experts on Double Taxation and Tax Evasion, *Report and resolutions submitted by the Committee of Technical Experts on Double Taxation and Tax Evasion* (Imp du Journal de Genève 1927).

[115] Ibid.

ahead with the conclusion of their own bilateral treaties, largely based on the early work of the League of Nations Fiscal Committee.

2.5.3 The OECD Model

In 1956, the Council of the OEEC agreed a resolution of establishing a Fiscal Committee for '[t]he study of questions relating to double taxation and of other fiscal questions of a similar technical nature'. In 1956, the Fiscal Committee began its work on a draft Convention on the basis of the work commenced between the Wars under the auspices of the League of Nations.[117] The objective was to establish a draft Convention that would effectively resolve the double taxation problems existing between OECD Member states and that would be acceptable to all Member states. On 30 September 1961, the Organisation for European Economic Co-operation ('OEEC') changed its name to the OECD on the accession of Canada and the USA.

The Committee on Fiscal Affairs (as the Fiscal Committee was renamed) brings together senior tax officials from all OECD Member countries that play an active role in formulating and implementing tax policies. The Committee sets the OECD's work programme in the tax area and provides a forum for exchanging views on tax policy and administrative issues

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[117] Philip Baker, *Double Taxation Conventions and International Tax Law: A manual on the OECD model tax convention on income and on capital of 1992* (Sweet & Maxwell 1994).

Four interim reports were prepared from 1958 to 1961 before, in 1963, a draft model double taxation agreement and a Commentary on each Article were published, with a view to forming the basis of double taxation agreements between member states. In the following years, the OECD Model Convention and the related Commentary were revised by the Committee on Fiscal Affairs based on practical experience. In 1977, the Committee on Fiscal Affairs approved a new report with a partially revised Model and Commentary. Following several reports and position papers of the Committee on Fiscal Affairs, a new 1992 Draft Convention was issued. Further amendments were made in 1994, 1995, 1997, 2000, 2003, 2005, 2008 and 2010. However, since 1977 the amendments to the text of the Model have tended to be relatively minor. Of arguably greater significance is the evolution of the Commentary to the Model Convention, which has developed beyond being a mere interpretive aide, into a tool for shaping and modifying the substance of the Model Convention itself.[119] It is through amendments to the Commentary that the OECD has elected to address many of the challenges posed by changing business practices, including those challenges that are the subject of this thesis.

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[119] Klaus Vogel, *Klaus Vogel on double taxation conventions : a commentary to the OECD-, UN-, and US model conventions for the avoidance of double taxation on income and capital, with particular reference to German treaty practice* (3rd edn, Kluwer Law International 1997).

2.6 Conclusion

Where the personal jurisdiction of one state coincides with the territorial jurisdiction of another, the potential for double taxation arises. As the problem of double taxation is a consequence of the normal operation of international law, positive intervention on the part of states is therefore necessary in order to alleviate it.

Recognition of the harmful effects of double taxation has led to states not only taking unilateral action to alleviate it, but also the proliferation thousands of bilateral tax treaties. However, as can be seen in subsequent chapters, the determination to avoid double taxation, combined with the maintenance of hundreds of independent tax systems, has resulted in situations whereby no state exercises its jurisdiction to tax – thereby presenting opportunities for avoidance. The mobility that the new economy affords enterprises makes exploitation of these opportunities easier than ever, resulting in an unjust allocation of the jurisdiction to tax.

Chapter 3: Jurisdiction and the Internet

This chapter examines the nature of the Internet, and the challenge of applying jurisdictional norms in a virtual environment. It considers attempts by domestic courts to determine the jurisdictional reach of states over online activity, as well as proposed approaches to making such determination. This chapter argues that though terminology such as 'cyberspace' can lead people to conclude that the Internet is *terra nova*, the Internet is ultimately a communications medium, facilitating real world activity. This chapter therefore concludes that it is those real world activities to which we should ultimately look in order to determine jurisdiction. The conclusions of this chapter are later applied to the specific context of taxation of highly virtual enterprises, in chapters 7 and 8.

Questions of 'cyber sovereignty' have proved challenging for both courts an academic commentators alike.[121] Traditional, Westphalian, conceptions of sovereignty

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[121] Of particular focus has been enforcement of criminal law over the internet, as well as the increasing prevalence of 'cyber warfare' between sovereign states. See, for example, David E. Sanger, 'U.S. Must Step Up Capacity for Cyberattacks, Chief Argues' *New York Times* (New York, 19 March 2015) <http://www.nytimes.com/2015/03/20/us/us-must-step-up-capacity-for-cyberattacks-chief-argues.html?ref=topics&_r=0> accessed 4 August 2015; Stephen K. Gourley, 'Cyber sovereignty' in Adam B Lowther Panayotis A Yannakogeorgos (ed), *Conflict and Cooperation in Cyberspace: The Challenge to National Security* (Taylor and Francis 2013); Forrest Hare, 'The virtual battlefield : perspectives on cyber

have been challenged by states' increased reliance on each other for trade and commerce, increasing capital flows across borders, improved communications across the globe, and the relatively easy movement of persons. The concept of sovereignty in international law has evolved to adapt to political and economic realities.[123]

However, despite the evident conceptual evolution which sovereignty has undergone it continues to be the subject of extensive criticism. While the overwhelming body of scholarship favours reforming or limiting the concept, others have gone so far as to call for it to be abandoned altogether.[125]

The challenges posed by new technology have exacerbated some scholars' frustrations with sovereignty. The growth of the Internet, in particular, sparked a flurry of activity from policymakers and commentators alike, who saw the Internet as a new frontier but couldn't decide on how such a frontier should be governed.

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warfare' in Christian Czosseck and Kenneth Geers (eds), *Cryptology and information security series,* (IOS Press 2009); Panayotis A. Yannakogeorgos and Adam Lowther, *Conflict and cooperation in cyberspace : the challenge to national security* (Taylor & Francis 2014).

[123] Certainly, the right to wage war is no longer considered to be inherent in sovereignty. Nor does the freedom from external interference in internal matters grant nation states carte blanche to act in any manner towards its people it so wishes.

[125] Stephen D. Krasner, *Sovereignty : organized hypocrisy* (Princeton University Press 1999).

3.1.1 Defining the Internet

'The Internet' is quite simply 'a computer network consisting of or connecting a number of smaller networks.'[127] While the Internet is often employed synonymously with websites, it is in fact more broadly defined as

> [t[he global computer network (which evolved out of Arpanet) providing a variety of information and communication facilities to its users, and consisting of a loose confederation of interconnected networks that use standardized communication protocols.[129]

The discussion contained within this thesis therefore includes all Internet-based communications, including: websites; email; instant messaging; voice over IP (VOIP); file transfer; file sharing, and; Internet Protocol TV (IPTV).

3.2 Nature of the Internet

Fundamental to the debate as to how sovereignty should be applied to the Internet is the nature of the Internet itself. While some contend that the Internet should be regarded as *terra nova*, others see it merely as a conduit for communication.

Kohl suggests that an understanding of the technology underlying the Internet is not necessary in order to comprehend the debate as to the application of law to the

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[127] "Internet, n.". OED Online. March 2012. Oxford University Press. 10 April 2012 <http://www.oed.com/viewdictionaryentry/Entry/248411>.

[129] *Ibid.*

Internet.[131] This may well be the case where a very broad conceptual view of Internet jurisprudence is taken. However, in the context of this study an understanding of the structure of the Internet and the technologies therein is necessary. This is particularly true when considering, as this thesis does in chapter 6, questions as to what elements of Internet infrastructure can constitute a permanent establishment for the purposes of taxation law.

The Internet is not like most other networks. Unlike the networks in most workplaces, there is no central server on which the proper functioning of the network depends – though there do exist a number of tiers. Tier 1 networks, often referred to as the 'Internet Backbone' are entirely interconnected to each other. Tier 2 networks, in addition to often being interconnected to some extent with each other, purchase access to the Internet from Tier 1 operators. Tier 2 operators often provide the bulk of domestic infrastructure.[133] Tier 3 network providers purchase network access from Tier 2 operators and tend not to be inter-connected with anyone. Though the growth in the Internet was highly organic, this de-localized nature of the Internet is not a product of accident but inherent in its design.

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[131] Uta Kohl, *Jurisdiction and the Internet : a study of regulatory competence over online activity* (Cambridge University Press 2007).

[133] Examples of Tier 2 networks include Eircom and UPC in Ireland, or BT and Virgin Media in the UK.

The Internet was conceptually envisaged as a military tool as early as the 1960s.[135] The US Department of Defence (DoD) were unsatisfied with the Mainframe network model, as they feared an attack on the centre would render the network inoperable. Through the Defence Advanced Research Projects Agency (DARPA) the DoD sought an alternative, de-centralized model, with multiple data paths and no centre.

The invention of packet switching, whereby blocks of data are lumped into packets for transmission across a network, provided the logical means for linking multiple networks across great distances. This led to the creation of ARPANET, the very first Internetwork. In the years that followed various other Internetworks appeared using differing network protocols.

The 1970s saw the development of standard protocols, in particular the Internetwork Protocol (now commonly referred to as the Internet Protocol, or IP) and the Transmission Control Protocol (TCP), which provide the functional basis of the modern Internet and remain relatively unchanged. These allowed the various Internetworks to connect with one another and form the basis of the modern day

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[135] For a more comprehensive history of the Internet, see Johnny Ryan, *A history of the Internet and the digital future* (Reaktion 2010); Brian Winston, *Media technology and society: a history: from the telegraph to the Internet* (Routledge 1998).

Internet. In the 1980s the Domain Name System (DNS) was developed to allow the Internet to operate using text, rather than numeric strings to resolve addresses.[137]

Many of the early difficulties in properly rendering jurisdiction over online activity arise as a consequence of the Internet's origins – with fears that its de-centralised nature left the Internet a lawless 'wild west'. However, as can be seen below, the evolution of the hierarchical nature of Internet infrastructure means that it has actually proven rather easier than originally anticipated to regulate the Internet.

3.3 Allocating legal authority on the Internet

The popularisation of the Internet prompted a flurry of scholarly consideration as to the question of the allocation of jurisdiction on the Internet. Even a cursory consideration of the contemporary literature of the mid-nineties reveals the considerable uncertainty as to how the technology would develop. Similar uncertainty surrounded how the Internet would be used and how it would develop. The result was an array of wildly divergent opinion in both academic commentary and judicial consideration.

Some academics, in particular David Post, advocated that radical new jurisprudence was needed in order to adequately govern the Internet. However, governments appeared disinclined to or disinterested in legislating for the Internet at a

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[137] For example, using the address "http://news.bbc.co.uk", as opposed to "212.58.226.75".

domestic or international level, save, perhaps, for extending their own regulatory competence over online gambling or pornography. Courts, therefore, extended their competence over the Internet. While domestic courts initially appeared comfortable in exercising jurisdiction over the whole of the Internet, judges quickly became more conservative in their approach.

3.3.1 Drawing a new border: David Post's Approach

Perhaps the most radical approach to addressing Internet jurisdiction was advanced by David Post, among others, in the mid-nineties. In a series of publications,[139] Post argues that the application of jurisdiction to the Internet is an uncertain, unfair and, in any case, futile exercise:

> [a]ny insistence on 'reducing' all online transactions to a legal analysis based in geographic terms presents, in effect, a new 'mind-body' problem on a global scale. We know that the activities that have traditionally been the subject of regulation must still be engaged in by real people who are, after all, at distinct physical locations. The Net enables forms of interaction in which the shipment of tangible items across geographic boundaries is irrelevant and in which the location of the participants does not matter. Efforts to determine 'where' the events in question occur are decidedly misguided, if not altogether futile.[141]

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[139] David G. Post, 'Anarchy State and the Internet' (1995) 3 Journal of Online Law; David R Johnson and David Post, 'Law and borders: The rise of law in cyberspace' [1996] Stanford Law Review 1367; David G. Post, 'Against 'Against Cyberanarchy'' (2002) 17 Berkeley Technology Law Journal 1365; David G. Post, *In search of Jefferson's moose : notes on the state of cyberspace* (Oxford University Press 2012).

[141] Johnson and Post, *ibid.*

Post argues that delimiting jurisdiction by geographical boundaries has four virtues. The first, is that sovereign states have a monopoly over enforcement of law within their borders and, as such, exclusively exercise the right to enforce all laws within their territory. Second, that the effects of a law are relatively proximate to the behaviour it seeks to control. Third, that legitimacy requires that the subjects of the law have given their consent to be bound by it and have played some part in its formulation.[143] Fourth, Post argues that when crossing from one territory to another it is usually relatively clear which set of rules applies.

Post argues that the lack of territorially defined boundaries on the Internet undermines the four virtues listed above. He proposes, as an alternative, that a boundary should be drawn around the whole of the Internet, and within it a single, unique jurisdiction should exist. Post cites a number of examples where the law could more effectively deal with undesirable behaviour, such as trademark infringement or defamation, if such behaviour was subject to a unique Internet jurisdiction. However, as is discussed below, Post fails to foresee how both the Internet and the law would develop to cope with such problems.

Post's proposals attracted considerable academic interest, though little support. In particular, *Law and Borders – The Rise of Law in Cyberspace* attracted the ire of Jack

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[143] Such an argument obviously ignores the fact that not all jurisdictions are as democratic as Post presumes,; however a jurisprudential discussion about the virtues of legitimacy in law making falls well beyond the scope of this thesis.

Goldsmith, with both authors engaging in an exchange of articles criticising each other's work.[145] Goldsmith argues that acts with multi-jurisdictional effects are nothing new, and that while the Internet may greatly multiply the number of scenarios where that is the case it is territorial sovereignty that remains the prevailing principle:

> if the extraterritorial source has no local presence or property, the efficacy of the local regulation is diminished. [...] In this sense the enforceable scope of a local regulation is much more significant that its putative scope. And the enforceable scope is largely limited by the old-fashioned conception of territorial sovereignty.[147]

Post's view of the Internet appears to be typical of its era – that the Internet was *terra nova.* There existed a considerable fear and uncertainty about what the Internet revolution might precipitate, although most of these fears have proved largely unfounded. Frank Easterbrook wrote with some prescience in 1996 that

> [b]eliefs lawyers hold about computers, and predictions they make about new technology, are highly likely to be false. This should make us hesitate to prescribe legal adaptions for the cyberspace. The blind are not good trailblazers.[149]

Post's proposals may have attracted considerable academic attention however it received little, if any, from policymakers and legislators. Given the reluctance of lawmakers to surrender competence over an area of regulation without some incentive

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[145] Jack L Goldsmith, 'Internet and the Abiding Significance of Territorial Sovereignty, The' 5 Ind J Global Legal Stud 475; Jack L Goldsmith, 'Against Cyberanarchy' The University of Chicago Law Review 1199.

[147] Goldsmith, 'Against Cyberanarchy', *Ibid.*

[149] Frank H Easterbrook, 'Cyberspace and the Law of the Horse' U Chi Legal F 207, 210.

to do so this hardly seems surprising. Courts, therefore, have been forced to take a more conservative approach to Internet jurisdiction – extending their existing competence to online acts.

3.3.2 Old-fashioned sovereignty and the Internet

Early jurisprudence relating to the applicability of local laws to the Internet appear to demonstrate the exact opposite of David Post's proposals – that online activity is subject the laws of any jurisdiction in which it can be accessed.[151] It remains the case that no over-arching principle has emerged for determining the grounds on which courts will found jurisdiction over online activity. However, as understanding about the nature of the Internet developed courts tended away from asserting jurisdiction over online activity solely on the basis of a website being accessible within its jurisdiction.

The effects based test as outlined in the American case of *Calder v. Jones*[153] was applied to Internet cases in *Blakey v. Continental Airlines*[155]. Such a strict test finds its foundation in the Due Process clause of the U.S. Constitution, and requires an intentional tortuous action expressly aimed at the forum state, and; that that action causes harm in the forum state that the defendant knows is likely to be suffered.

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[151] *Minnesota v. Granite State Resorts* (1997) 568 NW2d 715.

[153] *Calder v. Jones* (1984) 465 US 783.

[155] *Blakey v. Continental Airlines* (1998) 992 FSupp 731.

The United States District Court considered the question of internet jurisdiction in *Zippo Manufacturing v. Zippo Dot Com.* Crucially, the court considered the level of contact a website must have with a forum state in order to that state to assert personal (as opposed to specific) jurisdiction:

> [t]he likelihood that personal jurisdiction can be constitutionally exercised is directly proportionate to the nature and quality of commercial activity that an entity conducts over the Internet. [...] A passive [website] that does little more than make information available to those who are interested in it is not grounds for the exercise of personal jurisdiction. The middle ground is occupied by interactive [websites] where a user can exchange information with the host computer. In these cases, the exercise of jurisdiction is determined by examining the level of interactivity and commercial nature of the exchange of information that occurs on the [website].[157]

There is considerable merit in a sliding scale of interactivity as formulated in *Zippo.* The nature of a highly interactive online transaction, involving human input at either end, is very different from an entirely passive website designed only to display information.

However, it is also the case that the overwhelming majority of websites and online enterprises fall into neither of these two categories, and occupy the middle-ground McLaughlin J described. As web authoring has moved beyond the rigid framework of HTML to PHP and other dynamic languages even passive websites have gained a degree of interactivity. At the opposite end of the scale, rapidly increasing

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[157] *Zippo Manufacturing v. Zippo Dot Com* (1997) 952 F Supp 1124.

internet speeds have resulted in greater automation of e-commerce transactions, with large software packages and high-definition movies now being downloaded through DSL connections rather than packaged and shipped in hard-format, thus significantly reducing the amount of supply-side human input.

Nonetheless, the judgment is flawed for three reasons. First, it does not tell us at what point on this sliding scale jurisdiction should be founded. While at the passive end of the scale the court does not envisage jurisdiction being founded, and at the opposite, highly active end of the scale the court clearly does – it describes a middle ground that remains unclear.

Second, *Zippo* fails to foresee that the middle ground of its sliding scale would in-fact be overwhelmingly made up of the majority of websites. A decade after the decision in *Zippo* most websites offered a degree of interactivity which falls short of the 'knowing and repeated' interactivity at the one end of the sliding scale, but goes beyond the mere posting of information which *Zippo* envisages at the other.[159] It therefore remains unclear the level of interactivity a U.S. court finds necessary to found jurisdiction over the vast majority of websites.

Finally, *Zippo* doesn't replace the *Calder v. Jones* effects doctrine, but rather creates an additional hurdle. McLaughlin J's judgement therefore forces courts to first

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[159] In particular, social media allow users to 'Like', comment upon, and share otherwise passive web content with relative ease.

place a website on the sliding scale in order to determine its level of interactivity, and then go on to apply the *Calder v. Jones* test.

In the *Yahoo! v. LICRA*[161] litigation, the French Courts found American company Yahoo! to be in breach Article R645-1 of the French Criminal Code – which Yahoo! did neither contest on grounds of fact nor appeal. Importantly, LICRA sought judgment not only against Société Yahoo!, a French operating Company, but also against its U.S. parent company Yahoo! Inc. Yahoo! then sought a declaratory judgment in the U.S. District Court, seeking declaration that the judgment of the French court was unenforceable in the United States. Yahoo! claimed that to enforce Article R645-1 of the French Criminal Code would breach their First Amendment rights.

While the District Court granted judgment for the plaintiff in the first instance that decision was overturned in the Court of Appeal. The Ninth Circuit, while noting that Yahoo! is an American company whose servers were located entirely within the United States, concluded that the First Amendment did not grant Yahoo! *carte blanche* to break French law and therefore upheld the decision of the District Court.

Defamation has been the principle focus of most European litigation. Owing to the nature of defamation only the slightest contact with a jurisdiction is necessary in order for tortuous damage to occur. In *eDate Advertising v. Martinez and Martinez v.*

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[161] *Ligue contre le racisme et l'antisémitisme et Union des étudiants juifs de France c. Yahoo! Inc. et Société Yahoo! France* Tribunal de Grande Instance de Paris, 22nd May, 2000 in France; (2001) 145 F Supp 2d 1168, (9th Cir 2006) 433 F3d 1199.

MGN[163] the Tribunal de Grande Instance in France referred to the ECJ the following questions:

> [i]n respect of a breach of personality rights committed by a company outwith the forum jurisdiction placing content on a website, do Articles 2 and 5(3) of the Council Regulation on jurisdiction and enforcement of judgments[165] grant jurisdiction over such a breach to the said forum jurisdiction:
>
> 1. On the sole condition that the website can be accessed from within the forum state?
>
> 2. On the basis of a sufficient, substantial and significant link between the forum state and the harmful act, created by:
>
>   a. The number of hits on the website and, if so, is that number absolute or relative to the total number of hits;
>
>   b. The residence or nationality of the complainer or, more generally, the parties concerned;
>
>   c. The language of the publication or any other factor which demonstrates the publisher's intention to target a particular forum;
>
>   d. The place where the reported event occurred or the photographs were taken, or;
>
>   e. Some other criteria?[167]

The ECJ, unhelpfully, did not consider the individual questions referred by the French court in detail but instead chose to consider the issues raised in the two cases

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[163] Joined cases C-509/09 and C-161/10 *eDate Advertising v. Martinez and Martinez v. MGN* [2011] ECR I-10269.

[165] Council Regulation (EC) No 44/2001 of 22 December 2000 on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters.

[167] *Supra* note 83, para. 19.

more generally. Though the court considered that the nature of websites, as opposed to the distribution of printed material, was intended to create more ubiquity the court rejected the notion that accessibility in a forum state created an absolute jurisdiction nexus over the harmful act. The court, instead, adapted the *Shevill*[169] approach to printed media – restricting the remedy available in a Member State to the harm suffered in that State – while recognizing the ubiquity of websites and the need for a complainer to be able to seek a remedy in respect of all harm suffered. The court therefore held that in the case of a breach of personality rights the wronged party has a right of action either:

1. in a Member State where the harmful content is or has been accessible, but only in respect of harm caused in that state, or;
2. in the Member State where the publisher of the content is established or has its centre of interest in respect of all harm caused.

While it may appear that the ECJ has, in fact, created a test whereby jurisdiction is created by the mere fact of the accessibility of a website in a forum state, the reality is that the jurisdiction of a state over a website has been highly qualified. By limiting courts in third-party states to only enforce liability for damage incurred in that state the ECJ limited courts' jurisdiction to enforce to the 'real world' facts relevant to that jurisdiction.

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[169] Case C-68/93 *Shevill and Others v. Presse Alliance* [1995] ECR I-00415.

Following on from the decision in *eDate Advertising* the Irish Supreme Court delivered judgment in another Internet defamation case, *Coleman v. Mirror Group Newspapers.*[171] The plaintiff sought to rely upon *eDate* in order to claim damages for a photograph published in the Daily Mirror in the UK, along with a caption which suggested that the he was, among other things, 'a yob'. While the judgment of the court focussed principally of the insufficiency of the pleadings it also suggests that the court will not rely upon the fact that a defamatory website was accessible in Ireland at the material time, alone, to found jurisdiction. The Court held that

> [f]irst, there is no pleading that the publication alleged of the relevant articles is by internet publication of the relevant newspaper. Nor could such a pleading be inferred from the words of the Statement of Claim. Secondly, there is a need for evidence of publication to establish the tort of defamation. There is no evidence before the Court that the Daily Mirror was published on line in 2003. There is no evidence that the daily edition of the Daily Mirror was on the World Wide Web in 2003. Thirdly, *there is no evidence of any hits on any such site in this jurisdiction.* These are fatal flaws in the plaintiff's case.[173]

It is worth noting, therefore, that while the plaintiff sought to rely upon *eDate* – which would allow the court limited jurisdiction over a website which was merely accessible within the jurisdiction – the Irish court, notwithstanding the insufficiencies in the pleadings and evidence, appeared to decline so to do.

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[171] *Coleman v. Mirror Group Newspapers Ltd* [2012] IESC 20.

[173] *Ibid.*, emphasis added.

In the United Kingdom in particular, courts have been reluctant to found jurisdiction on the basis of a website alone. In *800-Flowers Trade Mark*[175] it was held that the existence of a website in New York was insufficient for the purposes of establishing a trademark in the UK. In the opinion of Parker LJ

> [t]he mere fact that websites can be accessed anywhere in the world does not mean, for trade mark purposes, that the law should regard them as being used everywhere in the world. It all depends upon the circumstances, particularly the intention of the website owner and what the reader will understand if he accesses the site.[177]

However Parker LJ qualified this, adding that '[i]n other fields of law, publication on a website may well amount to a universal publication, but I am not concerned with that.'[179]

A subsequent trademark case, *Euromarket Designs v. Peters and Crate & Barrel,*[181] also considered the nature of the Internet in determining the location of an enterprise:

> [w]hether one gets there by a search or by direct use of the address, is it rational to say that the defendants are using the words 'Crate & Barrel' in the United Kingdom in the course of trade in goods? If it is, it must follow that the defendants' are using the words in every other country of the world. [Counsel for the plaintiff] says that the Internet is accessible to the whole world. So it follows that any user will regard any website as being 'for him' absent a reason to doubt the same. She accepted that my Bootle fishmonger example in 800 Flowers is that sort

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[175] *1-800 Flowers Inc v Phonenames Ltd* [2001] EWCA Civ 721, [2002] FSR 191.

[177] Para. 41, *Ibid.*

[179] *Ibid.*

[181] *Euromarket Designs v. Peters and Crate & Barrel* [2001] FSR 20.

> of case but no more. I think it is not as simple as that. In 800 Flowers I rejected the suggestion that the website owner should be regarded as putting a tentacle onto the user's screen. [Counsel for the defendants] here used another analogy. He said using the Internet was more like the user focusing a super-telescope into the site concerned; he asked me to imagine such a telescope set up on the Welsh hills overlooking the Irish Sea. I think Mr. Miller's analogy is apt in this case. Via the web you can look into the defendant's shop in Dublin. Indeed the very language and the Internet conveys the idea of the user *going to* the site—'visit' is the word. Other cases would be different—a well-known example, for instance, is Amazon.com. Based in the U.S. it has actively gone out to seek world-wide trade, not just by use of the name on the Internet but by advertising its business here, and offering and operating a real service of supply of books to this country. These defendants have done none of that.

Jacobs J clearly saw a distinction between online those enterprises that actively seek out to trade internationally ('purposely availing' themselves of the laws of those other jurisdictions, as American jurists would describe it[183]) and those enterprises which merely happen to be accessible in a jurisdiction.

While these cases were not concerned principally with the question of jurisdiction so much as the location of a website for trademark purposes, the Scots courts were more unequivocal. In *Bonnier Media v. Smith*[185] Lord Drummond Young, having considered a number of analogies to describe the Internet, offered the following:

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[183] Wendy Perdue, 'Aliens, the Internet, and Purposeful Availment: A Reassessment of Fifth Amendment Limits on Personal Jurisdiction' (2003) 98 Nw UL Rev 455, discussed *copiose* at 7.4.

[185] *Bonnier Media v. Smith* 2003 SC 36.

> [i]t follows, in my opinion, that the person who sets up the website can be regarded as potentially committing a delict in any country in the world. It does not follow that he actually commits a delict in every country in the world, however.[187]

There is considerable merit in the approach taken to internet jurisdiction by Lord Drummond Young, and the preceding cases of *800-Flowers* and *Crate & Barrel,* which better reflect the true nature of the Internet.

What these cases show is that determining the location of an online enterprise is highly problematic, owing to the highly delocalised nature of the Internet. There also appears to be a reluctance on the part of national courts to assert jurisdiction merely by virtue of a website being accessible in that jurisdiction. To suggest, therefore, that a website is subject to the laws of every jurisdiction is touches would appear to be incorrect.

Although no single approach has emerged to applying local laws online, the general direction of travel appears to be away universal jurisdiction and towards a more surgical approach. The approach taken by *800-Flowers*, *Crate & Barrel*, and *Bonnier Media v Smith* is, it is argued below, consistent with those approaches that conceive of jurisdiction as being part of a *quid pro quo* for having entered a state's marketplace.[189] Furthermore, it is highly arguable that an approach that only applies jurisdiction where a person has actively sought to engage with, and therefore profit from, a state's

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[187] Para. 19, *Ibid.*

[189] See, 7.2, below.

marketplace is entirely consistent with the benefit theory of taxation, which this thesis discusses further below.[190]

Nonetheless, considerable uncertainty remains. Differing approaches are taken by different jurisdictions. Furthermore, within jurisdictions different approaches to jurisdiction are taken depending on the nature of the action. What is therefore needed is a degree of cross-border consistency, as well as greater consistency across the various aspects of law.

3.4 Rethinking Internet jurisdiction

Given that early American Internet legislation primarily related to obscenity and pornography it is perhaps unsurprising that US Government viewed the Internet in the same way that it viewed broadcast media. However unlike broadcast media the Internet does not radiate, nor do websites contaminate every jurisdiction it might reach. As the US District Court found in *ACLU v. Reno II*

> communications over the Internet do not 'invade' an individual's home or appear on one's computer screen unbidden[...] Although content on the Internet is just a few clicks of a mouse away from the user, the receipt of information on the Internet requires a series of affirmative steps more deliberate and directed than merely turning a dial.[191]

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[190] See, 5.4.1, below.

[191] *American Civil Liberties Union and others v. Reno II* (1996) 929 F Supp 824.

This view of the Internet would fit more easily with the view articulated in the British cases described above. Taking this view to its logical conclusion, websites, or their publishers, would not step into other jurisdictions when they engage in cross-border electronic commerce, but rather the consumer would step into that of the publisher. The certainty that such a formulation of internet jurisdiction would provide is appealing however it would doubtless place publishers of material at a significant advantage, forcing wronged parties to take action in the jurisdiction of the publisher.

This thesis proposes a compromise. There are, of course, circumstances in which a website should be subject to the sort of universal jurisdiction seen in *Yahoo! v. LICRA*, where a website or company has intentionally sought to operate worldwide. However, website operators should also be afforded a degree of protection from liability in every jurisdiction where it's quite evident that that both the intended and effective scope of their website is geographically limited.

Therefore, the alternative that this thesis proposes is a compound of the better elements of the foregoing case law. It proposes that websites should be subject to universal jurisdiction except where the operator can demonstrate geographic limitation. The following factors can be used to determine whether or not a website is geographically limited.

Location identification. Where a website attempts to limit access to its service, in full or in part, by some means of location identification. Such means include IP identification and filtering, credit card verification, and user selection.

ccTLDs. Where a website uses a country code top-level domain, such as .ie or .co.uk, as opposed to a generic top-level domain such as .com or .org. While some such domains are fairly strictly controlled by the registrar (such as .ie in Ireland) others make their ccTLDs more widely available, usually because they have fortuitous abbreviations (such as .tv in Tuvalu). Naturally the level of control and availability over the domain would have to be considered by the court.

Language. Languages such as English, Spanish or Arabic, for example, are so widely spoken across multiple jurisdictions that it is impossible to infer any geographic specificity. It can, however, be reasonably inferred that websites written in Polish or Norwegian are generally intended to be accessed exclusively in Poland or Norway, respectively. The French court in *Martinez v. MGN*[193] considered language as a potential criterion for founding jurisdiction.

Content relevance. Some web content is clearly intended to be consumed worldwide, while some content is of little relevance beyond a limited geographic area. A blog containing salacious gossip about the latest Hollywood 'celeb' for example, will attract hits worldwide. A piece containing allegations of impropriety on the part of a

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[193] *eDate Advertising v. Martinez and Martinez v. MGN, supra* note 83.

councillor in the County of Moray in the Scottish Highlands will be of little interest beyond Scotland, if even beyond Moray. The UK courts in *Bonnier Media v. Smith*[195] and *800-Flowers*[197] took the view that the true geographical reach of a website can be limited by its contextual relevance. Such relevance should be based upon the broader context of the website, and not individual items thereon.

Such a test, if widely adopted, would be generally consistent with preceding jurisprudence. It would distil previous attempts at delimiting Internet jurisdiction, and bring much needed clarity to otherwise muddy waters. It could also provide a degree of horizontal equality – as it could be applied more broadly than the specific contexts considered by the precedent. The principles outlined above could usefully be applied to almost any aspect of law, including taxation law, as this thesis proposes in chapter 7.

3.5 Conclusion

The Internet is, by design, simultaneously global in reach and delocalised in structure. This creates inherent difficulties in the application of jurisdictional rules to the Internet.

Early approaches to the allocation of jurisdiction on the Internet produced some novel jurisprudence – which regarded the Internet as universally pervasive. Conversely,

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[195] *Supra* note 94.

[197] *Supra* note 89.

commentators proposed that the jurisdictional reach of states should not apply to the Internet at all. However, it did not take long for more conceptually sound jurisprudence to develop.

This thesis endorses the approach seen in cases such as *1-800* Flowers and *Crate & Barrel*, and therefore proposes a set of principles for the application of jurisdiction to the Internet. These principles are based upon the better elements of the foregoing jurisprudence. Such principles could, if implemented, be applied to all Internet jurisdiction questions, including in matters of taxation, as is proposed in chapter 7.

Chapter 4: Addressing the challenges of new business models

4.1 Introduction

The tax policy difficulties posed by electronic commerce have not gone unchecked. Indeed, from an academic perspective, commentaries on taxing electronic commerce were once very much *en vogue.*[199] The combination of academic intrigue with what was oft considered to be a new frontier, combined with a political desire to be seen to

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[199] The sheer volume of commentaries on the taxation of electronic commerce while the industry was in its infancy is staggering. For examples of such commentaries between 1995-2000, see Mark A Harris, 'Advising the cyberbusiness: Applying fundamental tax concepts to Internet sales' (1996) 74 Taxes 709; Walter Hellerstein, 'State Taxation of Electronic Commerce' (1996) 52 Tax L Rev 425; Stanley I Katz, 'International Taxation of Electronic Commerce: Evolution Not Revolution' *ibid* 655; Michael J McIntyre, 'Taxing Electronic Commerce Fairly and *Efficiently*' *ibid* 625; Charles E McLure Jr, 'Taxation of Electronic Commerce: Economic Objectives, Technological Constraints, and Tax *Laws*' *ibid* 269; Walter Hellerstein, 'State and Local Taxation of Electronic Commerce: Reflections on the Emerging Issues' (1997) 52 U Miami L Rev 691; Tracy Hollingsworth, 'Taxation and electronic commerce' (1997) 183 Journal of Accountancy 29; Charles E McLure Jr, 'Electronic commerce, state sales taxation, and intergovernmental fiscal relations' (1997) National Tax Journal 731; Kyrie E Thorpe, 'International Taxation of Electronic Commerce: Is the Internet Age Rendering the Concept of Permanent Establishment Obsolete?' (1997) 11 Emory Int'l L Rev 633; John K Sweet, 'Formulating international tax laws in the age of electronic commerce: The possible ascendancy of residence-based taxation in an era of eroding traditional income tax principles' [1998] University of Pennsylvania Law Review 1949; David L Forst, 'Old and New Issues in the Taxation of Electronic Commerce' (1999) 14 Berkeley Tech LJ 711; Austan Goolsbee and Jonathan Zittrain, 'Evaluating the costs and benefits of taxing Internet commerce' [1999] National Tax Journal 413; Ned Maguire, 'Taxation of e-commerce: An overview' [1999] International Tax Review 3; Hal R Varian, 'Taxation of Electronic Commerce' (1999) 13 Harv JL & Tech 639; Clayton W Chan, 'Taxation of Global E-Commerce on the Internet: The Underlying Issues and Proposed Plans' (2000) 9 Minn J Global Trade 233; Peter Cobb, Stephen J Kobrin and Elizabeth Wagner, 'Taxing E-Commerce: The Landscape of Internet Taxation' (2000) 21 U Pa J Int'l Econ L 659; Charles McLure, 'Alternatives to the concept of permanent establishment: e-commerce and taxation' (CESifo Forum, Munich, 2000); Charles E McLure Jr, 'The taxation of electronic commerce: background and proposal' in Nicholas Imparato (ed), *Public Policy and the Internet: Privacy, Taxes and Contract* (Hoover Press 2000); Charles E McLure Jr, 'Implementing state corporate income taxes in the digital age' [2000] National Tax Journal 1287. Perversely, the volume of commentary has declined significantly as the challenges posed by the Internet to international tax rules have increased.

exploit a new economic asset, resulted in policymakers reaching the conclusion that urgent action was required.

However, enthusiasm towards acting on e-commerce taxation varied greatly between states, and between organisations. While the OECD set about reforming the Model Convention amidst lofty language and hyperbole, it quickly became apparent that any changes to international taxation principles would be modest at best.

The United States' hands-off approach was, it was argued, consistent with the OECD's stated aim of neutrality. However, inaction on the question of permanent establishment on the Internet would inevitably result in a shifting of the tax base from source to residence. As the largest exporter of electronic commerce, the United States would be the greatest beneficiary of such a shift.

It is hardly surprising, therefore, that the other OECD Member States, as well as the EU, saw the need to act as being somewhat more urgent. The result was a rushed reform process, with the Committee on Fiscal Affairs modifying the Commentary on the Model Convention whilst the work of the Technical Advisory Groups was in its early stages.

Meanwhile, the European Union took decisive action to update its VAT rules – creating a special scheme for non-European suppliers of digital goods and services, as well as amending the rules relating to business-to-consumer (B2C) transactions. There can be little doubt that the EU's reforms have been successful in creating an

administrative framework that makes compliance with VAT rules relatively simple. However as VAT, by its nature, lends itself to cross border trading it could be argued that the challenges the EU had to address were minor relative to those faced by the OECD. Furthermore, as every Member State could potentially benefit from being able to tax supplies of electronic commerce from beyond the EU, the task of reaching agreement was, arguably, considerably easier.

This chapter outlines the various new business models that have emerged as a result of technological advances, and considers the efforts that have been made thus far to adapt international taxation rules to these new models.

4.2 New business models

The term 'electronic commerce' covers a far broader range of businesses and transactions that is typically conceived of. E-commerce is more than merely the business of buying and selling through electronic means. 'E-commerce includes the sell-buy relationships and transactions between companies, as well as the corporate processes that support the commerce within individual firms.'[201] It is often these processes that prove problematic for taxation purposes. A simple, broad definition such

[201] Vladimir Zwass, 'Electronic commerce: structures and issues' [1996] International Journal of Electronic Commerce 3.

as 'any form of economic activity conducted via electronic connections'[202] is therefore attractive.

Those corporate processes within enterprises that have been impacted upon by electronic commerce include the vertical integration of business functions; centralization of secondary business functions such as data processing and finance; and development and use of intellectual property. In considering the concept of permanent establishment it is necessary to appreciate the various new business models that have emerged as a result of electronic commerce. A description of the most common e-commerce business models follows. This list is by no means exhaustive. It is also worth noting that new business models, such as social merchandising or collaborative consumption, continue to emerge and are proving increasingly successful. While such models do not yet warrant separate consideration, such business models are worth bearing in mind when formulating robust solutions to the challenges posed by electronic commerce.

4.2.1 Catalogue model

A business uses a website as a means of advertising goods and/or services. Such a website might include photographs and videos of goods, descriptions and specifications, prices, and contact details. Orders might be taken over the phone, or by email, or by the

[202] Rolf T Wigand, 'Electronic Commerce: Definition, theory, and context' (1997) 13 The Information Society 1.

customer visiting the business' premises. Orders are not taken through the website, and two-way human interaction is necessary for the conclusion of all transactions. Such a business model would be akin to a catalogue sent by retailers to prospective customers. Only in its broadest sense could such a model be considered to be electronic commerce. In any event, such a model poses no challenge to traditional international taxation principles and is, therefore, beyond the scope of this thesis.

4.2.2 Online conclusion/offline delivery model

A business uses a website or remotely hosted application[204] to display physical goods for sale. In addition to being able to browse through the stock of the seller, the customer can purchase goods through the website. The customer concludes the contract with an automated agent (the website). The order and payment are processed automatically (the payment is usually processed by a third party). The goods are packaged by hand or machine, and dispatched to the customer (usually by common carrier). Examples of such a model include Amazon and ASOS, and it is the dominant form of electronic commerce. As the income generating activities generally derive from a physical location such a business model is not particularly challenging insofar as cross-border taxation of income is concerned. However, such a model can pose challenging where consumption taxes such as VAT and Retail Sales Tax are concerned.

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[204] An application operated on a phone or tablet computer, for example.

4.2.3 Online conclusion and delivery model

A business uses a website or remotely hosted application to display its entire collection of digital goods or services, stored on a server or servers. The servers may be owned and operated by the business, they could be leased and at the disposal of the business, or the server could host the operations of a number of clients of which the business in question is but one. The customer concludes the contract with an automated agent (the website). The order and payment are processed automatically (the payment is usually processed by a third party). The website then interrogates the server, which responds by supplying the digital goods to the customer. Individual transactions require no human input on the part of the vendor. Examples of such a model include iTunes and Netflix, and is the most rapidly growing e-commerce model. As such a model does not involve any corporeal goods or physical place of business, it is challenging to the principles of permanent establishment and arms' length accounting. In addition, the potential volume of B2C transactions, combined with administrative and enforcement difficulties, make such a model challenging to consumption taxes.

4.2.4 Online intermediaries

A business uses a website or remotely hosted application to provide a marketplace through which third parties provide goods or services. Such a model might involve 'vetting' the third party seller, or the goods for sale, providing an online marketplace for

the display of goods, facilities for the automated conclusion of contracts, the processing of payments, provision of insurance for either the buyer or seller, and automated delivery of electronic goods or services. Such an enterprise may charge a commission on the transaction or parts of the transaction, a listing fee, or a subscription fee for sellers of multiple items. Examples of such a model include eBay and Expedia. Such a model need not involve a physical presence in the jurisdiction of either the buyer or the seller, or indeed anywhere in the world. Such a model is therefore challenging to the principle of permanent establishment and arm's length accounting. Difficulties in identifying and locating buyers and sellers poses problems in the application of VAT and sales taxes to transactions between the buyer and seller, as well as between the seller and the intermediary.

4.2.5 Online service provision

Such a business model uses a website or remotely hosted application in order to advertise and supply professional services. Although the conclusion of the contract may be done by automated agent, the service provided is of a similar nature to that which a client would receive in the offline world. Examples of such a business model include insurance providers and legal services. Since the removal of Article 14 (Independent Personal Services) from the OECD Model in 2000, such services are accorded the same treatment as business profits under Articles 5 and 7. However, as many tax treaties that

are still in force contain an equivalent of Article 14 the distinction will remain relevant for some time. As this thesis is concerned with the OECD Model, such services shall be treated in accordance with Articles 5 and 7, though they do not appear to pose significant difficulties.

4.2.6 Internet Service Providers

Internet Service Providers (ISPs) are the businesses that supply to the customer a connection to the Internet. This can be through the provision of a DSL, Cable, or other broadband connection for which the customer pays a subscription; a dial-up connection for which the customer might pay a subscription fee or pay per minute; or through wireless technologies such as 3G/4G, where a consumer might pay for a subscription, or per unit of data use, or some combination of the two. Such a business would not ordinarily be considered to be engaging in electronic commerce (except insofar as they use the internet to advertise and conclude orders as described at 4.2.2) and, as such, are generally beyond the scope of this thesis. Nevertheless, such business models are worthy of note as the Internet Tax Freedom Act (discussed below at 4.3) is applicable to such businesses.

4.2.7 Advertising

Online advertising could also be characterised as on online conclusion and delivery form of business. However, advertising is almost-exclusively a business-to-business

model, with its own peculiarities. The OECD identifies five main types of online advertising. These are search ads, display ads, classified ads, e-mail advertising, and referrals.[206] Search ads involve advertisers bidding on keywords that affect the position of their text ads on the user's results page, and are the prevalent form of online advertising. This is due to the primacy of search engines as Internet users' means of finding information.

Display ads are banners for which an advertiser pays an online company in order to appear on one of its pages; classified ads are listings of certain products or services on a web page; e-mail advertising consists of ads delivered through any type of electronic mail, and referrals are a method by which advertisers pay fees to online companies that refer purchase requests or provide customer information.

Online advertising is monetised through a number of different models. The cost-per-mile (CPM) pricing model is what Prussak calls the 'classic model'.[208] The CPM model involves advertisers being charged for every time their advertisement is displayed. Advertisements can be targeted to specific users, based upon their search terms or demographic information. For example, it is a relatively straightforward exercise to target advertisements for hardware stores to users who search on Google for

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[206] OECD, *OECD Information Technology Outlook* (Paris, France : OECD, 2000-) p.275.

[208] Assaf Y. Prussak, 'The Income of the Twenty-First Century: Online Advertising as a Case Study for the Implications of Technology for Source-Based Taxation' (2013) 16 Tulane Journal of Technology & Intellectual Property 39, 49.

drills, or for a university to target adverts for postgraduate degrees to students of certain subjects at specific universities on Facebook.

The models preferred by publishers are cost-per-click (CPC) and cost-per-action (CPA). These are performance-based models, requiring users to click on an ad in order to generate revenue for publishers. The CPA model, in particular, uses tracking cookies in order to monitor users' actions, with the possibility that commission might be payable to the publisher for any purchases made by the user. Prices can range from $0.01 to over $5 per click to be associated with the search term 'Internet marketing' on Google's AdWords.[210]

Advertising has also been central to the monetisation of social media. In addition to banner ads, advertisers can pay to have content appear in users' social media streams, such as promoted posts on Facebook and Twitter. Furthermore, a market has also developed for advertisers to purchase 'Likes' or 'Followers' on social media in order to give the impression of popularity.

Google's advertising revenue in 2014 amounted to $60 billion, out of a total gross revenue of $66 billion.[212] This represented growth in advertising revenues of 19%

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[210] OECD, *OECD Information Technology Outlook 2008* (OECD Publishing), p.275.

[212] Google, '2015 Financial Tables' <https://investor.google.com/financial/tables.html> accessed 11/06/2015.

on the preceding year.[214] As a form of online conclusion and delivery e-commerce, an online industry of this scale is, understandably, concerning for revenue authorities.

4.3 Highly virtual enterprises

Much of the existing literature focuses upon electronic commerce, which encompasses the business models outlined above. However, this thesis takes a broader view of the sorts of business models and practices that are problematic to existing international tax rules. As its name suggests, electronic commerce alone tends to be concerned with the online conclusion of contracts and delivery of goods and services. However, electronic communications media are problematic to international tax rules in a far broader manner than merely the final conclusion of contracts.

The Internet allows enterprises to organise themselves entirely differently. It is no longer necessary for enterprises to have a shop or salespeople located within a jurisdiction in order to sell to customers located therein. It is no longer necessary for employees to be located in the same place in order for them to collaborate. Consequently, enterprises can structure themselves along thematic lines, rather than national boundaries.

> In the new economy, the foundation for value creation is no longer primarily focused on tangible, measurable assets. For unlike traditional organisations, machines of the industrial age where value creation was

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[214] *Ibid.*

> largely derived from investment in tangibles such as plant and machinery, digital age organisations [...] leverage the power of 'smart resources' such as information/knowledge, relationships, brands and innovative and collaborative intelligence, to identify and exploit new opportunities. The trend towards virtual collaborative scenarios gives rise to a blurring of organizational boundaries.[216]

Therefore, this thesis considers more than merely the impact of the Internet on the taxation of electronic commerce *transactions*, but the taxation, more generally, of enterprises that are heavily reliant upon the Internet in its operation and value creation.

4.4 The challenge of the digital economy

While new technologies have spurred the development of new business models, they have also provided considerable challenges to tax authorities, in particular. Furthermore, it is arguable that whatever poses a challenge to tax authorities, presents opportunities for enterprises to minimise their liability to tax.

> Actual business activities are generally identified through elements such as sales, workforce, payroll, and fixed assets. [...] [I]n particular profits from mobile activities [are] being increasingly shifted to where they benefit from a favourable tax treatment.[218]

One such opportunity is the minimization of income that is allocable to isolated business entities. Under this model, a large multinational group maintains a presence in countries that represent significant markets for its products. This might take the form

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[216] L.M. Camarinha-Matos, H. Afsarmanesh and R. Rabelo, *E-Business and Virtual Enterprises: Managing Business-to-Business Cooperation* (Springer US 2013), p.5.

[218] OECD, *Addressing Base Erosion and Profit Shifting* (OECD Publishing 2013), 22.

of either a local subsidiary or a permanent establishment, with the local activities structured in a way that generates little taxable profit. Crucially, the activities of this subsidiary or establishment are largely isolated from those of other, more profitable aspects of the business. These structures need not, necessarily, reflect an intention to minimise tax liabilities. While functions are often located in a particular jurisdiction for non-tax reasons such as access to skilled labour or necessary resources, as business functions grow increasingly mobile, taxpayers may increasingly be able to locate functions in a way that takes advantage of favourable tax regimes.

However, the ability to allocate functions, assets and risks in a way that minimises taxation creates incentives to, for example, contractually allocate them in a way that does not fully reflect the actual conduct of the parties, and that would not be chosen in the absence of tax considerations. For example, assets, in particular intangibles, and risks related to the activities carried out at the local level may be allocated via contractual arrangements to other group members operating in a low-tax environment in a way that minimises the overall tax burden of the MNE group.

Similarly, the important role that intellectual property and intangibles plays in highly virtual enterprises creates both incentives and opportunities for avoiding withholding tax. By ensuring that intellectual property is beneficially owned in a low tax jurisdiction, licensing arrangements can be structured in such a way as to reduce profits in higher tax jurisdictions. However, such payments might often be subject to

withholding tax at source. This is particularly exacerbated by the inconsistent treatment of royalty payments for withholding tax purposes within the European Union. While withholding taxes have been abolished as between Member States,[220] there is not, as of yet, a common system of withholding taxes as between Member States and third-party states. This presents ample opportunity to shift profits within the EU to the Member State with the most favourable outward-facing withholding tax, and used that state as a point of departure of profits from the EU.

However, of greatest significance to this thesis, is the ability to engage significantly with the marketplace of an economy with little or any significant physical presence in the jurisdiction. It is increasingly easy to interact with customers through a website or other digital means. Furthermore, reliance upon automated processes decreases the need for a physical presence even further. Whether or not an enterprise is subject to the tax jurisdiction of a state for the purposes of income and corporation taxes is usually highly dependent upon whether or not that enterprise has a physical presence within that state, as a matter of both domestic law and of treaty law (see chapter 6). This concern has been recognized by the OECD in its Addressing Base Erosion and Profit Shifting report:

> it is possible to be heavily involved in the economic life of another country, e.g. by doing business with customers located in that country

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[220] Council Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States.

> via the internet, without having a taxable presence there or in another country that levies tax on profits. In an era where non-resident taxpayers can derive substantial profits from transacting with customers located in another country, questions are being raised on whether the current rules are fit for purpose.[222]

However, while the ability of a company to earn revenue from customers in a country without having a PE in that country is not unique to digital businesses, it is available at a greater scale in the digital economy than was previously the case. This ability can be combined with strategies that eliminate taxation in the state of residence, with the consequence that such revenue is not taxed anywhere. In addition, under some circumstances, tax in a market jurisdiction can be artificially avoided by fragmenting operations among isolated group entities in order to qualify for the exceptions to permanent establishment status for preparatory and auxiliary activities, or by otherwise ensuring that each location through which business is conducted falls below the permanent establishment threshold.

4.5 Efforts at addressing the challenges of the new economy

Numerous efforts have been made at addressing the challenges of taxing the new economy. Some of these have been thinly-veiled attempts at superimposing an ideological preference over the medium. However, with the exception of the EU's modifications to its VAT regime, attempts at addressing the challenges of the new

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[222] OECD, *Addressing Base Erosion and Profit Shifting*, 7.

economy thus far have yielded little in the way of substantial results. However, the ongoing Base Erosion and Profits Shifting (BEPS) agenda of the OECD shows some promise.

4.5.1 Internet Tax Freedom Act

In response to concerns that discriminatory taxes on electronic commerce would hamper the growth of what was expected to be a highly lucrative industry, the United States Congress introduced the Internet Tax Freedom Act (ITFA),[224] which has been subsequently extended and re-named the Permanent Internet Tax Freedom Act.[226] While the effect of the ITFA was, primarily, to prevent the effective levying of state and local sales taxes on Internet transactions, it set the terms of debate with respect to e-commerce taxation in the US. In particular, that no special rules should be developed for the taxation of electronic commerce.

The debate on the ITFA generally focused on matters of public policy – such as the desire to foster growth of e-commerce as an industry – and not the more pressing economic and legal concerns relating to the taxation of electronic commerce. While enshrining into federal law a statutory prohibition on taxes levied solely on Internet access or transactions is in keeping with the principle of neutrality so favoured by the

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[224] Internet Tax Freedom Act H.R. 3529 (105th Congress).

[226] Permanent Internet Tax Freedom Act H.R. 3086 (113th Congress).

OECD, there can be little doubting that the intended purpose of the law is to maintain the United States' effective tax-free zone on the Internet. This was observed by Pastukhov, who noted that

> the debate on the issue unavoidably reflects the political agendas of each country, despite their representatives attempts to cloak their ambitions with declaration to international consensus.[228]

The ITFA had two principal aims. First, it barred states from enacting any taxes on Internet access (except in the case of eight states which had already done so prior to enactment)[230]; and second, it barred states from enacting 'multiple or discriminatory taxes on electronic commerce'.[232] This thesis is primarily concerned with the latter.

The problem of levying and collecting of sales and use taxes in the US finds its genesis in *Quill Corporation v. North Dakota.*[234] Though *Quill* was a catalogue retailer and electronic commerce was in an embryonic stage of development, the consequence of this decision is to effectively exempt electronic transactions from sales and use taxes in the United States.

One of the effects of the ITFA therefore is to re-affirm the *Quill* decision's sales tax exemption. This would appear to fly in the face of the ITFA's aim of 'non discrimination', as is highlighted by Bruce *et al:*

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[228] Oleksandr Pastukhov, 'International Taxation of Income Derived from Electronic Commerce: Current Problems and Possible Solutions' (2006) 12 BUJ Sci & Tech L 310.

[230] §1101(a)(1).

[232] §1101(a)(2).

[234] *Quill Corporation v. North Dakota* (1992) 504 US 298

> [d]espite the statutory non-discrimination inherent in the ITFA, the act implicitly supports the court-determined definition of nexus requiring physical presence before the firms can be obliged to collect the use tax, which means the effective rate on remove sales is likely to be lower than on local sales.[236]

Proponents of the ITFA have argued that the benefits of favourable conditions towards electronic commerce as a fledgling industry outweigh the loss in revenue to state and local tax authorities. However, if it was ever the really the case e-commerce needed fostering, that certainly cannot be said today.

The effect of the level of taxation on electronic commerce is considered by Goolsbee. His research concludes that higher rates of local sales taxes result in more people turning to the Internet to make their purchases.[238]

However, Goolsbee's research isn't without its critics. Basu argues that the data on which the survey was based is grossly out of date, having been conducted in 1997.[240] He also argues that Goolsbee's study suffered from a selection bias, with the sample being more technologically savvy than the typical consumer at the time, as well was being more sensitive to tax liabilities. Indeed, anyone engaging in electronic commerce in 1997 would very likely have been considerably more affluent and far more technologically aware than is the case today. A decade ago electronic commerce was the

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[236] Donald Bruce, William Fox and Matthew Murray, 'To tax or not to tax? The case of electronic commerce' (2003) 21 Contemporary Economic Policy 25.

[238] Austan Goolsbee, 'In a World Without Borders: The Impact of Taxes on Internet Commerce' (2000) 115 The Quarterly Journal of Economics 561.

[240] Basu, S., To Tax or Not to Tax? That is the question? Overview of Options in Consumption Taxation of E-Commerce, Journal of Information, Law and Technology (2004).

exclusive domain of those already wealthy enough to own computers and access the Internet, whereas nowadays it is possible to buy an internet enabled device for under €50.

There can be little doubt that e-Commerce was and is a growth sector. US Census Bureau data clearly records a steady upward trend in e-Commerce transactions as a proportion of all sales, as well as real-terms increases in total e-Commerce sales[242]. However despite the fact that the U.K., like all E.U. nations, applies VAT to e-commerce transactions, a similar upward trend has been recorded in electronic commerce transactions as a proportion of all sales and purchases[244]. While a like-for-like comparison is almost impossible, these figures suggest that the growth in electronic commerce occurs irrespective of the tax advantages.

In 2007, The Permanent Internet Tax Freedom Act was introduced to the U.S. Senate. This succinct bill aimed to extend permanently the moratorium on taxes on electronic commerce[246]. Though this bill received little support, the ITNDA has been extended and remains in force until November 2014.

While the ITFA and the ITNDA would, on the face of it, appear to share the OECD's aim of neutrality of treatment between online and offline transactions, the

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[242] US Census Bureau, 'Quarterly Retail e-Commerce Sales: 3rd Quarter 2012' <http://www.census.gov/retail/mrts/www/data/pdf/eccurrent.pdf > accessed 29 November 2012.

[244] Office for National Statistics, 'E-commerce and ICT activity, 2010 Edition' <http://www.ons.gov.uk/ons/dcp171778245829.pdf> accessed 29 November 2012.

[246] S.156, 110th Congress, 1st Session.

effect of these two acts is quite the opposite. The ITFA was, in reality, the product of a desire to continue the favourable taxation treatment afforded to electronic commerce in the US. Hardly the sort of neutrality envisaged by the Ottawa Conference (see 4.5.2.2).

4.5.2 OECD efforts

Given the OECD's leading role in developing international tax policy, it is hardly surprising that the OECD has, so far, served as the principal respondent to the challenges of electronic commerce. In response to the challenges posed by electronic commerce, the OECD embarked upon a process of review and reform of the OECD Model Convention. This began with the Turku round table and culminated in the 2003 amendments to the Model Convention and the reports of the Technical Advisory Groups (TAGs). The OECD's onus to address the challenges of the new economy has subsequently been renewed, by the mandate from the G20 to pursue the BEPS agenda.

4.5.2.1 Turku Conference on dismantling barriers to electronic commerce

The OECD's work in the field of electronic began in earnest, in Turku, Finland in 1997. The Turku conference had three objectives:

1. To define general principles necessary for global electronic commerce to prosper;
2. Discussion as to approaches to devising various solutions;
3. Identification of organisations able to develop and implement these solutions.

Although these were hardly lofty ambitions, they laid the groundwork for the Committee on Fiscal Affairs report to the Ottawa Conference in 1998, which itself provides the guiding principles for the ongoing work of the OECD.

The principles agreed to at Turku were that e-commerce should be 'market-driven, led by business, and with minimal government intervention.[248] Despite the conference favouring a hands-off approach to regulation of electronic commerce, the conference also agreed that taxation was an area where there was little doubt that government-led action was required. In identifying suitable bodies to implement and develop solutions the conference recognized the OECD's expertise in the field of taxation and economic analysis. In particular, the OECD Committee on Fiscal Affairs was charged with developing principles for the taxation of electronic commerce that could be endorsed by Ministers at the Conference in Ottawa the subsequent year.

However, despite tasking the Committee on Fiscal Affairs with devising principles for the taxation of electronic commerce, it was clear from the proceedings and conclusions of the Turku conference that the principles of neutrality and efficiency were strongly favoured by the OECD. In his conference address, OECD Director-General Donald J. Johnston both advocated light-touch regulation and ruled out new taxes on e-commerce:

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[248] Technology OECD Directorate for Science, and Industry, *Dismantling the Barriers to Global Electronic Commerce* (DSTI/ICCP(98)13/FINAL, 1998).

> [a] priority must be to ensure that the evolution of the electronic world does not become ensnared and slowed down in the regulatory jungles which we are working to eliminate, or burdened with something like a 'bit' tax. No new taxes is a well-known refrain, but the reality is that Government treasuries should anyway be amply rewarded by the increase in profitable commercial activity which electronic commerce promises.[250]

Similarly the OECD's Business and Industry Advisory Committee's Declaration of Policy Principles for Electronic Commerce specifically advocated tax neutrality, and the application of existing international tax rules to electronic commerce:

> [t]ransactions conducted using electronic commerce should receive neutral tax treatment in comparison to transactions using non-electronic means. Taxation of electronic commerce should be consistent with established, internationally-accepted practices, and administered in the least burdensome manner.[252]

It is worth recognizing, therefore, the particular emphasis that the OECD places upon 'neutrality' in developing tax policy for electronic commerce.

4.5.2.2 Ottawa Conference and Taxation Framework Conditions

The Turku conference laid the groundwork for what was to be achieved at the Ministerial Conference in Ottawa, Canada – 'A Borderless World: Realising the Potential of Global Electronic Commerce' – in October 1998.[254] Unlike previous discussions on electronic commerce, the Ottawa conference included the OECD's

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[250] Johnson, D.J., Address to the OECD Conference "Dismantling the Barriers to Global Electronic Commerce", *ilbid.*

[252] BIAC Declaration, supra note 125.

[254] OECD, *OECD ministerial conference "A borderless world : realising the potential of global electronic commerce" : Ottawa, 7-9 October 1998 : a global action plan for electronic commerce prepared by business with recommendations for governments* (OECD 1998).

highest level of decision makers –Ministers from its Member States – as well as representatives from observer states, international organizations, consumer groups, trades unions, and the business community gathered in Ottawa. The conference focused on a wide range of e-commerce issues, including consumer protection, privacy, authentication, and taxation.

The outcome of this conference was an agreement on the broad principles which should guide the regulation of electronic commerce, including taxation, as well as an Action Plan for Electronic Commerce.[256] In particular, it was unanimously agreed that, rather than attempt to develop a new system of taxation for electronic commerce, the existing VAT and Sales Tax frameworks should be updated in light of the new challenges posed by electronic commerce.

Insofar as general principles for regulation of electronic commerce, the conference concluded that 'government intervention, when required, should be proportionate, transparent, consistent, and predictable, as well as technically neutral.' The conference also welcomed the report 'Electronic Commerce: Taxation Framework Conditions', which as Basu describes

> has served both as starting point and point of reference for governments from all over the globe rising to the fiscal challenges of e-commerce.[258]

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[256] *OECD action plan for electronic commerce* (OECD 1998).

[258] Basu, *supra* note 3.

The Committee on Fiscal Affairs felt that, at such an early stage, it would be easier to reach agreement on broad principles rather than specific proposals for reform.[260] As such, the Framework Conditions identified five 'widely accepted general tax principles' which, in the opinion of the Committee, should be applied to e-commerce:-

Neutrality

(i) Taxation should seek to be neutral and equitable between forms of electronic commerce and between conventional and electronic forms of commerce. Business decisions should be motivated by economic rather than tax considerations. Taxpayers in similar situations carrying out similar transactions should be subject to similar levels of taxation.

Efficiency

(ii) Compliance costs for taxpayers and administrative costs for the tax authorities should be minimized as far as possible.

Certainty and simplicity

(iii) The tax rules should be clear and simple to understand so that taxpayers can anticipate the tax consequences in advance of a transaction, including knowing when, where and how the tax is to be accounted.

Effectiveness and Fairness

(iv) Taxation should produce the right amount of tax at the right time. The potential for tax evasion and avoidance should be minimized while keeping counter-acting measures proportionate to the risks involved.

Flexibility

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[260] Interestingly, this mirrors the *raison-d 'être* of the Committee on Fiscal Affairs of the League of Nations for pursuing model articles rather than multilateral agreement on double taxation.

(v) The systems for the taxation should be flexible and dynamic to ensure that they keep pace with technological and commercial developments.[262]

The commitment to neutrality contained within the Framework Conditions was reflected in the conclusions of the Ottawa Conference. In particular, the conference rejected any suggestion of new or special taxes – in particular any kind of 'Bit Tax'.[264]

The Ottawa conference further concluded that whatever arrangements were to be but in place domestically, or whatever amendments or alterations should be made to the existing treaty framework, should be constrained so as to preserve the fiscal sovereignty of nation states.

4.5.2.3 Work of the Committee on Fiscal Affairs and Technical Advisory Groups

One important outcome of the Ottawa conference was the establishment of five Technical Advisory Groups (TAGs) on electronic commerce: the Technical Advisory Group monitoring the application of existing treaty norms for the taxation of business profits (Business Profits TAG); the Consumption Tax TAG; the Professional Data Assessment TAG; the Technology TAG; and the Technical Advisory Group on Treaty Characterisation Issues arising from E-Commerce (Treaty Characterization TAG). Of particular relevance to this thesis is the work of the Business Profits TAG.

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[262] OECD, *Electronic Commerce: Taxation Framework Conditions* (OECD, 1997).

[264] A tax on data flows. See Arthur J Cordell, 'Taxing the Internet: the proposal for a bit tax' (1997) 2 Journal of Internet Banking and Commerce; Luc Soete, 'Taxing Consumption in the Electronic Age: The European Bit Tax Proposal' (Symposium on Multi-Jurisdictional Taxation of Electronic Commerce, Harvard Law School, Cambridge, Mass, April 1997).

The mandate of the Business Profits TAG was to consider how the existing rules within the OECD Model Convention framework applied to business profits in the context of electronic commerce. The TAG sought to develop evaluation criteria for the existing treaty rules; identify alternatives to the existing treaty rules; and assess those alternatives on the basis of the evaluation criteria. The evaluation criteria adopted by the TAG were:

A. Consistency with the conceptual base for sharing the tax base;
B. Neutrality;
C. Efficiency;
D. Certainty and Simplicity;
E. Effectiveness and Fairness;
F. Flexibility;
G. Compatibility with International Trade Rules;
H. The need to have universally agreed rules.[266]

A substantive evaluation of the existing treaty rules, and potential alternatives, follows in chapters 6-8, however in considering the reform process undertaken by the OECD thus far it is worth briefly considering that which the TAG agreed upon and those proposals that it dismissed.

Assessment of criterion A proved to be problematic as agreement could not be reached about the conceptual base. While it was agreed that taxation at source should be non-discriminatory (non-resident enterprises should be taxed in the same manner as

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[266] Technical Advisory Group on Monitoring the Application of Existing Treaty Norms for Taxing Business Profits, *Are the Current Treaty Rules for Taxing Business Profits Appropriate for e-Commerce? Final Report* (OECD 2004).

resident enterprises), and that residence taxation rights should be residual (that is to say, that the country of source should enjoy the first right to tax income), the TAG could not agree upon economic principles for determining the source of income.[268]

A strong consensus did emerge around the principle of neutrality, however. Many members within the TAG argued that is was both technically and conceptually unsound to attempt to create one set of rules for "traditional" enterprises and another for e-commerce enterprises. The TAG therefore rejected out of hand any suggestion that a separate set of treaty rules should be devised for e-commerce business models:

> [w]hilst e-commerce has created new products and services, it also has changed the way 'traditional' business activities are being conducted by all enterprises (e.g., by introducing efficiencies into the procurement of supplies, collaborative R&D efforts, delivery of products and services to customers, performance of back-office functions such as accounting & finance, etc.). Accordingly, it would not be appropriate, nor possible, to design one set of nexus rules for 'e-commerce' companies, and another for non-e-commerce companies.[269]

An unfortunate consensus emerged surrounding the issue of the need for efficacy – with the TAG seemingly requiring an inordinately high compliance rate with tax rules before they could be considered fair:

> [a] system of taxation is only perceived to be fair if it can be applied in accordance with its terms. If there is a class of taxpayers (e.g., foreigners with no physical connection to the jurisdiction) that are technically

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[268] Discussed in chapter 5.

[269] *Supra* note 134, p18.

> subject to a tax, but as a matter of administrative practice are never required to pay the tax, then the taxpaying public will perceive that the system of tax is unfair and discriminatory.[271]

A more comprehensive discussion about efficacy follows in subsequent chapters, however it is worth highlighting the high compliance rate demanded by the TAG. Fairness is, of course, a matter of perception however from an objective perspective is does not follow that because a rules are not perfectly, or even near-perfectly, effective that that they are not effective at all.

Of particular note is the dissent that appeared to exist surrounding the issue of transfer pricing. Some members of the TAG questioned whether separate entity accounting was appropriate in light of the increasing integration of business functions enabled by advances in technology. Members also questioned whether it was appropriate to permit a state to tax a MNE that made overall losses – in particular where such an enterprise groups its operations and profit centres around similar business activities rather than on a geographical basis.

4.5.2.3.1 Alternatives considered by the TAG

The Business Profits TAG considered a number of alternatives to the existing treaty norms. Those alternatives can be divided into two categories: those that amount to a

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[271] *Op. cit.*

fundamental modification of treaty norms; and those that do not. Of the more modest alternatives to the existing treaty norms, the TAG considered:

a) Modification of the permanent establishment definition to exclude activities that do not involve human intervention by personnel, including dependent agents;
b) Modification of the permanent establishment definition to provide that a server cannot, in itself, constitute a permanent establishment;
c) Modification of the permanent establishment definition/interpretation to exclude functions attributable to software when applying the preparatory or auxiliary exception;
d) Elimination of the existing exceptions in paragraph 4 of Article 5 or making these exceptions subject to the overall condition that they be preparatory or auxiliary;
e) Elimination of the exceptions for storage, display, or delivery in paragraph 4 of Article 5;
f) Modification of the existing rules to add a force-of attraction rule dealing with e-commerce – websites as secondary PEs;
g) Adopting supplementary nexus rules for purposes of taxing business profits arising from the provision of services.

Alternatives 'a' and 'b' would effectively roll back the changes to the Commentary implemented by the Committee on Fiscal Affairs.

In addition to the minor modifications discussed above, the TAG also considered more fundamental options, including:

a) Adopting rules similar to those concerning taxation of passive income to allow source taxation of payments related to some forms of e-commerce;
b) A new nexus covering base eroding payments;
c) Replacing separate entity accounting and arm's length by formulary apportionment of profits of a common group;
d) Adding a new nexus of electronic (virtual) permanent establishment.

However the TAG dismissed the above four options, arguing that it would not be appropriate to embark upon such fundamental change at the material time. The

TAG concluded that '[c]ontrary to early predictions, there does not seem to be actual evidence that the communication efficiencies of the internet have caused any significant decrease to the tax revenues of capital importing countries.'[273]

4.5.2.3.2 2000 Clarification on the Application of the Permanent Establishment Definition in e-Commerce

Working in parallel to the Technical Advisory Groups was the Committee on Fiscal Affairs. Working Party No. 1 published discussion drafts on the issues surrounding Permanent Establishment in October 1999 and March 2000. On 22nd December 2000 the Committee on Fiscal Affairs accepted the recommendations of Working Party No. 1. In particular, the Committee on Fiscal Affairs was concerned with the 'threshold question' as to the level of contact an enterprise must have with a jurisdiction in order to constitute a permanent establishment.

The Committee was in broad agreement on the issues surrounding the application of the current definition of permanent establishment. In particular, the committee took the view that a website should never constitute a permanent establishment, while a server might result in a permanent establishment under limited circumstances. The Committee also took the view that human intervention is not as necessary requirement for the existence of a permanent establishment.

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[273] *Supra* note 134.

The Committee on Fiscal Affairs therefore issued its 'Clarification on the Application of the Permanent Establishment Definition in e-Commerce',[275] which including Working Party No. 1's proposed amendments to the Commentary to the Model Convention, which were to be included in the next set of revisions. The revisions were inserted into the Commentary on 28 January 2003, and introduced paragraphs 42.1-42.10 to the Commentary on Article 5.

Amongst the changes and clarifications inserted was a statement that a permanent establishment may exist without the presence of any personnel,[277] and that a website in itself is not a permanent establishment. It also provided that internet service providers should not be considered dependent agents for the enterprise for which it hosts websites – thus excluding ISPs from the application of dependent agent permanent establishments.

The primary focus of the 2000 Clarification was computer equipment and network infrastructure – in particular servers. Following the insertion of paragraphs 42.1 - 42.10, a server could constitute a permanent establishment where:

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[275] OECD, *Clarification on the Application of the Permanent Establishment Definition in e-Commerce: Changes to the Commentary on Article 5* (OECD, 2005).

[277] Confirmed ining the judgment of the German court in *German Pipeline Case* Decision of II R 12/921, ITLR 163 (Bundesfinanzhof), see Friedrich EF Hey, 'German Court Rules Remote-Controlled Pipeline Constitutes a PE' (1997) 14 Tax Notes International 651*German Pipeline Case* Decision of II R 12/921, ITLR 163 (Bundesfinanzhof), see Friedrich EF Hey, 'German Court Rules Remote-Controlled Pipeline Constitutes a PE' (1997) 14 Tax Notes International 651.

a) the enterprise 'has the server at its own disposal';[279]
b) the computer equipment is fixed;[281]
c) the business of an enterprise is wholly or partly carried on through such equipment, having regard to whether it can be said that, because of such equipment, the enterprise has facilities at its disposal where business functions of the enterprise are performed;[283]
d) the functions performed by the server are not preparatory or auxiliary.[285]

The deficiencies in the OECD's approach in this respect can be seen in a number of examples. IT equipment may form part of a permanent establishment provided it does not move from one location to another on a regular basis:

> [c]omputer equipment at a given location may only constitute a permanent establishment if it meets the requirement of being fixed. In the case of a server, what is relevant is not the possibility of the server being moved, but whether it is in fact moved. In order to constitute a fixed place of business, a server will need to be located at a certain place for a sufficient period of time so as to become fixed within the meaning of paragraph 1 [of Article 5].[287]

Though this might, on the face of it, appear consistent with the concept of a fixed place of business, the requirement to be fixed to a single location within a jurisdiction appears to be far greater for a server than it is for other permanent establishments. As Jean Schaffner points out,

> '[i]t is difficult to imagine that IT equipment may be simply moved from one place to another and, as a result, not be considered as a permanent

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[279] Ppara. 42.3, Commentary on Article 5, OECD, *Model Tax Convention on Income and on Capital 2010 (Full Version)* (OECD Publishing 2012).

[281] Ppara. 42.4, *ibid.*

[283] Ppara 42.5, *ibid.*

[285] Ppara 42.7, *ibid.*

[287] Ppara 42.4, *ibid.*

establishment, while, if it were kept at the same place, it would be a permanent establishment.'[289]

However, the 2000 Clarification was not entirely without merit. New paragraph 42.7 provides that no permanent establishment shall exist where 'the electronic commerce operations carried on through computer equipment at a given location in a country are restricted to the preparatory or auxiliary activities'. Examples of activities which would generally be considered to be preparatory or auxiliary include providing a communications link, advertising, relaying information through a mirror server for security and efficiency purposes, gathering market data for the enterprise, and supplying information. This exclusion is qualified such that where such functions form in themselves an 'essential and significant part of the business activity of the enterprise as a whole', or where other core functions of the enterprise are carried on through the computer equipment, then such activities go beyond those that are considered preparatory and ancillary.[291] Where the core function of a business is the provision of server capacity or storage then the computer equipment could constitute a permanent establishment of that enterprise, however it would not necessarily be considered a permanent establishment of those enterprises to whom it provides this function. This approach is consistent with that which applies to offline commerce.

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[289] Jean Schaffner, *How Fixed is a Permanent Establishment?* (Kluwer 2013) p65.

[291] Para 42.8, *supra* note 140.

Agreement on these additions to the Commentary is not unanimous. Spain and Portugal take the view that, not only should a server constitute a server under certain circumstances, but so too should a website.[293] India is also of the opinion that a website can constitute a permanent establishment.[295] The United Kingdom, however, takes the opposite view – that

> a server either alone or together with web sites could not as such constitute a [permanent establishment] of a business that is conducting e-commerce through a web site on the server[297]

and has entered a reservation into the Model Convention to that effect.[299] The effect of this reservation is that income attributable to a website in India may be subject to double taxation, while income attributable to a server in the United Kingdom may be subject to no taxation at all.

4.5.2.3.3 2002 Permanent Establishment Report

In 2002, the OECD Committee on Fiscal Affairs undertook an inquiry into the definition of permanent establishment under Article 5 of the OECD Model. Though not directly addressing issues arising out of electronic commerce, their Report considered, *inter alia*, the fixed place of business permanent establishment and the issue of the necessary geographical link.

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[293] *Supra* note 138.

[295] Para. 33, Positions on the Commentary.

[297] HMRC, International Manual (INTM266100, HMSO).

[299] Para. 45.5, Commentary.

In particular, discussion focused upon situations where enterprises traded through fixed places of business that were neither actually fixed, nor a single place of business. The Committee endorsed and expanded the already broad approach taken by the Commentary to Article 5, finding that

> the concept of a place that constitutes a coherent whole commercially and geographically in relation to a particular business [...] would be relevant in applying the concept of 'fixed place of business'.

In other words, trading regularly but infrequently through a sequence of different locations will constitute a fixed place of business will constitute a fixed place of business permanent establishment provided that those locations all fall within a single discernible geographical unit.

Though not explicit, the Committee on Fiscal Affairs implicitly endorsed the maintenance of the of the physicality requirement in order to meet the fixed place of business permanent establishment standard.

However, of some considerable note is the discussions of the Committee with respect to Article 5 as it applies to dependent agent permanent establishments. The Committee considered the fact that dependent agents, unlike fixed places of business, are not required to have any kind of permanent presence in a jurisdiction under Article 5.

The Committee agreed that, generally,

> paragraph 5 [of the Article 5] is intended to extend the scope of Article 5 so as to give the source country the right to tax foreign enterprises whenever they participate in the economic life of the source country so as to come within the jurisdiction of that State's taxing rights.[301]

The Committee further agreed that the object of paragraph 5 is to prevent enterprises from avoiding source taxation by trading through agents, rather than through a fixed place of business, and that the dependent agent permanent establishment works well in identifying 'cases where substantial business is carried on and that is the proper criterion for giving source state taxing rights.'

The Committee concluded that the dependent agent permanent establishment need not be a resident in a taxing jurisdiction, nor have a fixed place of business within it – and proposed an amendment to the Commentary to that effect. In doing so, the Committee confirmed that the jurisdictional threshold for taxing a dependent agent is lower than exists for the principal. This, it is arguable, further undermines the conceptual basis for the physical presence requirement of the fixed place of business permanent establishment threshold.[303]

4.5.2.4 Base Erosion and Profits Shifting (BEPS) Agenda

The early 2010s saw a renewed onus to address questions of erosion of the (in particular, corporate) tax base and of profit shifting for the purposes of tax avoidance.

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[301] OECD, *Issues in International Taxation 2002 Reports Related to the OECD Model Tax Convention* (OECD Publishing 2003).

[303] For further discussion, see chapter 6, below.

This political onus was reflected in the Agenda of the G20 group of finance ministers, who welcomed the ongoing work of the OECD in this field, and requested a report for their February 2013 meeting in Moscow. The OECD responded accordingly, producing their report 'Addressing Base Erosion and Profit Shifting' on 12 February 2013.[305] The report identified a number of key issues pressing upon revenue authorities, including transfer pricing, financing arrangements, mismatches in entity and instrument characterisation, harmful preferential regimes, the effectiveness of anti-avoidance measures, and, in particular, application of treaty concepts to profits derived from the delivery of digital goods and services.

Notably, the report advocated a 'holistic approach' in order to properly address issue of base erosion and profit shifting. It argues that government responses should be comprehensive and broad, addressing, *inter alia*, the balance between source and residence taxation, the tax treatment of intra-group financial transactions, the implementation of anti-abuse provisions, including CFC legislation, as well as transfer pricing rules.

The report recognised that base erosion and profits shifting represents a serious threat to the integrity of corporate income tax itself. It argues that the expertise employed by large MNEs undermines legitimate competition, as well as contributing to an inefficient allocation of resources. The report also expresses concern about the

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[305] OECD, *Addressing Base Erosion and Profit Shifting*, *supra* note 112.

reputational harm that base erosion and profits shifting has upon corporate income taxes:

> if other taxpayers (including ordinary individuals) think that multinational corporations can legally avoid paying income tax it will undermine voluntary compliance by all taxpayers – upon which modern tax administration depends.[307]

The report was followed by their 'Action Plan on Base Erosion and Profit Shifting' on 19 July 2013.

The Action Plan, which was negotiated and drafted with the active participation of its member states, contains 15 separate action points or work streams, some of which are further split into specific actions or outputs. The Plan is focused on addressing these issues in a coordinated, comprehensive manner, and was endorsed by G20 leaders and finance ministers at their summit in St. Petersburg in September 2013.

The 15 actions identified by the OECD are

1. The digital economy
2. Hybrid mismatch arrangements
3. Controlled foreign companies (CFC) regimes
4. Financial payments
5. Harmful tax practices
6. Treaty abuse
7. Permanent establishment (PE) status
8. Transfer pricing and intangibles
9. Transfer pricing and risks/capital
10. Transfer pricing and other high risk transactions
11. Data and methodologies

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[307] *Ibid*, 8.

12. Disclosure of aggressive tax planning
13. Transfer pricing documentation
14. Dispute resolution mechanisms
15. A multilateral instrument.

Of particular relevance to this thesis are actions 1 (the digital economy),[309] 7 (permanent establishments),[311] 14 (dispute resolution mechanisms),[313] and 15 (a multilateral instrument).[315] Although work was intended to be completed on all fifteen actions by October 2015, the timetable has already slipped somewhat, with actions 4, 5, and 15 outstanding, and a supplementary report on action 1 due in December 2015.

At the time of writing final recommendations have not been made, though there appears to be a momentum towards the sort of reforms contemplated by this thesis below. Amongst the options for reform identified under action 1 are the creation of a new nexus standard based upon 'significant digital presence', the creation of 'virtual permanent establishment' standards, and an e-commerce withholding tax, all of which are discussed below.[317]

What is perhaps most striking about the BEPS agenda is the holistic approach being taken by the OECD, as well as the political onus underlying the project. Though it remains to be seen how successful the BEPS agenda will be in tackling the issues

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[309] OECD, *BEPS Action 1: address the challenges of the digital economy* (OECD, 2014).

[311] OECD, *BEPS Action 7: preventing the artificial avoidance of PE status* (OECD, 2015).

[313] OECD, *BEPS Action 14: make dispute reolution mechanisms more effective* (OECD, 2015).

[315] OECD, *Action 15: developing a multilateral instrument to modify bilateral tax treaties* (OECD, 2014).

[317] At 8.5, Virtual Permanent Establishments6.4.3, and 8.4, respectively.

identified, if it is successful then a large part of the credit will surely go to the recently formed G20 for providing the agenda with its political impetus.

4.5.3 Criticism of the OECD Approach

4.5.3.1 Dis-jointed policy making

There can be little doubting the thoroughness of much of the work undertaken, in particular by the Technical Advisory Groups. However, insofar as permanent establishment and transfer pricing issues were concerned, there appeared to be two separate consultation and reform processes taking place in parallel with – and, often, in opposition to – each other.

The establishment of the TAGs following the Ottawa Conference was rightly lauded. In a similar vain to the Ottawa conference itself, the TAGs reached far beyond the government representatives that usually dominated OECD decision-making, and invited representatives from industry and academia to participate. The Business Profits TAG undertook a lengthy consultation and discussion process. Its final report is thorough and methodical, and reflects the broad range of opinion on many of the matters at issue.

However, the conclusions of the TAGs were pre-empted by the Committee on Fiscal Affairs – which agreed modifications to the Commentary on the Model Convention only a few months after the TAGs were first set up. There seems to be

little point in establishing an expert group to consider a matter, only to pre-empt their conclusions and acting in advance of their findings.

The conclusions contained within the final report of the Business Profits TAG were, for the most part, an endorsement of the position of the Committee on Fiscal Affairs. However, as is evidenced by the report itself, the endorsement of the Committee on Fiscal Affairs' modifications to the Commentary was not borne out in the discussions within the TAG. There was considerable disagreement over the question of source, as well as the website/server permanent establishment question. Furthermore, the TAG found itself in a situation whereby it was considering whether or not a server should constitute a permanent establishment. It could be argued that, given that the Committee on Fiscal Affairs had already made up its mind as to how to address the question of nexus and permanent establishment – and that the Commentary had already been amended to include the Committee on Fiscal Affairs' recommendations – there was little point in the TAG reaching any conclusion but the one already settled upon by the Committee on Fiscal Affairs. A more robust consultation would surely have seen the Committee on Fiscal Affairs waiting for the recommendations of the TAGs; accepting, rejecting, or further consulting on their recommendations; and then acting accordingly.

4.5.3.2 'Herd Mentality'

Arthur Cockfield is a long standing critic of many of the substantive elements of the OECD Model Convention – in particular, of the OECD's insistence upon maintaining the permanent establishment principle.[319] However, in addition to these substantive concerns, Cockfield posits that the OECD's answer to the server question was the result of a 'herd mentality':

> [a] danger exists that bad policy will result from the kind of herd mentality that led to the adoption of the server/PE rule. [...] [T]he OECD's e-commerce reform processes and ultimate international tax policy positions were shaped by political concerns: political 'horse-trading' uninformed by a coherent policy perspective creates a risk that 'bad' tax policy will result.[321]

Cockfield argues that the Committee on Fiscal Affairs was motivated by a desire to curtail the ability of the United States to further narrow the definition of permanent establishment and thus further shift tax jurisdiction away from the source of income and towards the residence of the recipient. He argues that the resulting fudge was a product of short-sighted political posturing, with little or no will to create a solid conceptual basis for applying taxes on the Internet.

A further example of the 'herd mentality' identified by Cockfield can be seen in the discussion that surrounded the conceptual base for sharing the tax base. The Ottawa

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[319] Cockfield's views on permanent establishment are discussed *copiose* in chapters 6 and 7.

[321] Arthur J Cockfield, 'The Rise of the OECD as Informal "World Tax Organization" through National Responses to E-Commerce Tax Challenges' (2006) 8 Yale Journal of Law and Technology 136.

conference set lofty aims of achieving 'fair sharing of the tax base from electronic commerce'[323] – a principle with which it is almost impossible to disagree. However, it is clear from the discussion that took place in the Business Profits TAG that there was little, if any, agreement as to what a fair allocation of the tax base actually would be. Given that there was little agreement as to the conceptual basis for determining the source of income, it is surely impossible to agree as to what a fair allocation of the tax base would be. Except, of course, that it should be 'fair'.

4.5.3.3 Lack of consideration of broader conceptual questions surrounding law on the Internet

Much of the work of the OECD lacked any consideration of broader questions as to the appropriate exercise of jurisdiction over the Internet. This is evidenced by the Committee on Fiscal Affairs fixation with computer equipment and the physical functions thereof, rather than the software operations carried out thereupon. This thesis has argued elsewhere that there is a need for a greater appreciation of the nature of the Internet – in particular its capacity to disaggregate functions that might otherwise only have been possible in a single location. Azam argues that

> [t]he OECD discussion exclusively focused on tax issues and did not pay any attention to cyberspace law literature that dealt with difficulties of regulating the Internet and applying the current law to Internet activity.[325]

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[323] *Supra* note 132.

[325] Rifat Azam, 'E-commerce taxation and cyberspace law: The integrative adaptation model' (2007) 12 Va JL & Tech 1.

Azam further argues, as this thesis does, that the OECD's thinking was too rooted in physicality. With the exception of Spain and Portugal, no member state was willing to countenance a website as constituting a permanent establishment. In the view of both the TAGs and the Committee on Fiscal Affairs, 'fixed place of business' should be read to include the prefix 'physically'. Yet there is nothing in the text of the Model Convention that says a fixed place of business must be corporeal. That the examples listed in paragraph 2 of Article 5 are only of physical presences is hardly surprising, given that paragraph 2 remains largely unchanged since it was first drafted in 1963. The OECD's reluctance to depart from purely physical conceptions of establishment demonstrates their unwillingness to consider the taxation challenges of electronic commerce in the context of the broader conceptual question of how to regulate the Internet.

4.5.3.4 Cautious

The OECD embarked upon addressing the challenge of e-commerce taxation with lofty language. However, despite talk of exploring *terra incognito*, the OECD's desire not to stray far from familiar taxation principles was apparent from the outset. The Ottawa Conference favoured a *laissez-faire* approach to Internet regulation generally, concluding that 'legal frameworks should be established only where necessary.'[327] It is hardly surprising therefore that neither the Committee on Fiscal Affairs, nor the TAGs,

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[327] *Supra* note 128.

gave any consideration to the broader conceptual questions surrounding the application of law to the Internet.

Similarly, the Taxation Framework Conditions expressly excluded the possibility of new administrative or legislative measures, except to assist in the application of existing taxation principles. But even then the Committee on Fiscal Affairs only sought to amend the Commentary to the Model Convention, and not the Model Convention itself. The result of such a cautious approach is that an Article that was principally designed to apply to factories and mines is now interpreted as applying to software operating on a computer server.

4.6 EU VAT on e-Services Directive

By its nature, VAT lends itself to cross-border commerce. Furthermore, unlike the United States – who benefitted from inaction in reforming international taxation principles – the EU's VAT rules left Members States at a competitive disadvantage in the field of electronic commerce. The 2002 e-Commerce VAT Directive had two principal aims. First, to eliminate the distortions that arose from the advent of e-commerce, specifically with respect to the significant tax advantage to those suppliers of electronic services who weren't established within the EU:

> In the interests of the proper functioning of the internal market, such distortions should be eliminated and new harmonized rules introduced for this type of activity. [329]

Second, to ensure that taxation occurs where consumption takes place

> [a]ction should be taken to ensure, in particular, that such services where effected for consideration and consumed by consumers established in the Community are taxed in the community and are not taxed if consumed outside the Community.[331]

The European Union therefore sought reform two aspects of VAT: the tax treatment afforded to supplies of electronic services within the EU; and the tax treatment afforded to imports of electronic services from outside of the EU.

4.6.1 Supplies of electronic services within the European Union

The EU's common VAT system distinguishes been the sale of goods and the supply of services[333]. Where sales of good or supplies of services take place across Members States' borders – but within the EU – a distinction is also drawn between transactions between parties registered for VAT, generally known as business-to-business (B2B) transactions; and transactions between a party registered for VAT and a consumer, known as business-to-consumer (B2C) transactions. As VAT is intended to be a tax on

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[329] Recital 2, Council Directive 2002/38/EC of 7 May 2002 amending and amending temporarily Directive 77/388/EEC as regards the value added tax arrangements applicable to radio and television broadcasting services and certain electronically supplied services [2002] OJ L 128/41.

[331] *Ibid.*

[333] Sixth Council Directive 77/388/EEC of 17 May 1977 on the harmonization of the laws of the Member States relating to turnover taxes - Common system of value added tax: uniform basis of assessment [1977] OJ L 145/1.

consumption, as a general rule VAT is chargeable in the country to which the goods are delivered, except where the sale is a B2C transaction, in which case VAT is chargeable in the country of the seller. At the time at which the EU sought to reform its VAT rules in light of electronic commerce, as a general rule the supply of services were chargeable in the country of the supplier.[335]

The EU treats 'pure e-commerce' transactions (online conclusion and delivery model) as supplies of services, which were therefore chargeable in the country of supply. This, it was felt, put EU suppliers of electronic services at a competitive disadvantage, as supplies from within the EU would be chargeable for VAT purposes, while imports of electronic services from beyond the EU would be VAT free.

Therefore, the European Commission proposed to amend the 6th VAT Directive to provide for special arrangements for supplies of electronic services. The 2002 e-Commerce VAT Directive therefore provides that in the case of electronic services, VAT is chargeable in the country where the service is received.

As the effect of this shift was to make taxable supplies of electronic services from outwith the EU, it was therefore necessary to make arrangements for the administration and collection of VAT from suppliers with little or no physical presence

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[335] From 1 January 2010, the general rule for B2B supplies is that the supply is chargeable in the country where the service is received, while the general rule for B2C supplies remains that the supply is chargeable in the country of the supplier,Council Directive 2008/8/EC of 12 February 2008 amending Directive 2006/112/EC as regards the place of supply of services [2008] OJ L 44/11.

within the European Union. Accordingly, the Directive also established the special scheme for supplies of electronic services from outside of the EU.

4.6.2 Administration and collection of VAT from outwith the European Union

As supplies of electronic services within the EU became chargeable in the country in which those services are received, suppliers of services, regardless of their location, are required under the 2002 Directive to levy VAT on those supplies. However, as registering for VAT in every jurisdiction in which a supply is made was thought an overly burdensome process, the 2002 Directive provides a special scheme for non-established suppliers. This, therefore, provides suppliers with three options for complying with VAT obligations.[337]

The first option available to non-established suppliers of electronic services is to establish within a Member State of the European Union and register for VAT in that state. As B2C supplies within the EU were chargeable in the country of supply (since 2010 B2B transactions are chargeable in the country where services are received) the supplier could opt to establish in the jurisdiction with the lowest rates of VAT, thereby applying that low rate of VAT to supplies made to any country within the EU. The

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[337] Stephen Bill and Arthur Kerrigan, 'Practical Application of European Value Added Tax to E-commerce' (2003) 38 Ga L Rev 71.

benefits of this approach have been substantially watered down by the 2008 VAT directive,[339] however as B2C sales of goods and supplies remain taxable in the jurisdiction of the seller the rate-shopping advantage still exists for companies who sell hard goods as well as supply electronic services.

A second option is to register for VAT in every EU Member State in which the supplier trades. This is, undoubtedly, an overly cumbersome process and would impose a significant administrative burden on suppliers. Given the availability of the special scheme, discussed below, it is unlikely that many businesses would choose to register in as many as 28 different states. The only advantage of individual registrations, as opposed to the special scheme, is that individual registrations permit an enterprise to offset input tax.

Under the special scheme, non-established suppliers register for VAT in only one member state. When making supplies of electronic services within the EU the supplier is obliged to identify the Member State to which the supply was made. The supplier then levies VAT based on the jurisdiction of the customer, and submits a state-by-state breakdown in their VAT return. A clearing process then takes place where the revenue authorities of Member States remit to each other the VAT collected through the special scheme that is due to each of the other Member States.

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[339] *Supra* note 168.

What all three VAT options demonstrate is that there is no conceptual reason against, and little practical difficulty in, exercising jurisdiction to tax over non-resident enterprises that lack a physical presence within that jurisdiction. It is difficult to conceive of reasons why thresholds based upon, for example, turnover work reasonably well where the taxation of consumption of intangibles is concerned, but not the taxation of the profits arising from that consumption.

4.7 Conclusion

The various reforms to international tax rules applicable to electronic commerce, on the whole, go some way to addressing the various issues surrounding the taxation of electronic commerce. However, as this thesis argues in subsequent chapters, many of the reforms lack a solid conceptual base; many questions remain unanswered; many issues remain unaddressed; and the potential for tax avoidance is, arguably, greater than ever. Crucially, because reform of the OECD Model has been cautious, advances in technology continue to undermine core principles of international taxation law.

The failures of the OECD process, in particular, to adequately address the issues surrounding e-commerce taxation were a result of rushed and dis-jointed policy making. In particular, creating a sound conceptual base for e-commerce taxation was of little concern to most states, relative to the desire of states to gain or retain tax

jurisdiction over the profits of online enterprises. The United Kingdom is perhaps alone in taking a position (on the tax status of a server) that diminishes their tax base.

Much has changed in the preceding decade. Technical advances have seen increased integration within MNEs; Cloud Computing has decentralized production processes; while increases in broadband speeds have resulted in the unabated growth in pure e-commerce businesses. However, in addition to technical advances, the economic and political landscape has changed considerably too. The United States' comparatively high rates of corporation tax has resulted in a substantial number of e-commerce enterprises establishing elsewhere. All the while, the revenue losses as a result of inadequate treaty rules are increasing at a time when states' revenue is, almost universally, falling.

The conservative approach adopted by the OECD means the requirement that an enterprise have a physical presence within a jurisdiction before it can be subject to that state's income taxes remains. Meanwhile, the EU has adopted a VAT regime in which physical presence within the Union is not necessary in order to be subject to VAT. As this thesis will argue in Chapter 6, a reassessment of the foregoing issues in light of these changes may well produce entirely different outcomes.

Chapter 5: The Concept of Source

5.1 Introduction

This chapter considers the difficulties defining the source of income – something that, curiously, the OECD has never agreed.[341] It then considers the justification for taxation at source, and argues that the only logical basis for taxation in an international context is the benefit principle. This chapter considers whether or not the principle of taxation at source can still be justified in light of the shift away from physical presence and tangible goods, and towards online enterprise and trade in intangibles. Finally, this chapter considers contemporary disquiet over existing source rules, and argues that the answer to such disquiet is not an abandonment of the principle of source, but a reinforcement of it.

5.2 Conspectus

Double taxation is a natural consequence of the overlap of taxing jurisdiction.[343] The purpose of the OECD Model and the thousands of tax treaties presently in force is to ensure that taxation occurs only in a single jurisdiction. It follows that, in order to

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[341] See OECD, *E-commerce: Transfer Pricing and Business Profits Taxation* (OECD Publishing), *supra* note 134.

[343] See chapter 2.

eliminate double and multiple taxation, at least one state will wholly or substantially surrender its jurisdiction to tax. Therefore, one of the fundamental questions of international taxation law is where a person or enterprise is subject to the jurisdiction of more than one state, which state ought to exercise the right to tax?

What follows is an example that illustrates the effects upon the various states connected with a MNE of residence based taxation; source taxation based on the arm's length method; and source taxation by way of formulary apportionment.

5.2.1 Illustrative example

Consider the example of a company, Río Grande, which sells goods through a website, and then delivers those goods to purchasers. Río Grande, a company domiciled in State X, trades in two jurisdictions: State A, and State B – with identical turnover in both. State A invests heavily in infrastructure, and has an excellent road and rail network. State B has neglected its infrastructure for decades, and its transport network is in a poor condition. As a result of its good infrastructure, the logistical costs of trading in State A are significantly lower than of trading in State B. Consequently, Río Grande makes a gross profit of 30% in State A, and a loss of 10%. The gross global profit is therefore 10%.

Source taxation sees State A reap the rewards of its investment in infrastructure. By creating an environment conducive to enterprise, Río Grande has

made a profit out of trading in State A, and State A therefore enjoys a right to tax those profits. In State B, however, the result of their lack of investment in infrastructure is that there is no profit to tax.

A global or unitary basis for taxation would deprive completely or substantially reduce State A's jurisdiction to tax Río Grande's profits. Residence based taxation would remove altogether Countries A and B's jurisdiction to tax, vesting that jurisdiction exclusively with the state of residence (State X). Alternatively, formulary apportionment would grant Countries A and B jurisdiction to tax a proportion of the global profits on a formulary basis (in this instance, and for the sake of simplicity, we shall assume that basis is turnover). Countries A and B would each, therefore, levy tax on a profit of 10%. State B, therefore, reaps the benefits of State A's investment, while State A's return on that investment is substantially reduced. State B sees no incentive to invest in infrastructure, as they will continue to benefit so long as State A invests. Meanwhile, State A's incentive to invest is substantially diminished as they receive such a poor return on their investment. However, as is discussed below, residence based taxation more readily enables progressive taxation, as well as satisfying the principle of capital export neutrality.

5.2.2 Methods for alleviating double taxation of foreign source income

Source based taxation grants the principal right to tax income to the jurisdiction where that income is earned. Under the OECD treaty regime, the state of residence is required to grant relief for taxes paid on income earned in the source jurisdiction. There exist numerous methods for granting relief from foreign taxes. Despite all being intended to reduce, or eliminate altogether, double taxation – the effects of these methods vary wildly depending upon the applicable tax rates in the respective jurisdictions. What follows is a description of the effect of unrelieved double taxation, as well as the various methods for granting relief, as well as illustrative examples. The basis for each of these examples is a top-rate taxpayer in Ireland, with foreign income from two jurisdictions: one, a jurisdiction with a higher income tax rate than Ireland; the other, a jurisdiction with a lower income tax rate than Ireland.

Method	Foreign Income	Foreign Rate	Taxable in Ireland	Tax payable in Ireland (41%)	Total Tax Paid
No deduction	€ 100.00	50%	€ 100.00	€ 41.00	€ 91.00
Deduction	€ 100.00	50%	€ 50.00	€ 20.50	€ 70.50
Unlimited Credit	€ 100.00	50%	€ 100.00	-€ 9.00	€ 41.00
Capped Credit	€ 100.00	50%	€ 100.00	€ -	€ 50.00
Exemption	€ 100.00	50%	€ -	€ -	€ 50.00
No deduction	€ 100.00	30%	€ 100.00	€ 41.00	€ 71.00
Deduction	€ 100.00	30%	€ 70.00	€ 28.70	€ 58.70
Unlimited Credit	€ 100.00	30%	€ 100.00	€ 11.00	€ 41.00
Capped Credit	€ 100.00	30%	€ 100.00	€ 11.00	€ 41.00
Exemption	€ 100.00	30%	€ -	€ -	€ 30.00

Table 5-1 - effects of different approaches to alleviation of double taxation

5.2.2.1 No relief

A taxpayer, domiciled in Ireland, earns income abroad. Ireland offers no relief for taxes paid on that income in the source jurisdiction. Assume said taxpayer's taxable income is 100, and the source tax rate is 50%. The source tax jurisdiction therefore collects 50 from the taxpayer. Being domiciled in Ireland, the taxpayer is also required to report his gross income to the Irish Revenue, which levies Income Tax on that gross income at 41%, thereby collecting 41. The total tax payable on 100 of income is 91. Should the tax rate payable in the source jurisdiction be 30%, as opposed to 50%, then the source jurisdiction takes 30 and the total tax payable is 71.

5.2.2.2 Deduction method

Under the deduction method, tax paid in the source jurisdiction is treated as a deduction from gross income. Again assume taxable income is 100, and the source tax rate is 50%. In this instance, the taxpayer's gross income is subject to a deduction of the amount of source tax paid, meaning the gross income of the taxpayer is 50. The taxpayer is then liable for tax at 41% of a gross income of 50, resulting in a tax bill of 20.5. The total amount of tax that will have been paid on that income is 70.5.

Should the tax rate payable in the source jurisdiction be 30%, as opposed to 50%, then the deduction from the taxpayer's income would be 30, resulting in a taxable income in Ireland of 70. The taxpayer is then liable for tax at 41% of a gross income of

70, resulting in a tax bill of 28.5. The total amount of tax that will have been paid on that income is 58.7.

5.2.2.3 Refundable/uncapped credit method

A refundable or uncapped credit for tax paid in the source jurisdiction has the effect of adjusting the total tax burden to that of the residence jurisdiction. In this instance, let's first assume taxable income is 100, and the source tax rate is 30%. The taxpayer reports his gross income of 100 to the Irish Revenue, and receives a credit against Irish tax for taxes paid in the source jurisdiction. The gross income of 100 is subject to tax at 41%, with a credit of 30, resulting in an Irish tax liability of 11. The total tax payable is therefore 41, which is exactly what it would have been had the income been earned entirely in Ireland.

However, assume now that the source jurisdiction rate is 50%. The taxpayer's gross income is subject to Irish tax at 41%, with a refundable credit of 50. The Revenue therefore refunds 9, resulting in a total burden of 41. This method undoubtedly achieves its goal of Capital Export Neutrality (see 5.4.5), however it results in the somewhat absurd scenario of Ireland refunding taxes paid to another state. In 1918, the US adopted this method, becoming the first state in the world to grant a unilateral

credit for 'taxes paid during the taxable year to any foreign country, upon income derived from sources therein'[345].

However, this generosity on the part of the US Treasury Department was short-lived, and in 1921 the US imposed a limitation formula on the foreign tax credit, effectively capping the credit at the applicable US tax rate.

5.2.2.4 Non-refundable/capped credit method

The method for levying a non-refundable or capped credit is largely the same as a refundable credit, however the effect is quite different. The distinction between a non-refundable and a capped credit is also worth noting. Though a non-refundable tax credit means the revenue is not obliged to return any money to the taxpayer, where the foreign tax credit is greater than the amount of tax that would otherwise be payable in the residence jurisdiction, the credit can still be off-set against other tax that is payable. A capped tax credit limits the available credit to the amount of tax that would otherwise be applicable to the foreign source income alone.

Again assume taxable income is 100, and the source tax rate is 50%. Ireland allows the taxpayer a non-refundable credit of 50, against an Irish tax liability of 41. No further tax is therefore payable, however no refund is given by the Revenue. The total tax burden is therefore 50.

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[345] § 222(a)(1) Revenue Act 1918 ch. 18.

Should Ireland grant a capped credit, rather than a non-refundable credit, then the credit would be 41 and no further tax would be payable. The total tax burden is therefore 50.

In this instance, where the applicable source jurisdiction tax rate is 30% then the effect is the same as can be seen above at 5.2.2.3, where a credit of 30 is therefore granted and the taxpayer is liable for a further 11 in Ireland, making the total tax burden 41. From the perspective of the taxpayer, therefore, the effect of a capped or non-refundable tax credit is to apply an effective tax rate equivalent to whichever is the highest in the respective jurisdictions.

5.2.3 Exemption method

Of all the methods for alleviating double taxation, the exemption method offers the most comprehensive relief, and adheres the most strictly to the principle of taxation at source. Under the exemption method, income from foreign sources is exempt from taxation in the jurisdiction of residence – the source jurisdiction enjoys the sole jurisdiction to tax. Where the source jurisdiction tax rate is 50%, the total tax burden on 100 of income would be 50. Where the source jurisdiction tax rate is 30%, the total tax burden on 100 of income would be 30.

5.3 The source of income

Prior to engaging in discourse as to whether or not source is the appropriate basis on which to levy tax, it is necessary, first, to determine what the source of income actually is. Curiously, little has been written on the definition of source itself, beyond the works of those authors discussed below.

Similarly, at an inter-governmental level there appears to have been little discourse of, and no agreement upon, the definition of the source of income. This much was evident from the debates that took place in the Technical Advisory Groups to the Committee on Fiscal Affairs of the OECD, discussed at 4.5.2.

5.3.1 Defining source

Adam Smith and John Stuart Mill consider the source of all income to be rent, profit, and wages.[346] However, such simple formulations are of little value in a multi-national economy. It cannot be denied that profit is a source of income. It is locating that profit that is problematic. Musgrave and Musgrave consider the source of income in the context of the multi-national enterprise to be the place where income-generating

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[346] Adam Smith and Edwin Cannan, *An Inquiry into the Nature and Causes of the Wealth of Nations ... Edited, with an introduction, notes, marginal summary and an enlarged index by E. Cannan* (5th edn, Methuen & Co. 1904); John Stuart Mill and William James Sir Ashley, *Principles of Political Economy ... Edited with an introduction by W. J. Ashley* (Longmans & Co. 1909). Income from immovable property (such as rent) is the subject of Article 6 of the OECD model; income from employment (wages) is the subject of Article 15 – both of which fall outwith the scope of this thesis.

activity takes place.[348] All of the foregoing definitions suffer from the same defect – they are imprecise, and offer little insight into the true source of income in an international context.

Klaus Vogel argues that source is not an *a priori* concept. Vogel contends that the concept of source is a legal construct. This analysis appears to be correct – the lack of any consensus on the actual source of income is evidence of this. Vogel argues that source is only generally defined by what it is not, that is to say that it is different from taxation on the basis of residence or citizenship. He further contends that

> [t]he only positive statement that can be made [...] is that 'source' refers to a state that in some way or other is connected to the production of the income in question, to the state where value is added to a good. In contrast, the type of connection that establishes the 'source' of income cannot be defined generally.[350]

In this respect, the work of John R. Searle is informative. Searle distinguishes between those characteristics of things that are intrinsic, and those that are observer-relative. Characteristics that are intrinsic are 'brute facts', while those that are observer-relative are 'institutional facts'. The size of an object is, in many respects, an institutional fact, because declaring its size is dependent upon the acceptance of an agreed scale of measurement. For example – 'the volume of this sphere is 20 cubic

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[348] Peggy B Musgrave, 'International tax base division and the multinational corporation' (1972) 27 Public Finance 394. A similar definition of source has been advanced by Skaar, see Arvid A. Skaar, *Permanent Eestablishment : erosion of a tax treaty principle* (Kluwer Law and Taxation 1991).

[350] Klaus Vogel, 'Worldwide vs. source taxation of income–A review and re-evaluation of arguments - Part I' 16 Intertax 216.

metres' is dependent upon a common understanding of what a metre is. However, the relationship between an object's dimensions is, in many respects, a brute fact – because that relationship is inherent in the nature of the object. For example, we may well have no understanding of the volume of a sphere; but whatever that volume is, it will be two-thirds of pi, multiplied by the radius of the sphere, cubed. It is the nature of a sphere. This analogy might seem abstract, however there is an analog with respect to the source of income. It is relatively easy to determine the rightful claim to be the source of income relative to other claims, however it is difficult to define the source of income solely by reference to some intrinsic determinant. This is what Vogel means when he states that the source of income is not an *a priori* concept.

This difficulty in defining the true source of income is reflected in the law and practice of states. The OECD Model does not define the source income, though it contains provisions for determining the source of income. Vogel's contention is borne out in domestic legislation, which tends to define foreign source income by reference to what it is not – that is to say, non-domestic income.[352]

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[352] See the definition of 'foreign dividends' within s123 Income and Corporation Taxes Act 1988; 'overseas earnings', s23 Income Tax (Earnings and Pensions) Act 2003; 'non-UK tax', s9 Taxation (International and Other Provisions Act) 2010.

Avi-Yonah distinguishes between formal rules for determining the source of income, and substantive rules.[354] Formal rules make no attempt to determine the actual source of income, but merely deem somewhere to be the source of income for administrative ease. Substantive rules, conversely, seek to determine the true economic source of income. However, it is submitted that this conceptual dichotomy is incorrect, for two reasons.

First, Avi-Yonah's distinction is dependent upon source as an *a priori* concept. He describes substantive source rules as attempting to 'trace the economic source of income'[356] – however that source is not, as Vogel argues, a self-defining concept. The source of income is not a brute fact, but an institutional one.[358] Source rules, no matter how elaborate, do not define the source of income – they determine it.

Second, these categories of source rule are not discreet. Avi-Yonah argues that formal rules 'do not attempt to trace the economic source of [...] income' – this is simply not the case. It is arguable, as Avi-Yonah so does, that certain source rules – such as the dividends rule – that employ bright-line tests can produce results that appear to bear no relation to the perceived 'actual' source of income. However, this, again, is dependent upon an objectively verifiable definition of source. In the

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[354] Reuven S Avi-Yonah, *International tax as international law: an analysis of the international tax regime* (Cambridge University Press 2007).

[356] *Ibid* at 44

[358] See, generally, John R. Searle, *The construction of social reality* (Allen Lane 1995).

alternative, the rule pertaining to taxation of business profits with which this thesis is *inter alia* engaged, cannot be said to be truly substantive. The OECD Model, as is noted by Peggy Musgrave, takes a schedular approach to source rules,[360] and in that respect, contains both formal and substantive rules. While it is the case that, through a combination of the permanent establishment rule[362] and the principle of arms' length accounting, the OECD Model seeks to tax business profits where they are earned (thus giving the appearance of substantiveness), it does so through a formalistic method. Article 7 of the OECD Model provides that income derived from a permanent establishment is taxable in the jurisdiction where that permanent establishment is situated. Article 5 describes, in some detail, what a permanent establishment is. Both of these articles contain formal rules, however these formal rules go some considerable way to tracking the source of income. In that respect, they are imperfect examples of both formal, and substantial rules.

If international tax laws do not define the source of income, but merely determine it, then the question of to the source of income is ultimately one of fact. This was the opinion of the Judicial Committee of the Privy Council in *Commissioner of Inland Revenue v Hang Seng Bank Ltd,* on appeal from the Court of Appeal of Hong Kong:

> [t]heir Lordships were referred in the course of the argument to many authorities on different taxing statutes in different common law jurisdictions

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[360] *Supra,* note 175, 397.

[362] Article 5, OECD Model.

> raising a variety of questions as to the geographical source to which income or profits should be ascribed. But the question whether the gross profit resulting from a particular transaction arose in or derived from one place or another is always in the last analysis a question of fact depending on the nature of the transaction. It is impossible to lay down precise rules of law by which the answer to that question is to be determined. The broad guiding principle, attested by many authorities, is that one looks to see what the taxpayer has done to earn the profit in question. [...] There may, of course, be cases where the gross profits deriving from an individual transaction will have arisen in or derived from different places. Thus, for example, goods sold outside Hong Kong may have been subject to manufacturing and finishing processes which took place partly in Hong Kong and partly overseas. In such a case the absence of a specific provision for apportionment in the Ordinance would not obviate the necessity to apportion the gross profit on sale as having arisen partly in Hong Kong and partly outside Hong Kong.[364]

Musgrave and Musgrave's definition of source therefore, though crude, appears to be valid. The determination as to the source of income is a factual determination of where income-generating *activity* takes place. Through a combination of formal rules and factual determinations, the OECD Model attempts to trace the factual source of income, albeit imperfectly.

5.3.2 Knowing the source of income

While the question of what actually is the source of income is seldom asked, the question of why we even need to define the source of income is considered even less-so. This is, most likely, because the answer seems fairly obvious. Any jurisdiction operating a source-based system of taxation, either upon residents or non-residents, it becomes

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[364] *Commissioner of Inland Revenue v Hang Seng Bank Ltd* [1990] STC 733.

necessary to establish rules as to when income is to be considered to have its source within its territory.[366]

This, of course, is only necessary where source-based tax systems have been established. Had every jurisdiction in the world adopted a completely residence-based system of taxation, there would be no need for rules determining the source of income. While this thesis is primarily concerned with source-based taxation, a global tax system based entirely upon residence is not without its supporters. Such a position receives at least qualified support from, *inter alia*, Reuven S. Avi-Yonah[368] and David S. Bradford.[370] Such proposals are considered in more detail by this thesis in Chapter 8.

5.4 Legitimation

The conceptual basis for taxation of income attributable to permanent establishments is well situated in source models of taxation. The claim of jurisdictions to exercise their taxing authority over income derived from within its territory 'is analogous to a nation's long recognized claim of sovereignty over natural resources within its boundaries.'[372] In the earliest debates on the appropriate allocation of jurisdiction to

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[366] Prussak, *supra* note 105, 57.

[368] Avi-Yonah, *supra* note 178.

[370] David F. Bradford, *Blueprints for basic tax reform* (U.S. Department of the Treasury 1977).

[372] Michael J Graetz, 'David R. Tillinghast Lecture Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies, The' 54 Tax L Rev 261, at 298.

tax, T.S. Adams was firmly of the belief that income tax revenues from domestic production 'fairly' belonged to the United States.[374]

> The idea that the source country has a fair claim to the income produced within its borders is also grounded in the view that foreigners, whose activities reach some minimum threshold, should contribute to the costs of services provided by the host government, including, for example, the costs of roads and other infrastructure, police and fire protection, the system for enforcement of laws, education, and the like.[376]

This contractarian model of taxation evinces the benefit theory of taxation which is discussed below. Benefit theories appear to dominate historical and contemporary discourse of the basis for allocation of taxing jurisdiction, however alternative theories are not without merit and are worthy of discussion.

5.4.1 Benefit theory vs. sacrifice theory

Historically, two competing theories have monopolized discourse on a state's justification for levying taxes: the benefit theory; and the ability-to-pay theory.

The justification for the ability-to-pay theory is usually based on some form of sacrifice. Kendrick proposes three forms of sacrifice theory: the equal sacrifice theory;

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[374] Internal Revenue Act of 1921: Hearings on H.R. 8245 Before the Senate Comm. On Fin., 67th Cong. 73 (1921) (statement of Dr. T.S. Adams, Tax Advisor, Treasury Dep't), in Bernard D. Reams, Jr. (ed.) *Internal Revenue Acts of the United States 1909-1950: Legislative Histories, Laws, and Administrative Documents* (Hein 1979).

[376] *Supra* note 187.

the proportional sacrifice theory; and the least-sacrifice theory.[378] Such theories can be said to be communitarian – through our personal loyalty to a state, we are obliged to make a form of sacrifice for the benefit of that state. However, while this thesis makes no comment on tax theory in a domestic setting, the author contends that notions of taxation based upon communitarianism cannot be justified in an international context. An Irish trader who earns profit through a permanent establishment in New York pays tax on that profit in the United States. It is difficult to justify levying tax on that profit on a communitarian basis where the taxpayer's sole connection with the taxing state is happening to earn some profit within its territory. Even residence is a questionable basis for levying tax under sacrifice theories. Such a view was advanced by Vogel, who doubts 'whether residence can establish an allegiance which is strong enough to support a claim for a "sacrifice".'[380] It therefore follows that only taxation on the basis of citizenship can be justified on the basis of communitarian theories – a basis currently employed by only two states: The United States of America, and Eritrea.

It is submitted, therefore, that the benefit theory of taxation is the only just one in an international context. Under the benefit theory of taxation, a state's jurisdiction to tax is justified as being a *quid pro quo* exchange for benefits received from the state.

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[378] M Slade Kendrick, 'The Ability-to-Pay Theory of Taxation' (1939) 29 The American Economic Review 92.

[380] Klaus Vogel, 'Worldwide vs. source taxation of income–A review and re-evaluation of arguments - Part III' 16 Intertax 393, 395.

While Mr Justice Holmes' now famous refrain, 'taxes are what we pay for civilized society',[382] is perhaps the most famous espousal of what Dodge describes as a contractarian principle of taxation,[384] it is most certainly not the first. Mill conceived a theory of taxation based upon specific benefits any particular person received from the state,[386] although he discounted such a theory on the basis that it would likely result in the poor paying more than the rich. This theory, however, rested upon a narrow definition of benefit.

Modern understandings of the concept of benefit are altogether broader. The benefit received from the state is not defined, nor particularly quantifiable. Here, the benefit includes the maintenance of a system of laws and norms that facilitates the individual's economic wellbeing.[388] This broad definition of benefit legitimizes, as Dodge describes,

> not only taxes, but also government and civil society itself. Here the concept of benefit binds taxation to the core role of government. Crucially, the benefit concept is here diffuse, indivisible, and nonallocable, as opposed to being an aggregation of assorted

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[382] Mr Justice Holmes (dissenting), *Compania General de Tabacos v Collector of Taxes* (1927) 275 US 87, at 100.

[384] Joseph M Dodge, 'Theories of Tax Justice: Ruminations on the Benefit, Partnership, and Ability-to-Pay Principles' (2004) 58 Tax L Rev 399.

[386] Mill, *supra* note 174.

[388] Deborah A Grier, 'Time to Bring Back the "Benefit" Norm?' (2004) 33 Tax Notes Int'l 899.

government activities and programs that inure differentially to various taxpayers and groups thereof.[390]

In formulating the League of Nations' Model Articles, Thomas S. Adams advocated taxation at source on the basis that 'corporations and other business units derive benefits and compete with one another as units, in the jurisdictions in which they do business.'[392] Edwin Seligman was less convinced, arguing that the taxation of income was based upon the ability to pay.[394] Sir Josiah Stamp envisaged a middle way, with the benefit principle justifying taxation of (most) foreign income at source at a flat rate, while the country of residence's residual right of taxation should be progressive, based upon the ability-to-pay principle.[396] The compromise that is evident in the Model Articles, upon which the Model Convention is largely based, bears a striking resemblance to that which Stamp proposed, albeit leaning more heavily towards Adams' view than Seligman's – taxation of business profits at source, with taxation of foreign source dividends in the country of residence, subject to a flat withholding tax at source.

The limitations to the taxing rights of source states is also informative as to the conceptual basis for such taxation. '[T]here is general agreement that geographically

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[390] *Supra* note 193, 402.

[392] Thomas S Adams, 'Fundamental problems of federal Income Taxation' [1921] The Quarterly Journal of Economics 527, 542.

[394] Edwin RA Seligman, 'Untitled Response to Speech by T.S. Adams, Taxes Upon Income and Excess Profits—Discussion' (1918) 8 American Economic Review 42, 43, see generally Michael J Graetz and Michael M O'Hear, 'The" Original Intent" of US International Taxation' (1997) 46 Duke Law Journal 1021.

[396] John F. Avery-Jones, 'Sir Josiah Stamp and Double Income Tax' in John Tiley (ed), *Studies in the History of Tax Law*, vol 6 (CUP 2014).

limited source taxation is the only principled regime available to a country for taxing the income of foreigners'.[398]

It is arguable that the geographical limitation on source taxation fundamentally undermines the principle of progressive income taxation. This is because the normative basis for progressive taxation is the ability to pay of the taxpayer – the sacrifice theory. Green argues that taxation at source is fundamentally at odds with this prevailing theory of income tax.[400]

One defence to this criticism is that the fairness of taxation upon international income involves consideration of two separate questions. The first is the determination of the jurisdiction to tax. The second is the allocation of the tax burden among those who are subject to that jurisdiction. Under this line of argument, the ability to pay is only relevant at the second stage. Shay *et al.* are unconvinced by this line of reasoning.[402] They cite the example of a non-resident with $100,000 of domestic source profits and $100,000 of foreign source losses. The ability to pay of that taxpayer would be zero – but under this view of international taxation only the domestic source income is to be considered in determining that taxpayer's ability to pay. Even more absurd might be where such an enterprise has worldwide losses but profits in a single

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[398] Stephen E Shay, J Clifton Fleming Jr and Robert J Peroni, 'David R. Tillinghast Lecture-What's Source Got to Do with It-Source Rules and US International Taxation, The' (2002) 56 Tax L Rev 81.

[400] Robert A Green, 'Future of Source-Based Taxation of the Income of Multinational Enterprises' (1993) 79 Cornell L Rev 18, pp29-30.

[402] *Op. cit.*

jurisdiction. To justify the tax payable on those profits on the basis of that enterprise's ability to pay makes little sense. Taken to its logical conclusion, this approach to ability to pay would see individual transactions from which a profit is earned taxed as income, with little regard for the profitability of the business as a whole. This is clearly absurd. The ability to pay of an enterprise ought to be measured by reference to its total worldwide income. It should therefore only be a consideration of the jurisdiction that enjoys the jurisdiction to tax an enterprise's entire worldwide income – being the jurisdiction of residence.

It is further arguable that the progressivity, or otherwise, of taxation ought not be a consideration of the source jurisdiction at all. The progressivity of a tax system should only ever be the consideration of a single taxing authority. That is because where more than one authority is concerned with allocating the tax burden fairly, they might (and frequently do) disagree as to what a fair allocation of that burden is – with the consequence that efforts by one jurisdiction to distribute the tax burden progressively is undone by efforts by another.[404] The ability to pay of a taxpayer ought to be of concern only to that jurisdiction to whom that taxpayer owes or has a personal, as opposed to territorial, connection.

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[404] Kay and King make a similar argument with respect to multiple taxing authorities within a state, however their arguments apply *mutatis mutandis* to multiple taxing authorities in an international context, John A. Kay and Mervyn A. King, *The British Tax System* (4th edn, Oxford University Press 1986).

At a more fundamental level, it is questionable whether or not businesses and non-natural persons even have an ability to pay (in the sense that natural persons do), or if they do, whether we should even care. While Fleming, *et al.*, make the case for unitary taxation on the basis of the ability to pay principle,[406] they do so on the basis that the principle is prevailingly accepted as the broad basis for all taxation, rather than because the principle is, of itself, either just or desirable. It is arguable that, unlike natural persons, (most) companies only exist to earn a profit. Without profits, there is no taxation, and a profitable company will always have the ability to pay. Taxation is merely a cost of doing business.

There is a considerable element of rational choice involved in doing business in a jurisdiction other than the one in which an enterprise is resident. The non-resident business will decide to trade in a particular jurisdiction on the basis of their expected profits within it. The profit potential in a jurisdiction will be a synthesis of numerous considerations, one of which will be the tax burden. This is clearly evidenced by the manner in which states use their business tax systems as a means of attracting inward investment. It is extremely unlikely that any enterprise would elect to do business in a jurisdiction if they did not expect that they would have the ability to pay taxes there. If

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[406] J. Clifton Fleming, Jr., *et al.*, 'Fairness in International Taxation: The Ability-to-Pay Case for Taxing Worldwide Income' (2001) 5 Florida Tax Review 299.

an enterprise is unable to meet the costs of doing business – one of which is taxes – then that enterprise is not viable and ought not be trading at all.

This lends further credence to the argument that the justification for taxation at source is the benefit theory of taxation, while taxation in the jurisdiction of residence might be better grounded in the principle of ability to pay.

Furthermore, even if it is possible to determine whether or not a company has the ability to pay, it is more broadly questionable why a state should even care. Wealth is an intrinsically human characteristic, with progressive taxation and personal allowances designed to ensure taxpayers retain the basic means of subsistence. However, companies have no need for basic subsistence. They are, after all, simply legal fictions designed to serve as vehicles for enterprise. Companies can be, and frequently are, wound up owing to non-payment of taxes. Such a harsh end would not befall so many companies if we had any regard for their ability to pay. Therefore, even if it is accepted that an individual's ability to pay ought to be of concern in a domestic context, it is arguable that that is not the case where a company is concerned in either an international or domestic context.

Avi-Yonah argues that the schedular approach of the division of jurisdiction to tax is justified by both benefit theory and sacrifice theory.[407] In particular, Avi-Yonah offers three justifications for the benefit principle legitimising taxation at source for

[407] Reuven S Avi-Yonah, 'International taxation of electronic commerce' 52 Tax L Rev 507, 520.

business profits. The first, is that the arguments in favour of taxing individuals at residence to not apply to corporations. Corporate residence based on place of incorporation is 'formalistic and subject to the control of the taxpayer', while 'residence based on management and control also can be manipulated.'[409] Avi-Yonah further argues that MNEs are not part of a single political community, and their income does not belong to any particular political community for distributive purposes. Avi-Yonah also points out that the democratic basis for residence taxation, discussed below at 8.6 do not apply to MNEs, who are capable of exerting considerable influence in jurisdictions in which they are not resident.

From a more pragmatic perspective, Avi-Yonah argues that as source jurisdictions enjoy the 'first bite of the apple' – that is to say that it is the jurisdiction in which profits are earned that will have the first opportunity to tax them – it is difficult to prevent states from imposing taxes on profits earned within their territory. Notwithstanding however preferable residence taxation may or may not be at a conceptual level, in reality it is unlikely that states will decline to tax profits earned within their territory, absent a particularly strong incentive to do so.[411] This, as Avi-Yonah argues, 'is particularly the case for business income derived from large markets,

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[409] *Ibid.*

[411] Graetz and O'Hear, supra note 197, 1102-03.

in which case there is little fear that the foreign investor will abandon the market because of source-based taxation."[413]

The OECD recognised the benefit principle as being the basis for taxation at source in 1991:

> [i]t is generally accepted that source countries are entitled to tax income originating within their borders, including income accruing to foreigners. One justification for this entitlement is that foreign-owned factors of production usually benefit from the public services and the protection of property rights provided by the government of the host country. A source-based tax like the corporation tax may also serve to prevent foreign investors from capturing all of the 'economic rent' which may arise when foreign capital moves in to exploit the host country's production opportunities, e.g. its natural resources.[415]

Therefore, while it may well be the case that communitarian principles of taxation are desirable, particularly in a domestic context, it seems clear that the justification for taxation at source in international taxation is the benefit principle.

5.4.2 Value-creating activity

If the benefit theory of taxation is to be used as the basis to exercise jurisdiction to tax, it follows that enterprises must enjoy some benefit from a host jurisdiction before it is just to be subject to that jurisdiction's tax. The prevailing view has traditionally been

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[413] *Supra* note 204.

[415] Co-operation Organisation for Economic, Analysis Development. Working Party No 2 on Tax and Statistics Tax, *Taxing profits in a global economy : domestic and international issues* (OECD 1991), 36.

that an enterprise enjoys some benefit from a jurisdiction where value-creating activity takes place within it.

The Experts Committee of the Fiscal Committee of the League Nations offered as their conception of the 'origin of wealth' as being

> all the stages which are involved up to the point of the wealth coming to fruition, that is, all the stages up to the point when the physical production has reached a complete economic destination and can be acquired as wealth.[417]

The focus upon production in their definition of the origin of wealth clearly suggests that it is those value-creating stages of the production chain that are creators of wealth. It follows that it is those stages in the production chain that benefit from 'participation in the economic life of a country'.

Certainly, this appears to be reflected in the definition of a permanent establishment contained within Article 5 of the OEC Model. A permanent establishment 'includes especially' places of management, offices, factories, workshops, as well as mines, quarries, and other facilities for the extraction of natural resources. The definition of a permanent establishment expressly excludes warehouses and storage facilities, the maintenance of a stock of goods for certain insignificant purposes where such activities are of a preparatory or auxiliary character. The common characteristic of those places of business that are expressly included in the definition and not of those

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[417] League of Nations, *supra* note 57.

that are expressly excluded is clearly one of value creation. Factories and workshops very obviously add value in the production chain; the contribution of storage facilities to the creation of wealth is far more questionable. The activities that take place at the fixed place of business must necessarily be of a 'productive character'.

Crucially, this conception of benefit seldom seems to include selling into a jurisdiction. While those who view sales as an essential component of taxable value are naturally concerned about the base erosion that occurs when the profits from significant sales within a jurisdiction escape the clutches of that jurisdiction's taxing authorities, those who see sales as merely realising value that has already been created will, naturally, be less concerned.

Sprague and Hersey have long argued that the integration of technological efficiencies into business models does not fundamentally undermine the creation of value within the production chain. They cite the relocation of manufacturing processes in entire industries as evidence of how the global rearrangement of value-adding activities were accommodated by the existing international tax framework.[419] 'The "new" economy', they argue, 'like the "old" economy, requires an enterprise to utilize capital, labour, and other property to produce and market its products and services.'[421] They argue that while the inputs might have shifted from 'brawn' to 'intellect', and the

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[419] Gary D Sprague and Rachel Hersey, 'Permanent Establishments and Internet-Enabled Enterprises: The Physical Presence and Contract Concluding Dependent Agent Tests' (2003) 38 Ga L Rev 299, 311.
[421] *Ibid.*

outputs from tangible property, 'an entrepreneur's labour inputs, property investments, and risk assumption remain necessary components to an enterprise's creation of products and services.'[423]

Certainly, the argument that technology is valueless without human input is both obvious and persuasive. However, it is arguable that the beneficiaries of the economic life of a jurisdiction extend beyond those who merely engage in value-creating activities within it. Alternatively, it is arguable that a far broader conception of value-creating activity is necessary than is offered by more traditional definitions.

With respect to the latter argument, it is submitted that the description of the origins of wealth provided by the League of Nations Expert Committee is arcane – their focus solely on 'physical production' is evidence of this assertion. Sprague and Hersey recognise that the inputs and outputs from value-creation have shifted significantly from the tangible to the intangible. This necessitates a revised conception of value-creation.

The obvious example of value-creation from intellectual inputs is of invention and design. These inputs typically take place early in the chain of production. However, intellectual inputs also create value at the latter stages of the production chain in a way and of a scale that would have been unthinkable in the 1920s, in the form of marketing, advertising, and sales.

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[423] *Ibid.*

In the period that has followed the initial allocation of jurisdiction to tax by the League of Nations and then the OECD, marketing has emerged as a whole new academic discipline, while advertising is now a massive industry, and a key source of income for some of the world's largest companies.

The notion that value is created exclusively by production is inherently flawed. Limiting production and optimising price can create significant increases in value in the same goods or services. The following example illustrates this. A manufacturer needs to sell widgets at 100 in order to make a normal profit.[425] 1,000 consumers are willing to pay 100 for a widget. Within that 1,000 consumers, 100 are willing to pay no-more than 100 for a widget, 100 are willing to pay no more than 200, and so on, such that 100 are willing to pay 1,000 for a widget. Assuming the manufacturer has to sell the widgets at a fixed price, he would be foolish to produce 1,000 widgets – as it would yield 100,000. Producing 500, however, would yield 300,000. In this simple example, the value of a widget increased considerably without any change whatsoever in its nature or characteristics. Nor was value created by producing more of something – quite the opposite, in fact. Value was created by assessing the price that participants in the *market* are willing to pay and setting the sale price accordingly. It is therefore entirely possible, and indeed commonplace, for market conditions greatly increase profitability.

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[425] That is to say, the minimum profit below which the manufacturer would not consider the enterprise to be worth his while.

Price	Market	Yield
100	1,000	100,000
200	900	180,000
300	800	240,000
400	700	280,000
500	600	300,000
600	500	300,000
700	400	280,000
800	300	240,000
900	200	180,000
1,000	100	100,000

Now assume that, while the widget manufacturer is resident in jurisdiction A. The invention and design of the widget was done entirely within jurisdiction A. The raw materials necessary to manufacture the widget were sourced entirely from within jurisdiction A, and the manufacturing took place entirely within jurisdiction A. However, the market in jurisdiction A is saturated, and the most that our manufacturer can sell widgets for is 100. The marketplace into which our manufacturer wishes to sell, therefore, is not in jurisdiction A – it is in jurisdiction B. The manufacturer realises he does not need a permanent establishment in jurisdiction B in order to sell to the market there. He can do so through independent agents, or, perhaps more relevantly to this thesis, a website. Under conventional treaty rules jurisdiction B would not be entitled to tax the profits from sales of widgets in their territory because our manufacturer does not make these sales through a permanent establishment. This is because, according to Sprague and Hersey, and our traditional notions of the origin or wealth, the source of income from these transactions is not the market that exists in jurisdiction B, but the

value that was created in jurisdiction A. The factors of production necessary to produce the widgets – the labour, goods, and capital – were all located in jurisdiction A. The manufacturer benefitted from the existence of these factors of production in jurisdiction A and it is therefore, under the traditional notions of value creation, just that the entirety of the profits from selling those widgets elsewhere should be taxable in that jurisdiction.

It is evident, however, from the example that the manufacturer benefitted from more than simply the factors of production available in jurisdiction A. The market that exists in jurisdiction A values widgets at 100, while people are willing to pay considerably more in jurisdiction B. The market that exists in jurisdiction B contributed significantly to the profitability of widgets. The manufacturer therefore derived considerable benefit from the market that exists in jurisdiction B. If it is indeed the case that the benefit theory of taxation is our correct one in this international context, it surely follows that he manufacturer should taxable in jurisdiction B owing to the benefit he derives from trading there.

This approach greatly widens the scope of notions of value creating activity. However, it has been argued that alternative bases than value creation should be used to determine whether or not a jurisdiction should enjoy jurisdiction to tax in an online environment. Richard Doernberg's base erosion approach, discussed below at 8.3, implicitly endorses the existence of a marketplace or consumers as a source of income.

Benjamin Hoffart proposes that an access to markets proxy should be used in order to found jurisdiction to tax.

5.4.3 Access to Markets

The notion that the market infrastructure legitimates a state's jurisdiction to tax is not a new one. One of the pioneers of international tax law, T.S. Adams, was of the opinion that

> [a] large part of the cost of government is traceable to the necessity of maintaining a suitable business environment. [...] Business is responsible for much of the work which occupies the courts, the police, the fire department, the army and the navy. New business creates new tasks, entails further public expense. [...] The relationship between private business and the cost of government is a loose one. The connection, however, is real [...] business ought to be taxed because it costs money to maintain a market and those costs should in some way be distributed over all the beneficiaries of that market.[426]

Benjamin Hoffart argues that scholars and tax policymakers have been too willing to accept location of value production as the conceptual basis for permanent establishment principles.[428] He argues that there are other plausible bases for permanent establishments as a threshold standard which have been too readily dismissed.

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[426] Thomas S Adams, 'The Taxation of Business' (Proceedings of the Annual Conference on Taxation under the Auspices of the National Tax Association, 1917).
Ibid, 186.
[428] Benjamin Hoffart, 'Permanent Establishment in the Digital Age: Improving and Stimulating Debate Through and Access to markets Proxy Approach' (2007) 6 Nw J Tech & Intell Prop 106.

Hoffart cites some of the earliest League of Nations discussions on apportionment of jurisdiction, and their focus on the origins of wealth rather than the creation of value. He argues that their understanding of the origin of wealth as meaning 'all the stages which are involved up to the point of the wealth coming to fruition' can be read to include access to markets as at least one of the bases for justifying jurisdiction to tax.

Hoffart argues that an 'access to markets proxy' can found the conceptual basis not only for permanent establishment rules as they were devised in the early 20th century, but also for many of the contemporary proposals to address the new challenges posed by the Internet. According to Hoffart,

> [i]t cannot convincingly be denied that providing a market contributes to the sales income at least to some extent as providing the goods does. There is no valid objection, therefore, against a claim of the sales State to tax part of the sales income.[430]

Arthur Cockfield proposes that in determining the source of income for the purposes of allocation of jurisdiction to tax, '[i]nstead of focusing on the location of production, the reform efforts should focus on the location of consumption.'[432] Cockfield argues that

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[430] Vogel, 'Worldwide vs. source taxation of income–A review and re-evaluation of arguments - Part III', *supra* note 191, 400.

[432] Arthur J Cockfield, 'Designing Tax Policy for the Digital Biosphere: How the Internet is Changing Tax Laws' (2001) 34 Conn L Rev 333, 395.

> [t]he use of location of consumption to allocate tax revenues to importing countries can be justified under a number of theories, including the fact that e-commerce importing countries created the market opportunities that enabled the profits to be made through the cross-border transaction (for example, by subsidizing the physical network infrastructure within their country that permitted the transaction to go forward).[434]

This argument, it is submitted, is highly persuasive.

On the basis of the foregoing, it is therefore submitted that the source of income is not simply the jurisdiction in which the factors of production exist, but also, at least, the jurisdiction that provides the marketplace into which goods are sold or services supplied.

5.4.4 Inter-nation equity

The concept of equity, both horizontal and vertical, is a well understood one in taxation theory. Horizontal equity requires that individuals of similar means should be taxed at similar levels. Vertical equity, as Smith notes, requires that individuals of differing means 'contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities'.[436]

Such equity considerations are only relevant in a unitary system of taxation. A third category of equity exists insofar as international taxation principles are concerned,

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[434] *Ibid.*

[436] Smith, *supra* note 174.

and that is the notion of inter-nation equity. That there should be some fairness in the allocation of tax jurisdiction was evident in earliest discussions on alleviation of double taxation,[438] however it was first identified and conceptualised by Peggy and Richard Musgrave.[440]

However, Musgrave and Musgrave's theory of inter-nation equity is a broader concept than a mere equitable sharing of tax revenues, but of national gains. They consider that inter-nation equity requires equity of the overall gains accrued by a state, rather than merely the exchequer coffers of the respective states. There is considerable merit in this analysis. Given that the OECD Model gives source states the right to levy corporation tax on income from within that state's territory, why then do some states, such as Ireland, levy it at such a low level?

Aside from the obvious answer – that levying corporation tax at a lower rate will attract more foreign investment, thereby increasing corporation tax receipts overall – there is a broader gain to the state than merely the revenue received by the government. Foreign capital increases economic output within the state, creating employment for residents of that state, and new business opportunities for domestic

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[438] Royal Commission on Income Tax, *Royal Commission of inquiry into the income tax, including supertax, of the United Kingdom. 1919. Reports and minutes of evidence* (H.M.S.O. 1919) pp.4-24, League of Nations, *supra* note 57.

[440] Peggy B Musgrave and Richard Musgrave, 'Inter-nation equity' in Carl S. Shoup and Richard M. Bird (eds), *Modern fiscal issues : essays in honor of Carl S Shoup* (University of Toronto Press 1972), 63.

suppliers. If that state taxes that investment, then the national gain also becomes a treasury gain. However, without the treasury gain, there remains a national gain.

Kaufman separates altogether concepts of inter-nation and inter-individual equity.[442] This makes eminently good sense, as the interests of the individual taxpayers and the overall interests of those taxpayers' respective states need not necessarily align. While inter-nation equity is of considerable concern to the subject matter of this thesis, inter-individual equity is not.

Peggy Musgrave argues that inter-nation equity is concerned with fairly allocating the tax base by limiting states' competence to tax; and that the will of a state to affect inter-individual equity should be done within the confines of its jurisdictional competence.

From the perspective of the capital exporter, the treasury gain of the source country results in some form of national loss. This occurs irrespective of whether or not the state of residence offers relief from source taxation. If the residence state does offer relief, then the loss is borne by the treasury. If it does not, then the loss is borne by the taxpayer. In any event, under Musgrave and Musgrave's theory of inter-nation equity, a national loss is accrued.

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[442] Nancy H Kaufman, 'Fairness and the taxation of international income' (1997) 29 Law & Pol'y Int'l Bus 145.

Though generally a proponent of the ability-to-pay principle, Peggy Musgrave argues that, taken to its logical conclusion, inter-nation equity would be self-implementing under the benefit theory of taxation. She argues that if taxes directly corresponded to the value of services received from the state, then there would, logically, be no gains or losses as a result of taxation at source. This, arguably, strengthens the case for taxation at source, as is discussed below.

5.4.5 Capital import neutrality and capital export neutrality

'Neutrality' with respect to foreign direct investment can be divided in to distinct, competing concepts: capital import neutrality and capital export neutrality. Insofar as taxation is concerned, capital export neutrality requires that the investor should be liable for the same tax burden on his total investment income regardless of that income's source. Capital import neutrality requires that inward investment in a jurisdiction should be subject to the same tax treatment irrespective of the location of the investor.

Capital import neutrality requires an exemption from tax for foreign source income in the jurisdiction of residence. Capital export neutrality requires worldwide taxation at residence and a foreign tax credit. The implied aim of residence basis taxation is, therefore, capital export neutrality, while source basis taxation is intended to create capital import neutrality.

Satisfaction of both criteria is virtually impossible. Not only would the perfect harmonization of tax rates, bands, and bases be necessary in order to satisfy both neutrality criteria, but also, as Peggy Musgrave argues, harmonization of benefits received in return. Musgrave further argues that income taxes are based on sacrifice, rather than the benefit theory of taxation, and that capital export neutrality must therefore be preferred.[444]

Charles McLure proposes that capital import neutrality is necessary for the efficient allocation of capital. McLure argues that, where returns on capital are taxed in the jurisdiction of residence, capital investments will be made where they are most profitable – that capital investments would become insensitive to the effect of taxation.[446]

However, such arguments that are based on economic efficiency pay scant regard to taxation as a tool of public policy. Dale Pinto advances the argument that

> to the non-economist generally and to businesses in particular, capital import neutrality is preferable as it relies on considerations of international competitiveness rather than theoretical economic efficiency.[448]

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[444] Peggy B. Musgrave, *United States taxation of foreign investment income; issues and arguments* (Harvard 1969), 83.

[446] Charles E. McLure, 'Substitution Consumption-Based Direct Taxation for Income Taxes as the International Norm' (1992) 45 National Tax Journal 145.

[448] Pinto, *supra* note 4, 26.

Capital export neutrality removes or substantially limits what in the case of many countries is one of their few competitive advantages. Within Europe this is particularly true of Ireland, Malta, and Estonia – and further afield in the Caribbean – who have used taxation rates to create a competitive advantage.

Furthermore, arguments advanced by opponents of capital export neutrality presume that investors receive little, if anything, in exchange for their taxes. Irrespective of the validity, or otherwise, of the benefit theory of taxation, the level of public service provision in a state usually corresponds, to a considerable degree, to the level of taxation.[450] The tax burden borne by the investor should therefore reflect, to some extent, the value of services provided by the state that would otherwise be a profit-reducing cost.[452] It is arguable, therefore, that the exemption method (i.e. capital import neutrality) provides the best approximation of capital export neutrality and capital export neutrality.

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[450] See 'General government revenues and expenditures – As a percentage of GDP', OECD, *OECD Factbook (Edition 2012)*.

[452] For example, should policing in a jurisdiction prove inadequate then the business would have to hire additional, private, security.

5.5 Classifying income

As is noted above, the OECD Model is schedular in nature. Fifteen different articles provide for differing tax treatment of fifteen different classes of income.[454] Broadly speaking, the fifteen classes of income can be separated into two categories: active income; and passive income. These classes of income, and the articles that deal with them, divide as is illustrated by Table 5-2 below.

Table 5-2 – active and passive income articles in OECD Model Convention

Active income		*Passive income*	
Article 7	Business Profits	Article 6	Immovable Property
Article 8	Shipping & Transportation	Article 10	Dividends
Article 9	Associated Enterprises	Article 11	Interest
Article 15	Employment	Article 12	Royalties
Article 16	Directors' fees	Article 13	Capital Gains
Article 17	Artistes and sportsmen	Article 18	Pensions
Article 19	Government service		
Article 20	Students		

With respect to passive income, there is a noticeable subdivision between income derived from movable assets, and income deriving from immovable assets. Income from immovable property is taxed in the jurisdiction in which the property is situated. Similarly, capital gains from the alienation of immovable property situated within a contracting state, or of equity shares of a company that derive more than 50

[454] Formerly sixteen. Article 14, concerning Independent Personal Services, was deleted in 2000.

percent of their value from immovable property within a contracting state are taxable in the jurisdiction in which the property is situated. While alienations by permanent establishments of an enterprise are to be taxed in the jurisdiction in which the permanent establishment is located, all other capital gains are to be taxed in the jurisdiction of residence. Payments of dividends, interest, and royalties are all – in general – to be taxed in the jurisdiction in which the taxpayer is resident, and not the jurisdiction in which the income arises. Pensions payable in consideration of employment are payable in the jurisdiction in which the employment was carried out, but otherwise in the jurisdiction in which the taxpayer is resident. Therefore, in general, passive income is taxable in the jurisdiction in which the earner is resident, except insofar as such income is earned from immovable property, in which case it is taxable in the jurisdiction in which the property is situated.

The picture with respect to active income, however, is a little more mixed. Business income earned through a permanent establishment – with which this thesis is, primarily, engaged – is taxable in the jurisdiction in which the permanent establishment is situated, but only so much of it as is attributable to the permanent establishment. Any income not attributable to that permanent establishment is taxable in the jurisdiction in which the business is resident. Income from employment is primarily taxable in the jurisdiction in which the employment is exercised. Income from government service in generally taxable in the state to which the government service is rendered. Income

derived from a non-resident in their capacity as an artist or sportsman is taxable entirely at source, irrespective of the existence or otherwise of either a permanent establishment or employment relationship within the source jurisdiction. Directors' fees paid by a resident company to a non-resident director are taxable in the jurisdiction of the resident company. Income from shipping and transportation in international traffic is taxable in the jurisdiction in which the enterprise has its place of effective management.[456]

Table 5-3 – allocation of active and passive income to source and residence in OECD Model

	Active	*Passive*
Source	Business Profits* Employment Directors' Fees Artistes and Sportsmen Government Service	Immovable Property Capital Gains* Pensions
Residence	Business Profits* Shipping & Transportation	Capital Gains* Dividends Interest Royalties

[456] For the sake of completeness, Article 9 concerning associated enterprises provides that where two or more associated enterprises trade with each other under conditions that differ from those that would have existed between independent enterprises then their profits should be notionally adjusted and taxed as though they were independent. This is not sourcing rule, but an allocation rule. Article 20 concerning the income of students and business apprentices resident in a state prohibits that state from taxing the income of such a student or business apprentice arising from outside that state where they are only resident in that state for the purposes of their education and training. This, it is arguable, is less a sourcing rule as a qualification upon the definition of 'residence'.

This schedular approach to the allocation of tax jurisdiction provides further evidence of the benefit principle as the primary justification for the OECD Model's allocation of jurisdiction.

In most instances, the jurisdiction to tax appears to have been allocated to the jurisdiction that could best be described as the source of the income. While it is indisputable that the source of income from immovable property is the jurisdiction in which the property is situated, it is arguable that the source of income from passive investment is the jurisdiction from which the capital originated. Unlike business profits – which are earned from a combination of factors of production such as labour, capital, property, and markets – the source of income from passive investment is capital. The source of the income from capital, therefore, is the place from which it is supplied, and not necessarily the place in which it is invested. Similarly, the jurisdiction to tax active income is generally allocated to the place where the income generating activities take place – whether employment income or business profits.

A system that was based upon sacrifice or the ability to pay would not classify and allocate income in this way. A system of taxation based upon sacrifice or ability to pay necessitates the unitary taxation of a person's worldwide income on the basis of a personal connecting factor to a single jurisdiction, such as domicile, residence, or citizenship. It is difficult, it is submitted, to conclude other than that the classification

and allocation of income primarily to the economic source of income is based upon the benefit principle.

5.6 Alternatives to taxation at source

Determining the antonym of source is almost as difficult as defining it. The dichotomy is conventionally regarded as being between source and residence,[458] while Vogel considers worldwide taxation as being the alternative to taxation at source.[460]

'Unitary', 'worldwide', or 'global' bases for taxation are often used as synonyms for residence basis taxation. This is quite incorrect. Residence basis taxation is a form of unitary or global taxation. The term 'residence based taxation' tends to encapsulate taxation on a number of bases, all of which are personal, as opposed to territorial, in nature.[462] For the purposes of this thesis 'residence based taxation' should be taken to mean unitary taxation of global income on a personal basis.

'Residence', as employed by Article 4 of the OECD Model, is defined much more broadly than the term is ordinarily understood, as 'any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature'. This definition of residence

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[458] See Green, *supra* note 201; Shay, Fleming Jr and Peroni, *supra* note 200.

[460] Vogel, 'Worldwide vs. source taxation of income–A review and re-evaluation of arguments - Part III', *supra* note 191, 213.

[462] For a discussion on the distinction between personal and territorial bases for taxation, see Martha *supra* note 2.

corresponds to what this thesis considers to be personal bases for taxation. Principally, these bases are residence (properly so called), domicile, and citizenship.

The definition of 'residence' is unclear from the OECD Model and, crucially, leaves determination of that basis to the contracting states. Insofar as non-corporate persons are concerned the most common test of residence is how many days an individual is resident in the state. Ireland regards a natural person as being resident where that person is present in Ireland for 183 days in a single year; or, where that person has been resident in Ireland for 280 days over a two-year period then they will be regarded as being resident in the second year. The United Kingdom employs a simple 183-day rule for determining residence.[464] The United States' residence rule uses the 183-day rule over three years, although the number of days counted in the years preceding the current one is tapered.[466]

The question of residence becomes more difficult with respect to corporate residence. A bright-line test of physical presence is obviously not possible where juristic persons are concerned. The decision in *De Beers Consolidated Mines v Howe* concerned a South African registered company which appeared to be run entirely from London. In analogizing a company with a natural person, Loreburn LC held that

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[464] s831(1)(b) Income Tax Act 2007.

[466] Over a three year period where year 3 is the current year, all the days in which a person is present in the United States in year 3 are counted, one third of those in year 2, and one sixth in year 1, 26 U.S. Code §937.

> [a] company cannot eat or sleep, but it can keep house and do business. We ought, therefore, to see where it really keeps house and does business. An individual may be of foreign nationality, and yet reside in the United Kingdom. So may a company. Otherwise it might have its chief seat of management and its centre of trading in England under the protection of English law, and yet escape the appropriate taxation by the simple expedient of being registered abroad and distributing its dividends abroad.[468]

The *De Beers* principle of central management and control in determining corporate residence is, perhaps, the prevailing conception of corporate residence in common law jurisdictions. Ireland, Australia, and Canada all employ some form of this rule principle in determining corporate residence. Curiously, the United States does not use the *De Beers* test in determining corporate residence, and instead employs a bright-line place of incorporation test.[470]

The result of these differing standards of residency is that it is entirely possible, and indeed common, for persons covered by tax treaties to be regarded as being resident in more than one of the contracting states. In such circumstances, Article 4(2) provides four tiebreaker rules, the final of which provides that the residence of a person shall be decided by mutual agreement between the states.

Another personal basis for taxation is domicile. The domicile basis offers a number of advantages over residence, in particular because an individual cannot be

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[468] *De Beers Consolidated Mines Ltd v Howe (Surveyor of Taxes)* [1906] AC 455.

[470] 26 USC § 7701.

without a domicile, they can only have a single domicile, and their domicile will continue until they acquire a new one.[472] Many states, such as the United Kingdom, reserve the right to tax all global income for persons domiciled within that state – albeit usually subject to DTTs and foreign tax reliefs.[474]

It is extremely uncommon for states to levy taxes on worldwide income on the basis of citizenship. However, the prominent exception to this rule is the United States. In *Cook v Tait,*[476] the US Supreme Court held that being an American citizen was such a privilege that that US had the right to tax the income of Mr Cook, despite his being domiciled and permanently resident in the City of Mexico, and the income arising entirely from sources within the state of Mexico.

Residence basis taxation requires that all income be taxed in the jurisdiction in which the taxpayer is resident, rather than the jurisdiction in which income is earned. A detailed discussion on the merits and demerits of alternatives to existing source rules follows in subsequent chapters 7 and 8. In general, however, the alternative arguments in favour of source and residence bases for taxation were elucidated by Stratford CJ in

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[472] 'RDR1: residence, domicile and the remittance basis' (*HMRC*, 3 October 2013) <https://www.gov.uk/government/publications/residence-domicile-and-remittance-basis-rules-uk-tax-liability> accessed 20 September 2015.

[474] As Rasmussen rightly identifies, there ought, in theory, to be no reason to conclude a Double Taxation Treaty with a state that only taxes at source, Mogens Rasmussen, *International double taxation* (Kluwer Law International 2011).

[476] *Cook v. Tait* (1924) 265 US 47.

the South African case *Kerguelen Sealing and Whaling Co Ltd v Commissioner for Inland Revenue*:

> [i]n some countries residence (or domicile) is made the test of liability, for the reason, presumably, that a resident, for the privilege and protection of residence, can justly be called upon to contribute towards the cost of good order and government of the country that shelters him. In others (as in [South Africa]) the principle of liability adopted is 'source of income', again, presumably, the equity of the levy rests on the assumption that a country that produces wealth by reason of its natural resources or the activities of its inhabitants is entitled to a share of that wealth, wherever the recipient of it may live. In both systems there is, of course, the assumption that the country adopting the one or the other has effective means to enforce the levy.[478]

The arguments advanced by the court in *Kerguelen* in support of either basis are consistent with the benefit theory of taxation. It is worth noting also that, in 2001, South Africa switched away from a source basis for taxation and onto residence as the basis for levying tax.

However, as is discussed further below,[480] while residence-based or unitary taxation may well be compatible with conceptual basis to tax in a domestic context, it is not so compatible with the conceptual basis to tax in an international context.

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[478] *Kerguelen Sealing and Whaling Co Ltd V Commissioner for Inland Revenue* [1939] AD 487; 10 SATC 363.

[480] At 8.6.

5.7 Global Value Chains

Determining the source of income was once a fairly easy exercise. The value-creating activities (see below at 5.4.2) that were previously dominant in the generation of income were discrete processes that were easily ascertainable. Furthermore, determining the value added at each stage of production was relatively straightforward – as most goods and commodities had an easily discoverable market value. However, there have been two key evolutions in the manner in which income is generated in a multi-national environment. These are the integration of business functions, both horizontally and vertically, and the role of intangibles.

5.7.1 Integration of Business Functions

The Multinational Enterprise is not a particularly new phenomenon. The provisions of bilateral tax treaties that provide for the allocation of business profits – now over 100 years old – are specifically aimed at enterprises that engage in their business in multiple jurisdictions. While such enterprises would conventionally have structures that consisted of multiple and largely independent operating arms divided along

geographical and jurisdictional lines, recent years have seen a shift away from territorial organisation of MNEs towards process or functional divisions.[482]

> [I]n many cases, enterprises no longer operate on a business model which relies on the establishment of discrete economic units within each jurisdiction. More and more multinational enterprises are moving towards global business models where their business operations are globally integrated to increase their overall competitiveness.[484]

Such integration has a profound effect upon the shape of global marketplaces. Not only do business operations transcend national boundaries; the marketplaces in which they trade are also becoming increasingly transnational:

> [u]nlike a multi-domestic industry where competitive forces are constrained by national boundaries, a global industry is 'a series of linked industries' where competitive forces transcend national boundaries, thereby creating a worldwide competitive arena.[486]

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[482] Thomas W Malnight, 'Emerging Structural Patterns within Multinational Corporations: Toward Process-Based Structures' (2001) 44 Academy of Management Journal 1187.

[484] OECD, *E-commerce: Transfer Pricing and Business Profits Taxation.*

[486] Kwangsoo Kim, Jong-Hun Park and John E Prescott, 'The Global Integration of Business Functions: A Study of Multinational Businesses in Integrated Global Industries' (2003) 34 Journal of International Business Studies 327, citing Michael E Porter, 'Competition in Global Industries: A Conceptual Framework' in Michael E Porter (ed), *Competition in global industries* (1986).

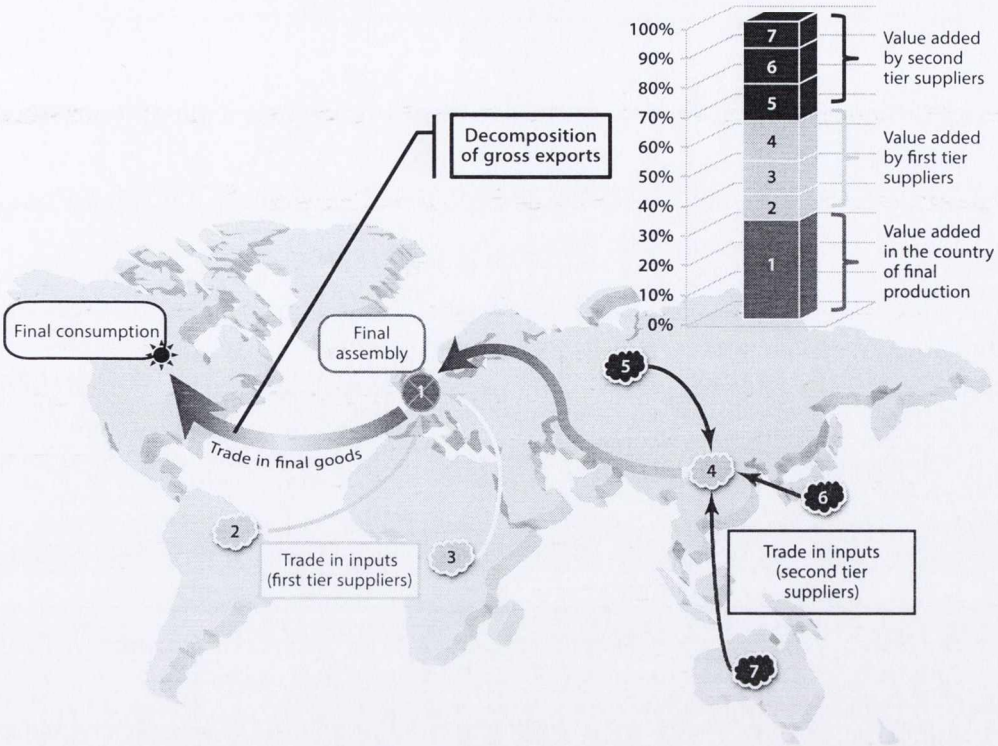


Figure 1: simplified representation of global value chain. Reproduced from OECD, 'Addressing Base Erosion and Profits Shifting' (2013).

In a multinational environment, the individual group companies undertake their activities within a framework of group policies and strategies that are set by the group as a whole. The separate legal entities forming the group operate as a single integrated enterprise following an overall business strategy. Furthermore, it is no longer necessary for management to be located in a single location, but rather it can be dispersed, with reporting lines and decision-making processes going beyond the formalistic legal divisions of the respective corporate entities.

Global value chains are characterised by the fragmentation of production across borders, and have become a dominant feature of the global economy, encompassing emerging as well as developed economies. Figure 1 is a simple illustration of these chains. Increasingly, the pattern of trade shows that goods produced in Economy 1 and

exported to its market of final consumption involves inputs supplied by producers in numerous other economies who themselves source their inputs from third economies. This inevitably raises questions as to the extent to which such enterprises have jurisdictional links with these intermediate economies, as well as how profits should be attributed to them.

However, the above simplified global value chain omits one of the key contributors to value creation and that is the role of intellectual property. From an economic point of view, most of the value of a good or service is typically created at one of two stages: upstream activities where product design, research and development, or production of core components occur; or in the tail-end of downstream activities where marketing or branding occurs. Knowledge-based assets, such as intellectual property, software and organisational skills, have become increasingly important for competitiveness and for economic growth and employment.

The increasingly integrated nature of markets and of MNEs poses a number of challenges to the allocation of corporate profits to its jurisdiction of source. In particular, the highly virtual enterprise is also, typically, highly integrated. In a multinational context this will, inevitably, involve a large amount of internal trade. It is arguable that profits derived from business integration do not, in fact, have a source as it is conventionally understood.

> The transactional model of the MNE holds that international firms arise in order to evade the failures of certain arm's length markets, especially those for intangible assets. Premier among those assets is the knowledge that represents new products, processes, proprietary technology, and the like. Thus, theory implies and empirical evidence confirms that MNEs appear prominently in industries marked by high expenditures on R&D and rapid rates of new product introduction and productivity advance... MNEs arise because of shortcomings in arm's length markets for intangible assets, and the statistical evidence establishes the prominence of MNEs in high R&D industries.[488]

Internal trade in MNEs constitutes an increasingly large share of world trade. Such internal trade gives the multinational considerable advantages over domestic enterprises, which, according to Dunning, are attributable to three factors, which he calls the 'OLI framework': ownership, location, and internalisation.[490]

Intangible assets often form a large part of the ownership advantage of MNEs. Through their ownership of certain assets, a firm enjoys a market advantage that outweighs the costs of doing business abroad. In an e-commerce environment, the costs of doing business in another jurisdiction are substantially reduced, thereby increasing the net-value of the ownership advantage. The ownership advantage enjoyed by MNEs is therefore a contributor to their profitability.

Location specific advantages are those advantages that accrue as a consequence of trading in a particular geographic location. This can include proximity to customers,

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[488] Richard E Caves, 'Multinational Enterprises and Technology Transfer' in Alan Rugman (ed), *New Theories of the Multinational Enterprise (RLE International Business)* (Taylor & Francis 2013).

[490] John H Dunning and Sarianna M Lundan, *Multinational Enterprises and the Global Economy* (Edward Elgar Publishing 2008).

cheaper labour, access to specialised skilled labour, legal or regulatory advantages, and, of course, tax advantages. Again, ICT makes it considerably easier for MNEs to avail of these location-specific advantages by facilitating the remote location of business operations.

However, the internalisation advantages offered by integration are arguably the most valuable. The cost-increasing externalities of open-market trading can be eliminated, such as asymmetry of information, uncertainty, credit risk, or lack of a marketplace. These externalities come on top of transaction costs such as finding a trading partner, negotiation, drafting of contracts, and transport.[492]

> [E]ven at a conceptual level, the traditional methods of calculating transfer prices (CUP, cost-plus, and resale price) will become increasingly and inherently unworkable in this environment, in which design, production, and sales are closely integrated and interdependent.[494]

Communication technologies have long contributed to the cross-border integration of business entities and functions. This has previously included databases, internet, intranet, e-mail, and electronic data interchanges.[496] However, parallel advances in both hardware and software have vastly increased the potential for businesses to further integrate regardless of the great distances that might be involved.

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[492] Jens Wittendorff, *Transfer Pricing and the Arm's Length Principle in International Tax Law* (Kluwer Law International 2010) 19.

[494] Charles E McLure, 'Taxation of Electronic Commerce: Economic Objectives, Technological Constraints, and Tax Laws' (1996) 52 Tax L. Rev. 269.

[496] Kim, *et al.*, *supra* note 243.

One consequence of the vast increases in Internet download and upload speeds is that remote access to network resources is comparable to local access. High network speeds and low latency make it possible to for employees working thousands of miles apart to participate in business activities as though they were in the same building. These advances in network technologies have spurred changes in the manner by which computer software operates, with a shift away from local hosting and processing to cloud-based systems.[498] Such systems allow for remote collaboration in a way that was previously considerably more difficult where computer processing was done locally.

While such integration is extremely challenging for accounting purposes, it poses further challenges in the determination of jurisdictional competence. For example, the delocalisation of personnel and potential for remote working has forced the OECD to re-assess the permanent establishment standard as it applies to home offices[500] Where distance is no barrier to integration, and markets become increasingly global, jurisdictional boundaries become blurred. In addition to the massive increase in the number of cross-border transfers of value and service provision, the problem of continuum pricing, discussed below, is greatly exacerbated.

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[498] Discussed at 6.4.2.3.

[500] In their consultations of 2001 and 2012, the OECD proposed introducing two new paragraphs to the commentary on Article 5, addressing the question of when a home office ought to be considered to be 'at the disposal of' an enterprise, and therefore subject to the jurisdiction of the state in which it is situated. See OECD, *Interpretation and Application of Article 5 (Permanent Establishment) of the OECD Model Tax Convention* (2011).

5.7.1.1 Vertical integration

Vertical integration involves the substitution of an external market with an internal governance structure. Companies seek to reduce or remove the risk-bearing externalities associated with arm's length dealings between different stages in the value chain. The profit-reducing externalities associated with remote decision making was considered by Hymer, who explains that the

> [d]ecentralized decision making – a free market – is defective where there are certain types of interactions between the firms; that is, each firm's behaviour noticeably affects the other firms'. If each firm pursues its own interest, joint maximization may very well not occur.[502]

Hymer describes what we would now call an MNE as a 'practical institutional device which substitutes for the market.'[504] Such integration produces two distinct types of advantage. The first eliminates exogenous factors, such as transaction costs, and thus improves the efficiency of the enterprise. The second is to compensate for structural imperfections, such as scale economies, distribution networks, and knowledge advantages. Such advantages allow a firm to enhance its position in the market and thus produce rents.[506]

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[502] Stephen Hymer, *The International Operations of National Firms: A Study of Direct Foreign Investment*, vol 14 (MIT Press 1976) p. 48.

[504] *Ibid.*

[506] John H Dunning and Alan M Rugman, 'The Influence of Hymer's Dissertation on the Theory of Foreign Direct Investment' (1985) 75 The American Economic Review 228.

Vertical integration is, arguably, less challenging from a jurisdictional perspective, as such integration would tend to take place within existing jurisdictional frameworks. Indeed, Basu argues that '[i]n the information age, there is less need for vertical integration'[508] as companies are more likely to define core competences and enter into join ventures, partnerships, and outsourcing agreements.

5.7.1.2 Horizontal integration

The divisions in the organisation of multinational groups of companies are often no longer jurisdictional in nature. Divisions of MNEs are increasingly organised on a functional basis. Communications technology has allowed for the seamless integration of cross border functions.

Horizontal integration involves the acquisition or integration by one enterprise of another, or the assets or functions of another, at the same stage in the value chain. As with vertical integration, horizontal integration can produce rents by enhancing an enterprise's market position relative to its competitors in a departure from perfect competition, as well as transactional savings.

Horizontal integration can also occur where externalities prevented such integration from occurring previously. Such externalities could be regulatory, technical, or administrative in nature.

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[508] Subhajit Basu, 'Taxation of Electronic Commerce' (2001) 1 Journal of Information, Law, and Technology.

Unlike vertical integration, horizontal integration is especially challenging from a jurisdictional perspective. The most obvious challenge is with respect to the allocation of profits to enterprises' permanent establishments within a state, with transfer pricing rules necessitating what is arguably an artificial division of the profits of an enterprise between the jurisdiction in which it is resident and those states purporting to exercise jurisdiction over a permanent establishment or permanent establishments located within their territory. This jurisdictional challenge is, however, a second order question – which falls outwith the scope of this thesis.

> Breaking the MNE up into its separate parts generally leaves an unaccounted residual, that is, the economies of scale and scope, technological and other intangible assets, managerial competencies, and so on that belong to an integrated business.[510]

By its nature, horizontal integration blurs the lines of jurisdictional competence. Enterprises that were previously discrete operations, with their own operational, support, and management structures might find themselves stripped of many of these functions. As the functions taking place within a jurisdiction diminishes, so too does the enterprise's jurisdictional links with the state in which it trades. While it was previously unusual for an enterprise to trade in a jurisdiction in any substantial way without the abovementioned supporting functions, the horizontal integration

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[510] Lorraine Eden, *Taxing Multinationals: Transfer Pricing and Corporate Income Taxation in North America* (University of Toronto Press 1998).

facilitated by electronic commerce permits such functions to be performed elsewhere. The result may well be, as is often the case, a substantial sales presence within a jurisdiction, without any of the other qualifying criteria required in order to meet the permanent establishment threshold.

5.7.2 The source of income from intangibles

Determining the source of income form intangibles is particularly difficult. Though this is not necessarily a new problem, it is a problem that is greatly exacerbated by the Internet – in particular as intangibles amount to more than the mere intellectual property within an enterprise. A definition of intangible that includes only legally protected intangibles is extremely narrow. However, a definition that captures the entirety of the difference in value between the book value (the total value of an enterprise's hard assets and cash equivalents) and market value of an enterprise is probably too broad. The UK Finance Act 2002 imports the definition used in accounting for the purposes of UK tax law.[512] The Financial Reporting Council defines intangible assets as '[n]on financial fixed assets that do not have physical substance but are identifiable and are controlled by the entity through custody or legal rights.'[514]

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[512] Para. 2(1), Sched. 29, Finance Act 2002.

[514] FRC, *FRS 10 - Goodwill and Intangible Assets* (1997).

International Financial Reporting Standards (IFRS) defines an intangible asset as 'an identifiable non-monetary asset without physical substance'.[516] Recognition of an intangible asset for the purposes of financial accounting therefore requires that two criteria be satisfied. The first, is that the asset is an identifiable intangible. And the second is that the recognition criteria is met.

The first criterion, that an asset is identifiable intangible, is met where it either

(a) is separable – that is to say, is capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, identifiable asset or liability, regardless of whether the entity intends to do so; or

(b) arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.

The second criterion, the recognition criterion, is met where

(a) it is probable that the expected future economic benefits that are attributable to the asset will flow to the entity; and

(b) the cost of the asset can be measured reliably.[518]

In general, the requirement that an intangible asset be identifiable and separable therefore excludes assets such as goodwill, which by its nature is inseparable from the

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[516] IFRS, *IAS 38 - Intangible Assets* (2012).

[518] *Ibid.*

core of a business. However, assets such as knowhow, business practices, and trade secrets are identifiable and capable of being transferred, and are therefore qualifying intangible assets. In a horizontally integrated e-commerce environment – where such assets are capable of being disseminated within an enterprise across its global subsidiaries, determining the source of income from such assets is extremely problematic.

The Regulations issued under the United States Internal Revenue Code (IRC) take a schedular approach to defining intangibles. Under the regulations, an asset is an intangible asset for the purposes of the IRC where it falls into one of the following categories and has a value independent of any service provided by any individual:

a) Patents, inventions, formulae, processes, designs, patterns, or know-how;

b) Copyrights and literary, musical, or artistic compositions;

c) Trademarks, trade names, or brand names;

d) Franchises, licenses, or contracts;

e) Methods, programs, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists, or technical data; and

f) Other similar items.[520]

This restrictive list of intangible assets has been criticised by Markham[522] and Mogle,[524] among others, in particular in light of the decision in *Merck*.[526]

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[520] Chapter 1E, Part III. Section 482, U.S. Code: Title 26 - Internal Revenue Code.

The Irish Tax Law definition of intangibles combines both approaches, by providing for a general definition that is similar in form to the UK definition,[528] as well as a list of specified intangible assets. The Irish list of specified intangibles includes secret processes or formulae or other secret information concerning industrial, commercial or scientific experience, whether legally protected or not, and know-how,[530] which the act defines as

> industrial information and techniques likely to assist in the manufacture or processing of goods or materials, or in the carrying out of any agricultural, forestry, fishing, mining or other extractive operations.[532]

The Irish definition of intangibles also includes goodwill 'to the extent that it is directly attributable' to any of the other specified intangible assets.[534]

In general, intangibles can be divided into two categories: legally protected intangibles, and legally unprotected intangibles. The prevailing view of income derived

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[522] John H Dunning and Alan M Rugman, 'The Influence of Hymer's Dissertation on the Theory of Foreign Direct Investment' (1985) 75 The American Economic Review 228.

[524] James R. Mogle, 'Intercompany Transfer Pricing for Intangible Property' (1997) 6 Tax Management, 2.

[526] In *Merck*, the parent company (Merck) provided a subsidiary with know-how that included a pricing-structure, an affiliate structure, and a group-wide planning structure, for which the IRS argued that the parent should have received consideration. The Tax Court rejected this argument, on the basis that such know-how did not amount to protected property rights *Merck & Co., Inc. v. United States* (1991) 24 Cl Ct 73.

[528] '"intangible asset" shall be construed in accordance with generally accepted accounting practice.'

[530] s291A(g), Taxation (International and Other Provisions Act) 2010.

[532] s768, Taxes Consolidation Act 1997.

[534] s291A(l), *op. cit.*

from intangibles is product of the inputs that created the intangible and the legal protection afforded thereto. However, this is unsatisfactory for two reasons.

First, the income derived from intangibles can often bear little correlation to the capital invested in its creation. While it is often the case that intangibles will be the product of extensive research and development programmes, with expected rates of return, forecast failure rates, *etc.*, there remains the possibility that intangibles can be the product of a fortuitous discovery. Furthermore, certain kinds of intellectual property require comparatively little input. Trademarks, for example, are principally composed of combinations of words, symbols, or other marks, which, on their own, have comparatively little value upon creation. The underlying value in a trademark is often derived from the legally unprotected customer goodwill and the reputation of the brand. The legal protection created by trademark laws is, as Landes and Posner argue, more akin to tort law than intellectual property law.[536]

Second, as Landes and Posner argue, intangibles need not be legally protected in order to be valuable. Landes and Posner identify a number of other factors that give value to intellectual property: that copies might be inferior and therefore not perfect substitutes for originals; copying may involve some original invention, and is not, therefore, a literal copy; the time delay involved in copying an original work;

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[536] William M Landes and Richard A Posner, *The Economic Structure of Intellectual Property Law* (Harvard University Press 2009). Even without the formal legal protection afforded to trademarks by intellectual property law, the tort of passing off remains available to the owner of a brand.

contractual alternatives to statutory protection; technological fixes that limit copying; the 'copiability' of the original work may enhance its value and therefore be reflected in its price; the benefits from publication that go far beyond royalty income, such as prestige and celebrity, which can manifest themselves in a pecuniary sense; reductions in the cost of copying helping reduce the cost of production in the first place; and the falling cost of expression.[537]

All of these advantages derive from the same basic premise: that the advantaged party is possessed of some knowledge or skill, which their competitors do not (or do not yet) have. In short, the intangibles of the sort Landes and Posner describe ultimately take the form of secrets. Furthermore, intangibles such as knowhow can benefit significantly from being kept secret. In such instances intangibles might not necessarily be derived from any direct legal protection (although such intangibles might benefit from indirect legal protection by way of breach of confidence, for example) but they might nonetheless be of considerable value owing to the fact that no one else has such knowledge.

The notion that the source of income derived from intangible is the legal protection that it is afforded in the country in which it was created is extremely questionable. First, the intangible will often be protected in every jurisdiction in which it is exploited, and not just the one in which it was created. Furthermore, there have

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[537] *Ibid.*

been considerable efforts in recent years to curb the unauthorised exploitation of intellectual property even in jurisdictions in which the intangible is not legally protected.[539]

Second, many intangibles derive their value from their international exploitation. For example, the value of a trademark is derived from a number of factors, one of which is its wide recognition. A trademark that is recognised worldwide will usually be far more valuable than one with limited domestic recognition. This value will be greatly enhanced by the legal protection afforded to such a trademark in the jurisdictions in which it is utilised. However, even unprotected intangibles can derive value from their international usage. The conglomeration of MNEs, discussed above, generate rents.

On the basis of the foregoing, it is therefore submitted that the source of income from intangibles is not, in fact, the location in which it was created. It is argued that the source of income from intangibles is the location in which the intangibles are exploited. While, there remain some good public policy arguments in favour of allocating jurisdiction to tax income from certain kinds of intangibles to the jurisdiction that facilitated their creation,[541] it is proposed that, in general, the jurisdiction to tax

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[539] For example, the Anti-Counterfeiting Trade Agreement.

[541] Such as patents and copyrights.

income from intangible assets should be allocated to the state in which those assets are exploited.

5.8 The enduring importance of source

Existing source rules have come under considerable scrutiny in recent years. These criticisms find their bases in two separate arguments. The first argument against existing source rules is that, while there is nothing wrong with the principle of taxation at source, modern business models, and in particular the Internet, make it impractical. The second such argument is that new business models, and in particular the Internet, render taxation at source unjust. The logical conclusion of the latter argument is unitary taxation in the jurisdiction of residence, while proponents of the former argument would advance formulary apportionment as a solution.

The recent outrage about alleged tax avoidance by certain large MNEs included criticism of existing source rules. In the Parliamentary session 2011-2012, the Public Accounts Committee of the UK House of Commons undertook an investigation into tax avoidance by MNEs. The committee heard evidence from senior executives from Google, Amazon, and Starbucks. The culmination of this investigation was their report 'HM Revenue & Customs: Annual Report and Accounts 2011–12'.[543] The tax practices

[543] House of Commons Committee of Public Accounts, *HM Revenue & Customs: Annual Report and Accounts 2011–12* (HMSO 2012).

of the three enterprises were branded as 'immoral' by the report, and the committee chairman. Similar public outrage was recorded recently in Ireland, too, against Google, again, along with Facebook.[544]

This outcry has reignited debate over source rules, and renewed calls for a shift away from source basis taxation, towards a system of unitary taxation. In December 2012 the Tax Justice Network called for a shift towards a unitary basis for taxation, arguing that

> [a] shift towards assessing [trans-national corporations] on a unitary basis, coupled with a principled basis for apportioning their tax liability, would bring the international tax system into closer alignment with economic reality.[545]

The argument that formulary apportionment better reflects economic reality is not a new one.[546]Recent converts to the cause of formulary apportionment include the European Commission, who are exploring the concept as part of their proposed shift towards a Common Consolidated Corporate Tax Base.

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[544] Colm Keena, 'Comment: Public anger over tax bound to force reforms' *Irish Times* (Dublin, 9 December 2014) <http://www.irishtimes.com/business/economy/comment-public-anger-over-tax-bound-to-force-reforms-1.2031766> accessed 2 March 2015.

[545] Sol Picciotto, 'Towards Unitary Taxation Of Transnational Corporations' (*Tax Justice Network*, 2012) <http://www.taxjustice.net/cms/upload/pdf/Towards_Unitary_Taxation_1-1.pdf> accessed 4 April 2015.

[546] '[Formulary apportionment] would be more equitable in allocating income among jurisdictions and be more consistent with both economic theory and the economic reality of how MNEs conduct their business', Jinyan Li, 'Global profit split: An evolutionary approach to international income allocation' (2002) 50 Canadian Tax Journal 823.

However, the argument that new business models undermine the effectiveness of existing source rules is not an argument against taxation at source. Invariably, proponents of formulary apportionment argue that it would tax income where it is earned more effectively than current source rules. The question of how profits are allocated once a jurisdictional link has been established is a second-order question, and not within the scope of this thesis. While this thesis does not propose or reject a shift to a formulary means of allocating profits, such a change would only be compatible with the benefit theory of taxation where its objective is to shift the allocation of profits towards their source.

The growth of electronic commerce has, in particular, precipitated concerns that source taxation may no longer be viable. Few have argued for a wholesale abandonment of the principle of taxation at source. However, notwithstanding issues relating to tax administration and enforcement, Charles McLure argues that, under the benefit principle, there should be no taxation in a jurisdiction without physical presence. McLure therefore argues that taxation at residence is the only just solution.[547] This, it is submitted, is not the case. McLure uses the example of police and fire services as being of little benefit to enterprises lacking a physical presence. However, states have undertaken considerable efforts to protect online enterprises in recent years. Among

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[547] Charles E. McLure, 'Alternatives to the concept of Permanent Establishment' (Report of the Proceedings of the First World Tax Conference: Taxes Without Borders, Toronto, 1 December 2000).

the more notable examples of this are the UK's Digital Economy Act,[549] the US' Digital Millennium Copyright Act,[551] and the Anti-Counterfeiting Trade Agreement.[553] New criminal offences have been created; new policing units have been established. In short, online enterprises do, in fact, benefit from public services, notwithstanding their lack of physicality.

The argument that economic entities without a physical presence in a jurisdiction still benefit from the infrastructure of a state is advanced by Arvid Skaar:

> [a permanent establishment] is merely a piece of evidence of economic allegiance, not the reason for source-state taxation. The circumstance that short-term business operations may accumulate substantial profits from domestic sources indicates on the contrary that the taxpayer benefits substantially from the infrastructure of the host country, even though no [permanent establishment] exists. It seems that an enterprise which does not need to invest in immovable facilities, or other fixed places of business, may still derive considerable advantages from the community in which its income sources are located. Today, the performance of a business activity in another country, the duration of the activity and the profits arising from it, are per se significant arguments ...[that] requires all enterprises which obtain such benefits from a country to render a corresponding contribution to this society, whether or not they have a [permanent establishment].[555]

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[549] Digital Economy Act 2010.

[551] Digital Millennium Copyright Act 1998.

[553] *Supra* note 269.

[555] Skaar, *supra* note 175, 559.

Dale Pinto built upon Skaar's argument, proposing that the normative and legal framework of a state is essential for any enterprise trading in a jurisdiction, irrespective of whether or not it has a physical presence in that jurisdiction:

> non-resident companies that do not maintain a physical presence in source countries nevertheless benefit from the source country's legal system inasmuch as they rely upon it to enforce payment for transactions, uphold intellectual property rights (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 digitised services and the protection of these rights arise independently of the need for any physical presence to be maintained in the source country. Likewise, vendors of digitised content (including music and computer games) would not have a market in source countries that did not have a suitable telecommunications infrastructure or whose population lacked competency in computers. The provision of these benefits therefore adds weight to the case for source based taxation under the benefit principle, even in the absence of a physical presence in a source country.[557]

This broad conception of benefit is consistent with Dodge's theory of 'benefit'[559] as being diffuse and nonallocable.

It is submitted, therefore, that the benefit principle remains valid. The benefit that an MNE derives from a jurisdiction in which it trades amounts to far more than the use roads and the protection of heritable property. The system of laws that protects

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[557] Dale Pinto, 'The theoretical foundations and continued rationale for source-based taxation in an electronic commerce environment' (2012) 27 Australian Tax Forum 443.

[559] *Supra* note 193.

the intellectual property that is the prime commodity on the Internet, as well as the legal and regulatory environment that provides a functioning marketplace in which the MNEs trade. It follows from this that the principle of taxation at source should remain the basis for the allocation of profit in international taxation.

This too, appears to reflect public sentiment. McLure's advocacy of residence basis taxation places him in the minority. Following the public outcry about Google, Amazon, and Starbucks tax affairs John Kay argued that '[w]ell conceived apportionment is the best – perhaps only – answer to the problem presented by multiple company tax jurisdictions.'[561] Other, long standing advocates of formulary apportionment, such as Reuven S. Avi-Yonah have renewed calls for international apportionment.[563] Such proposals (which seem to make up the majority of those in favour of reform) share a common outcome: the allocation of income to the jurisdiction where income-generating activity takes place.[565]

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[561] John A Kay, 'Corporate Tax Should Be Fair and Shared' *Financial Times* (London, 27 November 2012) <http://www.ft.com/cms/s/0/b6ef8ab4-388f-11e2-981c-00144feabdc0.html> accessed 8 July 2015.

[563] Reuven S Avi-Yonah, 'Corporate and International Tax Reform: Proposals for the Second Obama Administration (and Beyond)' (2012) 40 Pepp L Rev 1365;Reuven S Avi-Yonah, Kimberly A Clausing and Michael C Durst, 'Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split' (2009) 9 Florida Tax Review 3.

[565] See Musgrave and Musgrave, *supra* note 220.

Chapter 6: Permanent Establishment

6.1 Introduction

This chapter considers the concept of permanent establishment in international taxation law. On the basis of the foregoing discussion in chapter 5, the premise of this chapter is that the principle of permanent establishment is a sound one. However, abandonment of a principal so entrenched[567] in international tax law seems so unlikely that the case for doing so must be compelling.[569] It is submitted in this chapter, and the chapter that follows, that the case for abandoning, or at the very least supplementing, the permanent establishment threshold with a new standard is, indeed, compelling.

This chapter considers the conceptual basis for the permanent establishment requirement in international taxation law. It considers the various interpretations

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[567] Avi-Yonah has argued that certain principles of international taxation law have become normative, see Avi-Yonah, *supra* note 178.

[569] India has argued for the complete abandonment of the principle of Permanent Establishment. In 2001, the Foreign Tax Division of the Indian Revenue argued that 'applying the existing principles and rules to e-commerce does not ensure certainty of tax burden and maintenance of the existing equilibrium in sharing of tax revenues between countries of residence and source. The Committee is also firmly of the view that there is no possible liberal interpretation of the existing rules, which can take care of these issues, as suggested by some countries. The Committee, therefore, supports the view that the concept of PE [Permanent Establishment] should be abandoned and a serious attempt should be made within OECD or the UN to find an alternative to the concept of PE.' This position, however, has not attracted support from any OECD Member States. See High Powered Committee on E-Commerce and Taxation, *Report of the High Powered Committee on E-Commerce and Taxation* (Ministry of Finance (India), 2001). For discussion, see Arthur J Cockfield, 'The Rise of the OECD as Informal World Tax Organization through National Responses to E-Commerce Tax Challenges' (2005) 8 Yale JL & Tech. 136.

placed upon the concept, by the commentary to the OECD model, and others. In particular, this chapter challenges the conventional view that a permanent establishment need be a physical presence within a jurisdiction. It concludes that where an enterprise benefits from the legal, economic, and physical infrastructure of a jurisdiction, under the befit theory of taxation, that enterprise ought to be considered to have a taxable presence within that jurisdiction notwithstanding its lack of a physical presence.

6.2 Permanent Establishment

The concept of permanent establishment provides a threshold standard for the exercise of tax jurisdiction over a non-resident enterprise. The level of contact that a non-resident person must have with a state before that state can exercise its jurisdiction to tax has been considered extensively by US courts with respect to sales taxes. In cases such as *National Bella Hess*[571] and *Quill v North Dakota*[573] that standard was called a 'nexus'. Though the sales taxes fall outwith the scope of this thesis, the term 'nexus' is a useful one for describing the jurisdictional connection between a state and a non-resident person, and is so used in this thesis accordingly.

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[571] *National Bellas Hess v. Department of Revenue* (1967) 386 US 753.

[573] *Supra* note 118.

The concept of permanent establishment is the starting point for the exercise of jurisdiction. The point at which the permanent establishment standard is met is the point at which an enterprises trades in a jurisdiction, as opposed to merely trading with a jurisdiction.[575] As Jagannadha Rao J. held,

> the words 'permanent establishment' postulate the existence of a substantial element of an enduring or permanent nature of a foreign enterprise in another country which can be attributed to a fixed place of business in that country. It should be of such a nature that it would amount to a virtual projection of the foreign enterprise of one country into the soil of another country.[577]

Much of the language employed by Article 5 is alien to the Common Law. In *Ostine v Australian Mutual Provident Society* the House of Lords held that

> the language employed in this agreement is what may be called international tax language and that such categories as 'enterprise', 'commercial or industrial profits' and 'permanent establishment' have no exact counterpart in the taxing code of the United Kingdom.[579]

While it is therefore both necessary and desirable to utilise international definitions of these terms, as can be seen below, difficulties arise where no such definitions actually exist.

The definition of a permanent establishment is of importance to several Articles of the Model Convention – in particular Article 7, which deals with the taxation of

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[575] Baker, *supra* note 6*Double taxation conventions : a manual on the OECD Model Tax Convention on Income and on Capital*, 5B.01

[577] *CIT v. Visakhapatnam Port Trust* (1983) 144 ITR 146.

[579] *Ostine v Australian Mutual Provident Society* [1960] AC 459, 480.

business profits. The default position of the OECD Model is that profits of an enterprise, resident in a contracting state, derived from another contracting state, will be taxable in the jurisdiction in which the enterprise is resident; except where those profits derived from the other contracting state are earned through a permanent establishment, in which case any such profits will be taxable in that other contracting state.

Article 5 of the OECD Model defines permanent establishment as a 'fixed place of business through which the business of an enterprise is wholly or partly carried on.'[581] The commentary to the Article develops this definition, making it dependent upon satisfaction of three conditions:

> [1] the existence of a "place of business", *i.e.* a facility such as premises or, in certain instances, machinery or equipment;
>
> [2] this place of business must be "fixed", *i.e.* it must be established at a distinct place with a certain degree of permanence;
>
> [3] the carrying on of the business of the enterprise through this fixed place of business. This means usually that persons who, in one way or another, are dependent on the enterprise (personnel) conduct the business of the enterprise in the State in which the fixed place is situated.[583]

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[581] Article 5(1), OECD, *Model Tax Convention on Income and on Capital 2010* (Organisation for Economic Co-operation and Development 2012).

[583] OECD, *Commentary on Article 5 Concerning Definition of Permanent EstabishmentEstablishment, Model Tax Convention on Income and on Capital 2010* (Organisation for Economic Co-operation and Development 2012) C(5)-1.

This kind of permanent establishment is often described as the 'fixed place of business' permanent establishment. However, Article 5 also constructs a second type of permanent establishment - a 'dependent agent' permanent establishment. Such a permanent establishment is constituted where

> a person – other than an agent of an independent status [...] — is acting on behalf of an enterprise and has, and habitually exercises, in a Contracting State an authority to conclude contracts in the name of the enterprise.

It has been argued that the dependent agent permanent establishment could be used to tax online enterprises at source, through electronic agents.[585] However, such arguments have failed to gain any considerable traction. Therefore, the arguments within this chapter are primarily focused upon the fixed place of business test.

Electronic commerce poses two challenges to conventional threshold standards. The first arises from network infrastructure, such as servers, and whether and under which circumstances such hardware should constitute a permanent establishment. The second relates to the content of the Internet itself, and whether or not websites should constitute permanent establishments.

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[585] Barrett Schaefer, 'International Taxation of Electronic Commerce Income: A Proposal to Utilize Software Agents for Source-Based Taxation' (2000) 16 Santa Clara Computer & High Tech. LJ 111.

6.3 Constitution of a fixed place of business

6.3.1 'Enterprise'

The first consideration of whether or not a permanent establishment exists is whether or not the person in question is an enterprise. An 'enterprise' could said to be very easy to describe, but very difficult to define. Naturally, some motivation to earn profit must exist – though that is not to say that the enterprise need actually be profitable. A definition of 'enterprise' was long absent from the Model Convention, however following the 2003 update Article 3 of the Model Convention provides that 'the term "enterprise" applies to the carrying on of any business'. Article 3 declines to define 'business' except to say that it includes the performance of 'professional services' and 'other activities of an independent character'.

The Commentary further provides that the question as to whether or not activity is deemed to constitute an enterprise is to be determined according to the domestic laws of contracting states.

The use of word 'enterprise', and the lack of definition thereof in the Commentary, has long been a source of considerable criticism. Van Raad identifies numerous instances in the Model Convention in which 'enterprise' appears to have

different meanings.[587] This is compounded by the fact that the term 'enterprise' is not a commonly employed one at Common Law – with the terms 'business' or 'trade' being preferred by UK legislators and courts.[589] This leaves something of a vacuum insofar as the Common Law is concerned.

Within the context of the Model Convention, the term enterprise appears to be both a noun – either a person or a business[591] – or a verb.[593] The use of the indefinite article in Article 5 would suggest that the 'enterprise' contained therein is an enterprise in its nounal sense. However, even in its nounal sense, 'enterprise' can mean both a business entity in the sense of an undertaking, or an activity of such an undertaking.[595] While the English language version of the Model Convention does little to illuminate which of these two meanings of enterprise is intended by Article 5, the French language version is a little more informative:

> [a]u sens de la présente Convention, l'expression «établissement stable» désigne une installation fixe d'affaires par l'intermédiaire de laquelle une entreprise exerce tout ou partie de *son* activité.[597]

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[587] Kees Van Raad, 'The Term "Enterprise" in the Model Double Taxation Conventions–Seventy Years of Confusion' (1994) 11 Intertax 491.

[589] G. Maisto, *The Meaning of "enterprise", "business" and "business Profits" Under Tax Treaties and EU Tax Law* (IBFD 2011), p546.

[591] *Ibid.*

[593] Maisto, *op. cit.* p.455.

[595] A similar dichotomy might be between 'a business' and 'business'.

[597] A literal translation of Article 5 describes a fixed place of business through which an enterprise carries out all or part of *its* activities. Article 5, French language version. Emphasis added.

This would therefore appear to suggest that the form of enterprise used by Article 5 is that of a business entity. However, this form of enterprise is quite narrow, and there is evidence to suggest that courts are willing to take a broader view of what constitutes an enterprise under the OECD Model.

The Supreme Court of Western Australia took perhaps the most expansive view of what constitutes an enterprise in a DTC in *Thiel v Federal Commissioner of Taxation.*[599] The case concerned a taxpayer resident in Switzerland, who earned a profit from a single transaction. The court held that

> to be an enterprise within the meaning of the agreement the profit making activity of the Swiss resident need not amount to the carrying on of business as understood in Australian tax law and it is sufficient if that activity is an undertaking being an isolated venture, an activity, which has the features of a business operation or deal.[601]

In this instance, this single transaction amounted to sufficient activity to constitute an enterprise under the treaty.

Though some uncertainty remains, the 2000 update to the Model Convention appears to conflate the terms 'enterprise' and 'business' in a relatively broad sense. The 2000 definition of 'enterprise' as applying to the 'carrying on' of any business connotes an ongoing concern rather than a single activity. Accordingly, the scope of activities to which Article 5 applies is likely somewhat narrower than was held in *Thiel.*

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[599] *Thiel v Federal Commissioner of Taxation* [1990] HCA 37.

[601] *Ibid.* at 4108.

6.3.2 'Place of business'

Where an enterprise is resident in a jurisdiction, it is not necessary for the business of that enterprise to be carried out in any particular place. Indeed, in the absence of permanent establishments in other jurisdictions, it is not necessary for a resident enterprise to have any fixed place of business at all. However, for a non-resident enterprise, the business of the enterprise must be carried out through a particular location in order for the jurisdiction in which the enterprise is carrying out its business to have jurisdiction to tax that enterprise.

In most traditional industries the business of most enterprises takes place through a place of business that is fairly obvious. Such places might be shops, or factories, or offices, or any of the other examples listed in Article 5. However, we have seen a number of other, less obvious, locations act as places of business for the purposes of Article 5.

The OECD Model provides a fairly broad definition of a place of business. The Commentary describes para. 1 of Article 5 as providing the 'general characteristics' of a permanent establishment – a distinct *'situs'*. The OECD Model itself provides a non-exhaustive list of places of business that constitute a permanent establishment. These include a place of management; a branch; an office; a factory; a workshop, and a mine,

an oil or gas well, a quarry or any other place of extraction of natural resources.[603] This list gives an impression of sorts of premises the term 'place of business' is designed to include, and might be considered, as Skaar submits, to be examples of *prima facie* permanent establishments.

However, notwithstanding the drafting of Article 5, the mere possession of the sorts of premises listed above does not in itself create a permanent establishment. Such premises must meet the other criteria, or fall within one or more of the exclusions, discussed *supra* and *infra*.

The Commentary states that 'place of business' covers any premises, facilities or installations used for carrying on the business of the enterprise. Such a place need not be used exclusively for that purpose, and the place need not be owned or rented by the enterprise, but merely 'at the disposal of' the enterprise.[605] The Commentary further provides that actual premises are not required, but that merely having a certain amount of space at your disposal might suffice. The enterprise does not necessarily need to have any legal right to make use of the space available.

'Place of business' has been held to include a shed[607] and a trade stand, occupied regularly for three weeks a year.[609] Vending or gaming machines can constitute a

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603 A place of management, a branch, an office, a factory, a workshop, a mine, or an oil or gas well are all specified by the OECD Model.

605 *Supra* note 293, C(5)-2.

607 *Transvaal Associated Hide & Skin Merchants (Pty) Ltd* (1967) 29 SATC 97 (Court of Appeal, Botswana).

permanent establishment where the enterprise that sets them up (or a dependent agent) maintains and operates them for their own account.[611] So too can an oil pipeline be considered a permanent establishment.[613] Conversely, a mailing address within a jurisdiction, with little else, has been held not to constitute a permanent establishment.[615]

It is not sufficient for the place of business to merely be subject to the activities of the enterprise, it must serve the business activities of the enterprise.

6.3.3 'Fixed'

The fixed nature of a permanent establishment has been the primary focus of discussion relating to online enterprises. It is from the requirement that a permanent establishment be fixed that it is generally concluded that a permanent establishment requires a physical presence.

'Permanent', as employed by the OECD Model, appears to require the intention of indefinity, rather than actual indefinity. Du Parcq LJ in *Henriksen (Inspector of Taxes) v. Grafton Hotel Ltd* held that '"[p]ermanent" is indeed a relative term, and is not

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609 *Joseph Fowler v. MNR* (1990) 90 DTC 1834 (Tax Court of Canada).

611 *Supra* note 293, C(5)-8.

613 *Infra* note 318.

615 *Consolidated Premium Iron Ores Ltd* (1959) 265 F 2d 320.

synonymous with "everlasting."[617] This definition of permanent has been subsequently applied to the OECD Model. In *No. 630 v. Minister of National Revenue* the Canadian Supreme Court held that 'permanent'

> does not necessarily mean permanent in the sense that that word is often used. The question was considered in *Henriksen v. Grafton Hotel, Ltd.*, [1942] 2 K.B. 184, at p. 196. [sic] In that matter, also an income tax case, du Parcq, L.J., of the Court of Appeal in England, said that 'permanent' was a relative term and not synonymous with 'everlasting'. That, I rather think, is the meaning intended by its use in the Protocol.[619]

The Commentary to the OECD Model takes the view that it logically follows from the fact that a place of business must be fixed, that that place of business must have a 'certain degree of permanency'[621] - but not, therefore, necessarily actual permanence. It must simply be more than a mere temporary presence. Even a short-term presence can constitute a permanent establishment where the nature of the business is such that it will only be carried on for that short period of time.[623] Furthermore, temporary interruptions of activities carried on at a fixed place of business do not cause a permanent establishment to cease to exist.[625]

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[617] *Henriksen (Inspector of Taxes) v. Grafton Hotel Ltd* [1942] 2 KB 184, 196.

[619] *No. 630 v. Minister of National Revenue* (1959) 59 DTC 300 (Supreme Court of Canada).

[621] *Supra* note 293.

[623] *Ibid.*

[625] *Ibid.*

It is clear, therefore, that a fairly transient presence within a jurisdiction is sufficient to constitute a permanent establishment. On that basis, therefore, it is entirely conceivable that a website could indeed constitute a permanent establishment. This is, in particular, consistent with the view that the Internet allows a business to virtually step into a jurisdiction to trade as much as it allows a consumer to visit another jurisdiction to shop.[627]

However, the requirement that a place of business be fixed tends to be interpreted as meaning that that place of business be corporeal in nature. According to Baker,

> [t]he nature of the fixed place of business permanent establishment is very much that of a physical location: one must be able to point to a physical location at the disposal of the enterprise through which the business is carried on.[629]

It is arguable that the ordinary meaning of 'fixed' does not necessarily require physicality – rather, that the on-going existence of any such a presence must not be variable. However, the German Supreme Court took the view that a fixed place of business is necessarily a physical place – a view that has been subsequently affirmed by the OECD.[631]

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[627] An argument made by this thesis in chapter 3.

[629] Baker, *supra* note 60 at 5-2/2.

[631] Klaus Eicker, 'Germany: OECD PE guidance consistent with German case law and decree' (2001) International Tax Review 121.

The *German Pipeline Case*[633] concerned a Dutch *Besloten Vennootschappart* (BV) of whose business concerned the operation of an underground oil pipeline that ran from the Netherlands into Germany. German businesses were supplied with oil at a number of outlets operated entirely by German *gesellschaft.* In addition to the pipeline itself, the Dutch BV owned two pumping stations in Germany, which consisted of land, buildings, and equipment which was entirely automated and remotely controlled; as well a further German installation which consisted of oil storage tanks. Neither the pipeline nor any of the associated installations had any personnel stationed at them. The German Federal Tax Office considered the underground pipeline and associated installations to be a permanent establishment to which taxable profits could therefore be attributed. The Dutch BV contested this view, arguing *inter alia* in the alternative that the lack of any personnel in Germany meant neither the pipeline nor associated installations could constitute a permanent establishment.

The decision of the German Supreme Court is of particular relevance to Internet taxation, for two reasons. First, the decision of the Court leaves little doubt that 'fixed' for the purposes of the OECD Model means 'physically fixed'. Second, the Court also held that personnel were not necessary for a place of business to constitute a permanent establishment.

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[633] *German Pipeline Case, supra* note 139.

While whether a permanent establishment required corporeality was not at issue in the case – there can be little doubting that an oil pipeline is corporeal – the Court constructed a definition of 'fixed' which seems to require a physical connection with the earth:

> [a] pipeline which essentially runs underground can be a 'fixed' place of business within the meaning of §12 s1 [*Abgabenordnung*][635] 1977. This is the case where a fixed contact with the earth's surface exists or the place of business or installation is situated for a certain period of time in a definite place. [...] Such presence in a certain place can be the result of mechanical connection with the ground or of mere occupancy of the same place.[637]

It follows from this definition that a fixed place of business must be physically fixed. An incorporeal presence can neither be mechanically fixed with the ground, nor can it occupy a place. It is on this basis that consensus converged around excluding websites from the definition of permanent establishment.

With respect to personnel, however, the court took the view that they were not required in order for a place of business to constitute a permanent establishment:

> [t]he utilisation of personnel (whether management, employees, independent contractors, sub-contractors) in or at the place of business is not required in every case. Rather, the undertaking of a course of activity by the enterprise by means of the place of business is sufficient, especially in the case of apparatus which works in a fully automatic manner. [...] It is therefore immaterial that the appellant's use of the pipeline in Germany, i.e. the transport of crude oil through the pipeline,

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[635] General Tax Code.

[637] *Op. cit.* at 176.

> has not been carried on through employees or contractors working at its direction in Germany but through remote control of the installations exercised from abroad or a remote control system of computers located in another country.[639]

This is of special significance with respect to computer hardware – in particular, network infrastructure and computer servers which are capable of being remotely owned and operated. Although at the time of the decision the modern Internet was very much in its infancy, consequence of the *German Pipeline Case* appeared to be that while a website could never constitute a permanent establishment, a server could under certain circumstances. This view was affirmed by the OECD Model and the commentary amended accordingly.

6.3.4 'Through which the business of the enterprise is carried on'

It is not enough for an enterprise to merely have a presence in a jurisdiction. The activities of the business must be carried on at the location of that presence, either in whole or in part. While such activities need not necessarily be of a productive character, they must be more than merely preparatory or auxiliary.

The OECD Model provides a non-exhaustive list of activities it considers preparatory or auxiliary.[641] The Commentary to Article 5 further provides a list of e-

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[639] *Ibid* at 177-178.

[641] '(a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise; (b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery; (c) the maintenance of a stock of goods or

commerce based activities that it considers to be preparatory or auxiliary, which includes:

> — providing a communications link — much like a telephone line — between suppliers and customers;
>
> — advertising of goods or services;
>
> — relaying information through a mirror server for security and efficiency purposes;
>
> — gathering market data for the enterprise;
>
> — supplying information.[643]

The preparatory or auxiliary character of certain functions of online enterprises, in particular computer hardware, is considered below.

6.4 Reconceptualising Internet taxation

This thesis argues in chapter 3 that there is a need to reconceptualise the general approach to the application of laws to the Internet. This, it is submitted, is particularly true of taxation law.

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merchandise belonging to the enterprise solely for the purpose of processing by another enterprise; (d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise; (e)the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character', Art.5(4), *supra* note 292.

[643] C(5)-26, *supra* note 293.

First, a greater distinction needs to be drawn between medium and content. The Internet itself is a medium. It is merely a collection of hardware, cables, and network infrastructure for the purposes of communication. While there is, of course, an inherent value in communication, the transactions that we week to assert jurisdiction over are not exclusively for the provision of communications services.

Looking beyond the medium, all commerce – whether online or not – is a product of communication. Such interaction need not necessarily be immediate, nor need it be direct. Enterprises can set up servers to act as automated sales agents, while consumers can use servers to act as automated purchasers.[645] The various e-commerce business models described in chapter 4 all involve some combination of websites and servers, however the commerce itself is ultimately a transaction between two parties. It is therefore necessary to consider the roles that websites and servers play in concluding online transactions.

Servers perform a variety of functions in electronic commerce. At the very simplest level, servers can act as little more as a conduit for communication. In the same way that a telephone call requires an exchange to direct the call, an email exchange

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[645] An example of the latter can be found in the operation of eBay, where a consumer can specify a starting bid and maximum price they are willing to pay for an item. When a competing bid is made, further bids are automatically placed by competing parties until the prescribed maximum of all parties is beaten by a single bidder.

between two contracting parties requires mail servers in order to route the data packets to each other.

A server can also be used to store information, with the intention that that information can be retrieved by a remote computer and displayed on a user's screen. This would be the case where, for example, a very basic website were used to display goods and services, provide pricing information, and contact details. A more sophisticated use of a server would involve the collection and processing of orders for offline delivery. Finally, it is growing increasingly common for a server not only to collect and process orders, but also to affect delivery of online goods or services.

In each case, the server performs a function of the business. In some cases it may be that a server performs a function that adds real and quantifiable value to the transaction. However, it is often the case that when the functions of a server are analogised with offline business models, the roles that even the most sophisticated servers perform are perfunctory at best.

6.4.1 Servers as Permanent Establishments

In 2002 the OECD amended to commentary to the OECD to address the issue of servers as permanent establishments.[647]

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[647] A discussion on the background to this can be found in chapter 4.

> Where, however, such functions form in themselves an essential and significant part of the business activity as a whole, or where other core functions of the enterprise are carried on through the computer equipment, these would go beyond the activities covered by paragraph 4 and if the equipment constitutes a fixed place of business of the enterprise [...] there would be a permanent establishment.[649]

The OECD's determination that servers could be taxable as permanent establishments, but that websites could not, appears to be consistent with the *German Pipeline* case.[651] However, there are a number of pragmatic reasons why the taxation of servers is extremely difficult. Servers are highly mobile and easily transplantable, and their functions need not be performed at a single location. Furthermore, it is submitted that, notwithstanding those practical difficulties, the taxation of servers – but not websites – is conceptually unsound.

6.4.1.1 Defining 'server'

A 'server' can typically mean one of two things. Either, a software program that provides a specific kind of service to client software running on the same computer or other computers on a network, or else the hardware upon which such software runs.

There exists a great many kinds of server, including web servers, mail servers, and file servers. The functions that a server performs are dependent upon the software it is running, and the capabilities of the hardware upon which it runs. For example, a

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[649] C(5)-18.

[651] Eicker, *supra* note 317.

web server may run Apache HTTP Server or Microsoft IIS, which both provide access to websites over the Internet. A mail server may run a program like Exim or iMail, which provides SMTP services for sending and receiving email. A file server might use Samba or the operating system's built-in file sharing services to share files over a network. However, in addition to running the appropriate software for the required task, the hardware must also capable of meeting the demands placed upon it. In order for a device to act as a web server, it would likely require considerable processing power, whereas if it were to act as a file server it would require considerable file storage.

However, it is arguable that it is the software, and not the hardware, that is the defining characteristic of a server. It is usually possible for an ordinary computer to function as a sever with the appropriate software installed, and indeed, it is increasingly commonplace for home computers to serve as print servers, file servers, media servers, *etc.* While large operations might utilise what might be stereotypically considered to be servers – large rack-mountable equipment – in a smaller organisation a server might appear to be virtually indistinguishable from standard computer – both aesthetically, and increasingly so technically too. There is little about the equipment that necessarily makes it a server – what makes it a server is the software that runs upon it.

On this basis, it is arguable that the OECD fundamentally misunderstood the nature of a server when it formulated rules aimed at including servers in its definition of a permanent establishment.

Paragraph 42.2 of the OECD Model Convention provides that 'a location where automated equipment is operated by an enterprise may constitute a permanent establishment in the country where it is situated'. It explicitly rules out a website ever constituting a permanent establishment on the basis that, as a website is a combination of software and electronic data, it does not constitute a 'fixed place of business'.

The Commentary also distinguishes between the location at which the automated equipment is located, and the equipment itself. It is also possible for the equipment itself to constitute a permanent establishment, independently of the place in which it is located. Para. 42.3 provides that

> [i]f the enterprise carrying on business through a web site has the server at its own disposal, for example it owns (or leases) and operates the server on which the web site is stored and used, the place where that server is located could constitute a permanent establishment

provided that certain other criteria are met.

The first criterion is that the server needs to be fixed. That is not to say that the server must be incapable of being moved, but rather that it must not be moved for a sufficient period of time in order to be considered to be fixed. The Commentary does not specify what that period of time ought to be.

The second criterion is that the business of the enterprise is wholly or partly carried on through the equipment. The Commentary declines to elaborate further as to what sort of activities might constitute carrying on business through the equipment, but simply provides that such a determination should be made on a case-to-case basis, having regard for 'whether it can be said that, because of such equipment, the enterprise has facilities at its disposal where business functions of the enterprise are performed.' This is not particularly enlightening.

The Commentary also provides that a server must meet the requirement of not being preparatory or auxiliary. This seems obvious, however it is perhaps restated for the avoidance of doubt. It specifically excludes providing a communications link – much like a telephone line – between suppliers and customers; advertising of goods or services; relaying information through a mirror server for security and efficiency purposes; gathering market data for the enterprise; and supplying information.

However, where such functions form an 'essential and significant' part of the activities of the enterprise, those functions should not be considered to be preparatory and auxiliary. It is arguable, therefore, that this is the only circumstance in which a server could ever constitute a permanent establishment.

6.4.1.2 Conceptual unsoundness

Notwithstanding the foregoing practical arguments against considering servers to be permanent establishments, it is submitted that to do so is, in most circumstances, conceptually unsound.

This thesis argues in chapter 5 that the benefit theory of taxation is the most just one in an international context. This thesis also argues in chapter 3 that there is a need to look beyond the medium to the substance of transactions. Upon these bases, it is submitted that there is a need to reconceptualise our approach to the permanent establishment principle.

6.4.1.2.1 Misapplication of offline analogs

The first of the five Ottawa principles requires that '[t]axation should seek to be neutral and equitable between forms of electronic commerce and between conventional and electronic forms of commerce.'[653] Those parts of different enterprises that perform the same functions should, therefore, be subject to the same tax treatment regardless of whether that enterprise is an online enterprise or not. However, as the example below illustrates, functionally similar components of online and offline enterprises appear to be subject to differing tax treatment.

Consider an enterprise that is engaged in the sale of large electronic goods, white goods, or furniture. Such an enterprise will usually have a shop-front or

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[653] *Supra* note 128, see chapter 4 for a discussion on the Ottawa Framework Conditions.

showroom where customers can browse through products and conclude transactions for the purchase of such goods. Customers pay by credit card, with such payments processed remotely and automatically by the enterprise's merchant bank. The goods for sale are not kept on the premises but stored in a warehouse, differently located, from where the purchased goods are dispatched for delivery to the customer's home. Under such a business model, the warehouse would not constitute a permanent establishment, as 'the use of facilities solely for the purpose of storage, display, or delivery of goods or merchandise' is specifically excluded from the definition of permanent establishment under the OECD Model.[655] The permanent establishment, under the OECD Model, is the shop-front. This business model is, however, broadly analogous that which has become common on the Internet.

Consumers purchasing digitized goods over the Internet browse and conclude transactions through a website, payment is processed (usually separately), and delivery is affected by a server on which the digitized goods are stored. In this scenario, the website performs a similar function to the taxable shop-front, while the operations of the server are similar to that of the non-taxable warehouse. The key distinction, according to the Commentary, is that the conclusion of the contract is also affected by the server. However, such a function is not a product of the server's hardware, but of the scripts it is programmed to process. Websites written using server-side scripting

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[655] Art. 5(4), *supra* note 292.

languages, such as PHP or ASP.NET conclude the transaction with the customer, before interrogating the databases stored on the server for the purchased electronic products.

The blurriness of the line between functions that are a product of software and functions that are a product of hardware was largely overlooked by the OECD. Arthur Cockfield argues that the conclusion reached by the OECD that

> [t]he use of a computer server as a substitute for traditional physical presence fails to take into account the nature of the Internet. The server/PE focuses attention on the software functions performed within the server to determine whether the requisite threshold of activities has been surpassed. The income-producing functions hence will be allocated according to software functions, which can be shifted to anyplace in the world.[657]

The United States Treasury took a sceptical view as to whether or not the activities carried out by a server in the US should constitute a permanent establishment. Though their scepticism was partly predicated upon the highly mobile nature of computer servers, they also doubted whether the functions of a server were sufficiently significant:

> [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

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[657] Arthur Cockfield, 'Through the Looking Glass: Computer Servers and E-commerce Profit Attribution' (2002) 25 Tax Notes International 269.

creation of certain types of income to be taken into account for purposes of determining whether a U.S. trade or business exists.[659]

HMRC taxes a similar view, that a server, whether together with a website or otherwise, should never constitute a permanent establishment.[661] The United Kingdom has lodged an observation of Article 5(1) to this effect.

Websites hosted on a server, in particular dynamic websites, are a product of the software running thereupon. Furthermore, servers would be incapable of performing any business functions without that software. This, inevitably, leads to one of two conclusions.

The first, is that it is impossible to meaningfully separate websites and servers. The logical extension of this conclusion is that websites and servers should either be taxable together, or else not at all. It is submitted that this is not an acceptable outcome, on both ontological, and political grounds. As this thesis attempts to demonstrate, websites and servers do perform real and substantive commercial functions, analogous to shops, and offices, and warehouses. It is right, and consistent with the Ottawa principles, that they should therefore be accordingly taxable. Furthermore, ignoring websites and servers as taxable establishments would result in a substantial shift

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[659] Office of Tax Policy, 'Selected Tax Policy Implications of Global Electronic Commercee' (*US Department of the Treasury*, November 1996) <http://web.archive.org/web/20020823004934/http://www.treasury.gov/taxpolicy/library/internet.txt >

[661] HMRC, *supra* note 149.

towards residence based taxation – which, as this thesis discusses in chapter 8, would not satisfy the objectives of the international tax regime.

The second conclusion is that the distinction between a website and a server is misplaced. When a user accesses a website written in a dynamic scripting language, for example PHP, the code is parsed by the server's PHP processing module, and output to the end user's browser as hypertext mark-up. The user's inputs are then returned to the server, where the website can command the server to perform certain functions, such as concluding a transaction, processing a payment, or delivering electronic goods. It is arguable, therefore, that a more appropriate distinction would be between the server hardware, and the software running upon it. A functional analysis of these two components would, it is submitted, lead to the inevitable conclusion that the profit-making functions of an operation such as the one described above are performed by the software on the server, and not the hardware. However, the difficulty with attributing profit-making functions to software, is that software lacks a physical presence.

6.4.1.2.2 Physical presence not necessary under the benefit principle

The standards contained within the OECD Model are determinative of the source of income, rather than definitive.[663] Though the physicality requirement is not explicit in the convention, nor was it interpreted as being so necessary until comparatively

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[663] Discussed at 5.3.

recently, it is at least arguable that a physicality requirement is implicit in Article 5. However, this notwithstanding, there is, as Cockfield argues, 'no sacred reason why a physical presence requirement should be used to determine nexus for income tax purposes.'[665]

A permanent establishment is not the reason for source taxation. A permanent establishment is, as Skaar notes,[667] merely evidence of a jurisdictional nexus between the activities of a non-resident enterprise and a state. It is clear from the earliest discussions that took place in the League of Nations that the original intent of the permanent establishment principle was to provide an evidential threshold that was sufficiently high as to discount a mere transient presence within a jurisdiction. It was thought that a bricks-and-mortar establishment in a state is necessary in order to 'purposefully avail', as Justice Stevens might put it,[669] of the benefits offered by that state.

Sprague and Hersey argue that that all of the things that were necessary in order to meaningfully participate in a marketplace and earn a profit are as necessary in electronic commerce as they are in traditional businesses. They argue that

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[665] Arthur J Cockfield, 'Reforming the Permanent Establishment Principle through a Quantitative Economic Presence Test' (2003) 38 Can. Bus. LJ 400., 403.

[667] AA Skaar, *Permanent Establishment: Erosion of a Tax Treaty Principle* (Kluwer Law and Taxation Publishers 1991), 559.

[669] *Quill, supra* note 288.

> [t]he 'new' economy, like the 'old' economy, requires an enterprise to utilize capital, labor, and other property to produce and market its products and services. Even if the nature of those inputs and outputs differs somewhat under the 'new' economy *(e.g.,* from 'brawn' to 'intellect' on the input side, and from tangible property to intellectual property on the output side), the essential fact remains the same: physical presence and activity as reflected by an entrepreneur's labor inputs, property investments, and risk assumption remain necessary components to an enterprise's creation of products and services.[671]

It is certainly arguable that this was the case in the early days of electronic commerce. The Amazon business model was heavily reliant warehouses, distribution centres, and physical infrastructure in order to conduct business. However, advances in technology, in particular data bandwidths, have resulted in a proliferation of businesses that rely upon little or no physical infrastructure, labour, or capital whatsoever. Two of the companies whose tax affairs have become the subject of public scrutiny, Google and Facebook, are the produ cts of college dorm rooms, which required no capital or property. The opportunity to earn a profit from nothing but one's inventiveness may not have been available to entrepreneurs in the 'old' economy, but it most certainly available in the 'new' economy.

This thesis argues at 5.8 that non-resident enterprises can receive considerable benefits from a state notwithstanding the lack of any physical presence. This is not necessarily an argument for abandoning the permanent establishment standard.

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[671] Gary D Sprague and Rachel Hersey, 'Permanent Establishments and Internet-Enabled Enterprises: The Physical Presence and Contract Concluding Dependent Agent Tests' (2003) 38 Ga. L. Rev. 299.

The shift away from the need for bricks and mortar in order to participate in a market is not caused by electronic commerce, though it is, undoubtedly, exacerbated by it. Arvid Skaar considered the erosion of the permanent establishment principle by increasingly mobile and physically absent enterprises a decade before electronic commerce became a concern for policymakers. Skaar rightly predicted that

> [t]he future is likely to prove that the [permanent establishment] principle has lost its force for new and mobile industries, whether tax treaties are renegotiated for this purpose or not. An enterprise's economic connection to the soil, its [permanent establishment], is no longer a reliable evidence of economic allegiance.[673]

If we are to abandon the physicality requirement in the OECD Model, then the search then becomes, as Luc Hinnekens suggests,

> for ideas for a new taxing nexus denoting a threshold for source jurisdiction that does not require a fixed place of business but that still effectively and closely connects the business to the territory of the taxing source state.[675]

There exist a number of alternatives to existing tax norms. While some commentators advance a shift away from the permanent establishment standard altogether, this thesis argues that a more modest approach could adequately address the problems discussed above.

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[673] Skaar, *supra* note 335, 573.

[675] Luc Hinnekens, 'Looking for an Appropriate Jurisdictional Framework for Source-State Taxation of International Electronic Commerce in the Twenty-First Century' [1998] Intertax 192.

6.4.1.2.3 Difference between fixed place of business and dependent agents

While Article 5 is principally concerned with enterprises that trade through a fixed place of business, an additional jurisdictional standard is provided for in paragraph 5:

> [...] where a person other than an agent of an independent status to whom paragraph 6 applies — is acting on behalf of an enterprise and has, and habitually exercises, in a Contracting State an authority to conclude contracts in the name of the enterprise, that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph.

This alternative jurisdictional standard is more commonly referred to as the 'dependent agent permanent establishment'. The primary object of paragraph 5 is to prevent an enterprise from being able to avoid a creating a permanent establishment in a jurisdiction through the use of agents.[677]

> It is a generally accepted principle that an enterprise should be treated as having a permanent establishment in a State if there is under certain conditions a person acting for it, even though the enterprise may not have a fixed place of business in that State within the meaning of paragraphs 1 and 2.[679]

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[677] OECD, *Issues in International Taxation 2002 Reports Related to the OECD Model Tax Convention, supra* note 151.

[679] Commentary on Article 5, para. 31.

However, what is notable about the provisions of paragraph 5 is that, unlike where an enterprise itself trades directly within a jurisdiction, the dependent agent is not required to do business through a fixed place of business in order to create a permanent establishment within it.

> Such persons may be either individuals or companies and need not be residents of, nor have a place of business in, the State in which they act for the enterprise.[681]

The conceptual soundness of such a distinction is highly questionable. The Committee on Fiscal Affairs recognised that the distinction between the fixed place of business permanent establishment and the dependent agent permanent establishment appears to create something of a paradox: an enterprise trading indirectly in a jurisdiction through a dependent agent can be deemed to have a permanent establishment situated therein, where under the same circumstances an enterprise trading directly within the same jurisdiction does not.

The Committee, however, takes the view that

> [t]he absence of a 'fixed place of business' requirement explicitly justifies the treatment as a permanent establishment of a dependent agent with capacity to bind the enterprise, provided he works and contracts in a State with a sufficient degree of permanence that the 'habitually' requirement is satisfied, and the apparent paradox identified above is

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[681] *Ibid.*, para. 32.

> properly resolved by treating the enterprise as possessing a permanent establishment where it contracts directly.[683]

It is certainly defensible that alternative threshold standards are necessary to supplement the fixed place of business standard in order to prevent enterprises from being able to easily structure their business operations in order to avoid a charge to tax. After all, this is ultimately what this thesis proposes. However, it is difficult to defend the apparently different treatment afforded to these two different jurisdictional standards. The level of economic integration necessary in order to satisfy these two jurisdictional threshold standards is significantly higher in the case of the fixed place of business standard than is the case for the dependent agent standard.

There is no requirement that an enterprise trading through a permanent establishment within a jurisdiction must conclude contracts habitually. There is no *de minimis* exception to the fixed place of business standard – all business conducted through a fixed place of business within a jurisdiction is taxable within that jurisdiction. Conversely, there is no requirement that a dependent agent have any physical presence located within a jurisdiction in order to for its activities to be subject to that jurisdiction's tax regime; while an enterprise trading directly within a jurisdiction without a physical presence can never be subject to that jurisdiction's tax regime. Table

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[683] *Op. cit.*

6-1 illustrates the differing tax treatments that arise from the two jurisdictional standards.

Table 6-1: Differing tax treatment of fixed place of business and dependent agent permanent establishments

	Habitual	Infrequent
Physical presence	Fixed Place of Business: ✔ Dependent Agent: ✔	Fixed Place of Business:✔ Dependent Agent: ✗
No physical presence	Fixed Place of Business: ✗ Dependent Agent: ✔	Fixed Place of Business: ✗ Dependent Agent: ✗

This thesis does, however, share the view of the Committee on Fiscal Affairs that paragraph 5 of Article 5 is designed to capture enterprises that engage in activity sufficient within a jurisdiction so as to cause themselves to participate in the economic life of that jurisdiction. To tax the profits of an enterprise that habitually trades within a jurisdiction, it is submitted, is entirely consistent with the principle of taxation at source. It is arguable, therefore, that the 'habitual exercise' test is a more conceptually sound one than the 'fixed place of business' standard. However, this is certainly not a universally held view.

Sprague and Heresey take a highly restrictive view of agencies as permanent establishments. They take the view that the straightforward conclusion of contracts ought not to be sufficient to establish a jurisdictional nexus. They propose that

> the Commentary be clarified to ensure that an agency PE requires the exercise by the dependent agent of at least some business judgment in the formation of the contract.[685]

The basis of this argument is the original intent of paragraph 5. Sprague and Hersey argue that paragraph 5 was not intended to apply to travelling agents with no authority to negotiate, who can merely conclude contracts on standard terms at fixed prices. In their view, paragraph 5 is intended to apply to

> a person who is entrusted by the foreign enterprise with authority to make business decisions, and whose activities in the host jurisdiction in binding the foreign enterprise are pursuant to that power and discretionary authority.[687]

Sprague and Hersey cite the example of out-of-jurisdiction telesales or call centres. In these situations, a telesales agent's authority is largely limited to accepting customers' orders over the phone. However, they argue that, notwithstanding the frequency with which this might take place, such transactions should never create a dependent agency permanent establishment. Their rationale, is that

> [i]n these situations, the agent's in-jurisdiction activities are comparable to that of telephone operator or recording device. The foreign principal has retained control over the terms of trade, though that control may have been exercised at a point in time prior to the actual act of contract conclusion.[689]

Absent any discretion on the part of the agent, Sprague and Hersey conclude that

> [a]ttending to phone calls in the jurisdiction is hardly the type of participation in the economic life of a jurisdiction that warrants a state's

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[685] Sprague and Hersey, *supra* note 210, p. 328.

[687] *Ibid*, p. 330.

[689] *Ibid*, p. 340.

> taxation of a portion of the business profits of an enterprise that otherwise has no physical presence in the state.[691]

By analogy, therefore, Sprague and Hersey further take the view that automated equipment, such as computer software processed on a server, should never constitute a dependent agent permanent establishment. To this, they add a further disqualification that software is not a person, and that it is inappropriate to personify computer code.

However, conceptually, it is difficult to argue that there is a difference between discretion exercised within pre-set parameters by a human agent, and discretion exercised within the same pre-set parameters by an automated agent.

6.4.2 Practical difficulties in taxing servers

6.4.2.1 Mobility

Computer servers are highly mobile. Large servers are often composed of easily transportable 'racks', while more modest servers resemble contemporary desktop computers far more closely than they do the Ferranti Mark 1.[693]

A server need not have any geographical connection with the jurisdiction in which its income producing activities are carried-out. It was once arguable that it was preferable to locate servers in the jurisdiction in which an enterprise was trading,[695] as locating servers in too remote a location resulted in poor performance. However, this is

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[691] *Ibid.*

[693] The first commercially available computer.

[695] Michelle L Prettie, 'Are There Any Tax Havens in Electronic Commerce' (2001) 3 NCJL & Tech. 1.

no longer the case. Internet bandwidth and infrastructure has improved considerably across the world.

Furthermore, computer servers do not require personnel in order to run. Servers can be maintained or programmed by employees or agents located outside of the jurisdiction. This is further exacerbated by improvements in Internet speeds and network infrastructure.

The highly mobile nature of a computer server presents considerable opportunities for tax avoidance.[697] Existing OECD rules make it simple to shift servers that constitute permanent establishments to low or zero-tax jurisdictions.[699] Where an enterprise operates a number of servers in a number of locations, it is a fairly simple matter to programme the servers so that the income generating processes take place in low tax jurisdictions, and those servers located in high tax jurisdictions perform only preparatory or auxiliary functions.[701] Caching is an entirely commonplace practice, whereby a single server performs core operations – such as accepting orders and processing payments – with multiple servers located nearer to the end user storing static content.

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[697] Cockfield, 'Designing Tax Policy for the Digital Biosphere: How the Internet is Changing Tax Laws', *supra* note 216.

[699] For example, an enterprise could easily locate its profit-generating servers in Barbados, which has a 0% Corporation Tax rate.

[701] *Op. cit.*

Finally, servers often run software that permits the creation of 'virtual servers'. Such software creates the appearance of multiple server installations on a single piece of hardware. Such hardware may be at the disposal of the enterprise, however as the operations performed by the server are a construct of computer code, an enterprise can shift their virtual server to another server, located elsewhere, without having to move a single physical piece of hardware. The problems associated with virtual servers are similar to those posed by cloud servers, discussed below.

6.4.2.2 Disaggregation

One characteristic of the highly virtual enterprise is the capability for extensive disaggregation of business functions. This can usually be for legitimate commercial reasons, such as local caching of static content, however it also presents opportunities for tax planning. The Australian Tax Office noted that the disaggregation of business functions

> would allow an internet business to be divided into a number of small functions which, of themselves, would probably only be considered auxiliary or preparatory in any particular jurisdiction but which, when linked via the internet mean that there is a viable business that is not subject to tax in any jurisdiction.[703]

This conclusion is somewhat typical of the hysterical reactions to the advent of the Internet, as it ignores the fact the residuary rule of international taxation law is that

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[703] Australian Tax Office, *Tax and the Internet: Discussion report of the Australian Taxation Office Electronic Commerce Project Team on the challenges of electronic commerce for tax administration* (Australian Government Publishing Service, 1997).

of residence. However, disaggregation does make it possible to substantially limit the number of jurisdictions in which profits may be taxed.

Disaggregation is not a new problem in taxation law. The separation of business functions is recognised in the OECD Model.[705] There exists some precedent that such disaggregation need not necessarily be problematic for the purposes of international taxation law. The Dutch *Hoge Raad* case[707] concerned two Dutch nationals who purchased flowers in the Netherlands. The two then travelled to Germany, where a friend loaned them a room. The two had a shed in Germany for storage and preparatory work, as well as a licensed market stall. The Dutch court held that while the activities taking place at these locations, individually, could not constitute a permanent establishment, when taken together, these activities on the whole constituted a permanent establishment in Germany. This decision would appear to answer Australian concerns that disaggregation of business functions would result in businesses that were established nowhere, however it is worth noting that all of the locations in the *Hoge Raad* case were within Germany. The difficulty with respect to the Internet, is that these functions can easily take place in multiple jurisdictions.

Enterprises with large-scale computing needs will utilise server arrays. Server arrays, much like cloud servers, consist of a number of linked servers to which

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[705] Article 5(4), *supra* note 292.

[707] *Hoge Raad case* (24 March 1976) BNB 1976/121.

commands are directed on the basis of available processor time and physical proximity. This, as Pinto argues, makes performing a functional analysis as to which servers performed what parts of what transactions is therefore difficult:

> [i]n terms of the treaty analysis of *how* a permanent establishment is defined, a server array would generally constitute a permanent establishment for each of the servers involved, although whether this leads to them constituting a permanent establishment will depend on whether the functions performed on any particular server amount to the carrying on of a business or are otherwise excluded from being a permanent establishment, for example, by being regarded as a preparatory or auxiliary activity.[709]

Another component of the trend away from single-server processing has been a downward shift towards users' devices. At the start of the 21st century web-servers would sometimes push small pieces of software ('applets') to the end-user's computer in order to perform some of the processing at the user's side. Though Cockfield's prediction that almost all server processing would be pushed to local devices has, so-far, failed to be proved correct,[711] there has been some downward movement in processing. The proliferation of smart phones and tablet computers has spurred a massive surge in the use of 'apps' to perform Internet tasks. These locally hosted applications perform much of the processing that, had the same service been accessed using a website, would have been performed by the server.

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[709] Pinto, *E-commerce and source-based income taxation, supra* note 224.

[711] Arthur J Cockfield, 'Transforming the Internet into a Taxable Forum: A Case Study in E-Commerce Taxation' (2000) 85 Minn. L. Rev. 1171.

6.4.2.3 Cloud Servers

The rules applying the permanent establishment principle to servers are heavily predicated upon being able to identify a single location through which the business of the enterprise is carried on. It must be possible to point to a box that carries out a material function. However, such rules pre-date the advent of cloud servers, which make such an identification near-impossible. What follows is a brief explanation of cloud computing, and a discussion on the difficulties in applying the permanent establishment principle to cloud servers.

A simple way to understand cloud computing is to think about time-sharing.[713] In the 1960s, computers were large and extremely expensive, and the 'mainframe model' of computing was extremely common. Multiple terminals consisting only of input/output devices would connect to a mainframe computer, often remotely through the telephone network, in order to share a single computer's storage and computational capabilities. As computers became cheaper and more widespread, however, storage and processing that was once done remotely tended to be done locally. Personal Computers that acted as autonomous units became the norm.

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[713] This analogy was employed in David J Shakow, 'The taxation of cloud computing and digital content' (2013) 140 Tax Notes International 13.

Recent trends in computing technologies have resulted in a shift away from local processing and storage. 'The Cloud' is, in many ways, similar to the 1960s mainframe, albeit considerably more delocalised.

The National Institute of Standards and Technology ('NIST') definition of cloud computing is, perhaps, the most commonly employed.[715] It defines cloud computing as

> a model for enabling ubiquitous, convenient, on-demand network access to a shared pool of configurable computing resources (e.g., networks, servers, storage, applications, and services) that can be rapidly provisioned and released with minimal effort or service provider interaction.[717]

This broad definition of cloud computing includes a number of service models, the most prominent of these being 'Software as a Service' (SaaS), 'Platform as a Service' (PaaS), and 'Infrastructure as a Service' (IaaS).

6.4.2.3.1 Software as a Service

The SaaS model of cloud computing allows users to access a suite of software tools hosted at a remote location. Services such as Dropbox and iCloud allow users to store their files remotely and access them on any Internet-enabled device anywhere in

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[715] See L Wang and others, *Cloud Computing: Methodology, Systems, and Applications* (Taylor & Francis 2011), Walter Hellerstein and Jon Sedon, 'State Taxation Of Cloud Computing: A Framework For Analysis' (2012) 117 Journal of Taxation 11–31, Shakow, *Ibid.*

[717] NIST, 'Definition of Cloud Computing' (*United States Department of Commerce*) <http://csrc.nist.gov/publicaitons/nistpubs/800-145/SP800-145.pdf> accessed 1 October 2013.

the world. Google goes a step further, offering remote storage and processing through its Google Docs environment.

The increase in popularity of cloud services can be explained by a number of factors. The first is inter-operability, in particular in organisations. Operating a number of autonomous units requires individual maintenance of each machine. It also requires a degree of ubiquity in order to ensure inter-operability. Software on all machines used must be compatible in order to collaborate on a piece of work. Similarly, if the software needs to be updated then a technician must do so on every machine. Second, cloud computing makes collaboration simpler. Previously, if a number of individuals were collaborating on a file on a number of machines, each user would have to download a master file from a fileserver, make changes to a locally cached copy, and then integrate any changes into the master file. This can result in considerable overlap of labour. In a cloud environment, the individuals collaborating on a piece of work all work on the same file, which is stored and processed remotely on a cloud server. Edits can be seen live, eliminating any chance of overlap.

The SaaS model is challenging to existing rules in a fairly indirect manner. The SaaS model proliferates remote working, including home offices. The disaggregation of labour can prove challenging for tax administration, especially where apportioning profits on collaborative works are concerned. However the SaaS model, ultimately,

exacerbates difficulties in allocating profits to labour working in remote locations, and thus falls outwith the scope of this thesis.

6.4.2.3.2 Platform as a Service

PaaS includes the provision of an operating system, a programming language runtime execution environment, databases, and web servers. This model is principally used for the development, testing, and deployment of online applications. Insofar as it includes a suite of software tools as well as the provision of certain hardware elements, it falls between the SaaS and IaaS models. How problematic PaaS is to tax rules depends largely upon how it is used. If such a service is merely used to provide the software environment in which applications are developed, then the tax issues arising therefrom resemble those arising from the SaaS model. If, however, the business model involves using the service to deploy and execute applications which constitute a substantial part of the business of the enterprise, then the tax issues arising resemble those of IaaS, discussed below.

6.4.2.3.3 Infrastructure as a Service

The 'Infrastructure as a Service' (IaaS) model of cloud computing is, ultimately, where the real challenge to the permanent establishment principle can be found.

The server farm – a location where thousands of computers are kept for the benefit of multiple users – is a familiar concept in the IT industry. Such locations do not, in theory, pose any greater challenge to tax authorities than a single server located

in an enterprise's premises – provided, of course, that their 'allotment' of the server farm is at their disposal and a substantive part of their business is carried on through it.

However, cloud servers are rather different. Cloud servers provides users with access to a shared pool of computer hardware. This access is ubiquitous and flexible, capable of being rapidly scaled-up and scaled-down with negligible effort. Processes are not run, nor files stored on any particular server. Instead, processes can be run on any one of potentially thousands of computer servers, with cloud computing protocols directing requests to the most appropriate resource. Crucially, these servers need not be in the same building, country, or even continent – and, indeed, that is one of the advantages of cloud servers. Operating multiple servers in multiple remote locations allows for reduced latency, as requests can be directed to the nearest server. Similarly, operating multiple remote locations also reduces the risks associated with disruption at a single location. Cloud servers provide redundancy by directing requests to alternative locations.

The difficulty that the IaaS model poses is in performing the functional analysis necessary in order to determine which, if any, servers constitute a permanent establishment. First, each server used is part of a shared pool of resources. An enterprise's utilisation of any particular server can be fleeting and arbitrary. A server that is part of a cloud network cannot be said to be 'at the disposal' of the enterprise as the OECD Model requires.

Second, it is arguable that the distribution of functions to any one of potentially thousands of servers located anywhere in the world poses practical difficulties for the purposes of tax administration.[719] However, servers maintain logs, and it would be a matter of fairly simple programming in order for a server to log on which server each operation takes place. Of greater concern is the arbitrariness by why operations will be directed. Commands will usually be directed wherever there is spare capacity on the network. There is little commercial basis for the allocation of functions on a cloud computer network.

Case study: Amazon Web Services

The market leader in IaaS is Amazon Web Services.[721] Amazon provides cloud-based server infrastructure at nine different locations in the Americas, Europe, and Australasia, as well as caching and DNS routing at over forty locations around the world. One of AWS' major clients is Netflix, a subscription based service that streams films and television programmes to customers' computers, smart-televisions, smartphones, or tablets. Netflix previously owned and operated its own servers out of its headquarters in California, however between 2008 and 2010 migrated onto Amazon cloud servers.

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[719] Ronan Gill and Tom Collins, 'Permanent Establishment: Up in the Clouds?' (Proceedings of the 12th European Conference on e-Government, Barcelona, 14-15 June 2012).

[721] Gartner, 'Magic Quadrant for Cloud Infrastructure as a Service, 19 August 2013' <http://www.gartner.com/technology/reprints.do?id=1-1IMDMZ5&ct=130819&st=sb> accessed 12 December 2013.

Previously, Netflix's servers in California would certainly have constituted a permanent establishment under the OECD Model.[723] The servers were clearly a fixed place of business, the substance of their business was carried on through those servers, and they were at the disposal of the enterprise. However, having shifted that large part of their business onto the cloud, the hardware that performed the core operations of the enterprise no longer constituted a permanent establishment for the purposes of the OECD Model.

6.4.3 Virtual Permanent Establishments

The permanent establishment standard is a useful proxy for a substantial economic activity test. The rationale behind the permanent establishment standard was that it was, at the material time, extremely difficult to have a substantial economic presence in a jurisdiction without a fixed place of business. That it is now possible to engage in substantial economic activity in a jurisdiction without a fixed place of business is clearly evident. Therefore, if the objective remains the same, then it is arguable that what is required is a supplement to the fixed place of business test.

6.4.3.1 Conceptual basis for Virtual Establishment

A virtual permanent establishment standard is, it is submitted, consistent with both the benefit theory of taxation, and the original purpose and intent of the principle of

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[723] Although as the servers and headquarters were co-located such a question would never arise.

permanent establishment. This thesis has discussed at length the various ways in which online enterprises receive benefits from states notwithstanding their lack of physical presence. The disapplication of the permanent establishment to online enterprises – in particular, its disapplication to websites – is inconsistent with the benefit theory of taxation.

The permanent establishment is a relatively straightforward bright-line test of presence within a jurisdiction. It is argued below that a virtual establishment standard can provide that same simplicity and certainty, without the need for functional analyses of business and network operations. The creation of a new permanent establishment fiction is a comparatively conservative approach, consistent with the evolution of the principle over the past century.

In disapplying the permanent establishment principle to websites, international tax law has taken a considerable step towards residence basis taxation. A virtual establishment threshold would reverse that step. Although the requirement that a permanent establishment be physical in nature was a long held assumption, it was only comparatively recently that it was held to be so by a national court. However, as is discussed below, there exists similarly authoritative jurisprudence to suggest that, in fact, the opposite is true.

6.4.3.1.1 French Radio Case

Curiously little attention has been paid to a 1968 decision of the French Administrative Court. The extent to which this case has been overlooked in the context of electronic commerce is particularly surprising. While the physicality requirement implied in the German pipeline case appears to be considered to be weightily authoritative, this earlier directly contradictory case from the Administrative Supreme Court of another OECD founder member appears to be almost entirely overlooked.

French jurisprudence with respect to permanent establishments relies heavily upon the doctrine of a 'complete commercial cycle'. This, more recently, has come to be defined as 'a set of commercial operations, artisan or industrial directed towards a determined goal and forming a coherent detachable activity by the headquarters.'[725]

A 1968 decision of the French Administrative Court concerned a Monegasque radio station whose broadcast footprint extended into France. The broadcaster had no offices, personnel, or broadcasting equipment within the French republic. The French revenue argued that the broadcaster,

> [c]ompany X [...] whose office is located in the principality of Monaco, [...] collected orders of advertisements provided by French customers to be distributed by radio for French listeners, so that that company

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[725] *French Radio Case* D adm 4 H-1413, 1 March 1965 (Administrative Court, France), Exercise of a Business Activity in France [author's translation].

performed in France a commercial activity, the profits of which were, in principal, liable for income tax.[727]

The court held that, notwithstanding the broadcaster's lack of any physical presence in France, the broadcaster should be liable for tax on the profits derived from advertising sales in France. Though subsequent French practice has followed the OECD Model, this thesis argues that the approach adopted by the French courts in its early jurisprudence is worthy of reconsideration.[729]

The parallel between the business model employed by the Monegasque broadcaster and contemporary online business is considerable. Online enterprises are alleged to avoid Corporation Tax in the UK by 'booking' profits derived from advertising sales at their European headquarters in Ireland. Advertisements are purchased from these companies by British businesses, and such advertisements are

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[727] D Conseil d'Etate no 66 503, 13 July 1968 (Council of State, France), hereinafter the '*French broadcasting case*'.

[729] It is worth noting, however, that there is an ambiguity in the case as a result of the brevity and anonymity of French judgments. While the judgment initially states that the Monegasque broadcaster has no physical presence in France, it later references two pPermanent eEstablishments. While the most logical conclusion is that these pPermanent eEstablishments are legal fictions (perhaps the *situs* of the businesses purchasing advertising) the redacting of French judgments makes it impossible to say for certain. A thorough search of available materials in both French and English reveals unanimity on the part of commentators that the Court constructed these pPermanent eEstablishments in France despite no physical presence. See further, Thierry Pons and Stéphane Gelin, 'Taxation of income derived from electronic commerce, France' [2001] Cahiers de Droit Fiscal International 383.

often exclusively disseminated by domestic consumers. The process is usually entirely automated and involves no interaction with any personnel in Ireland whatsoever.[731]

Achieving a standard similar to that employed in the French broadcasting case could be done in one of two ways. The most conservative option is a qualitative approach to applying the permanent establishment principle to online enterprises. The most radical alternative is the abolition of the permanent establishment standard altogether for electronic commerce, and adoption of a withholding tax on gross income, advocated most prominently by Richard Doernberg, discussed at 8.4. The middle-way, however, would appear to be the adoption of a qualitative approach to applying the permanent establishment principle to online enterprises.

6.4.3.2 Support for Virtual Establishments among States

A number of OECD Member states took a sceptical view of the OECD's position on the taxation of websites and servers. In particular, Spain and Portugal had previously taken the view that a website can constitute a permanent establishment.[733] These positions have shifted over the course of the ten years that have followed the 2003 update to the Commentary.

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[731] Quite unlike would have been the case in Monaco in 1968, where a Monegasque employee would have been necessary to take the order and arrange for transmission of the advertisement.

[733] Arthur J Cockfield, 'Reforming the Permanent Establishment Principle Through a Quantitative Economic Presence Test' (2003) 38 Can Bus LJ 400.

At the adoption of paragraphs 42.1 to 42.10 to the Commentary in 2003, the following observation was included at para. 45.6:

> *Spain* and *Portugal* have expressed a number of reservations on the Report 'Clarification of the permanent establishment definition in e-commerce'. *Greece, Spain,* and *Portugal* have some doubts concerning the opportunity of introducing paragraphs 42.1 to 42.10 of the Commentary in the Model at this time. Since the OECD continues the study of e-commerce taxation, these States will not necessarily take into consideration the aforementioned paragraphs until the OECD has come to a final conclusion.[735]

Portugal subsequently firmed-up its opposition to the OECD treatment of electronic commerce. The Commentary was accordingly amended in 2008, removing Portugal from the above paragraph, adding that '*Portugal* wishes to reserve its right not to follow the position expressed in paragraphs 42.1 to 42.10.'[737]

A number of OECD non-Members also took a sceptical view of the OECD's determination with respect to electronic commerce. Brazil and Chile both lodged observations to this effect.[739] Chile acceded to the OECD in May 2010. Paragraph 45.6 was updated to include Chile's position on electronic commerce; however, at the same time Spain withdrew its reservation and now adheres to the OECD position.

While positions on paragraphs 42.1 to 42.10 have shifted slightly, there remains a latent scepticism about the OECD's approach to electronic commerce. This seems likely to be exacerbated further by the likely accession of further e-

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[735] C(5)-75.

[737] C(5)-43.

[739] P(5)-7, P(5)-24.

commerce importing states into the OECD. Furthermore, in 2013, France became the first large OECD economy to support an amendment to the OECD Model to provide for a Virtual permanent establishment standard.

6.4.3.2.1 French proposals

In 2012, the French Government commissioned Pierre Collin, a member of the Council of State, and Nicholas Colin, an Inspector of Taxes, to prepare a report on the taxation of the digital economy. The Collin and Colin Report[741] was published in January 2013. Among its various recommendations was that the French Government commence seeking an amendment to the OECD Model providing for the addition of a virtual permanent establishment standard. The French Government endorsed this recommendation in its Roadmap for the Digital Economy, published in February 2013.[743] The report made the argument, previously advanced by Skaar[745] and Pinto[747] that

> in the digital economy, the concept of a fixed place of business is no longer relevant to characterize the place from which the substance of the economic activity is exercised.[749]

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[741] Pierre Collin and Nicholas Colin, 'Mission D'expertise Sur La Fiscalité de L'économie Numérique' [2013] Ministère des Finances et de l'Economie [all translations are the author's].

[743] Gouvernement de France, 'Feuille de route du Gouvernement' <<http://www.gouvernement.fr/sites/default/files/fichiers_joints/numerique_feuille-route.pdf>> accessed 16 December 2013.

[745] Skaar, *supra* note 335.

[747] Dale Pinto, 'The Need to Reconceptualize the Permanent Establishment Threshold' (2006) 60 Bulletin for Int'l Taxation 206.

[749] *Supra* note 372.

The report proposes that the G20 would be the most effective forum for negotiating amendments to the OECD Model. It proposes that 'an autonomous definition of the virtual permanent establishment'[751] should be included in the OECD Model. Amendment of the OECD Model should be followed by renegotiation of France's bilateral double taxation treaties in order to include this new definition, in particular with those jurisdictions in which the largest digital economy companies are resident. It recognises that a 'simple modification of the Commentary may not be sufficient, as the current model seems hardly compatible with the new proposed definition.'[753]

The report also argues that through the 'free and voluntary contribution of internet users' to the collection of data that companies would previously expend considerable resources to collect, the consumer effectively acts as uncompensated labour. The report argues that the value attributable to that data collection should be reflected in France's tax laws:

> [i]n the context of the digital economy, it could be considered that a company that provides a service in the territory of a State, using data from the regular and systematic monitoring of users in the territory of that State, should be considered as having a virtual permanent establishment there.

As an interim measure, the report therefore recommends that France unilaterally impose a tax on data collection within France. The report also recommends

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[751] *Supra* note 372 at 121-124.

[753] *Ibid.*

that such a tax could be adjusted favourably towards companies that demonstrate best practice with respect to data collection.

The Collin and Colin Report has clearly had a considerable impact on French fiscal policy. However, it is yet to have any apparent effect on international tax policy. The virtual permanent establishment concept was absent from the communiqué following the G8 Summit at Lough Erne,[755] while only a broad commitment to updating International Tax Rules was contained in the G20's St Petersburg Declaration. However, there appears to be increasing interest in such a proposal, as can be seen in the work of the OECD in advancing the BEPS agenda.

6.4.3.2.2 BEPS agenda

Despite having seemingly previously discounted any approach to nexus that involves the creation of a permanent establishment without a physical presence, the creation of virtual permanent establishment standards have been included by the OECD as potential options for addressing the challenges of the digital economy under BEPS action 1.[757] The OECD outlines three virtual permanent establishments as potential options.

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[755] 'G8 Lough Erne Declaration' G8 <https://www.gov.uk/government/publications/g8-lough-erne-declaration/g8-lough-erne-declaration-html-version> accessed 26 November 2013.

[757] *Supra* note 155.

The first, is a virtual fixed place of business, which would create a permanent establishment when the enterprise maintains a website on a server of another enterprise located in a jurisdiction and carries on business through that website.

The second, is a virtual agency permanent establishment, which would seek to extend the existing dependent agent concept to circumstances in which contracts are habitually concluded on behalf of an enterprise with persons located in the jurisdiction through technological means, rather than through a person.

The third, is the somewhat novel on-site business presence permanent establishment, which would look at the economic presence of an enterprise within a jurisdiction in circumstances in which the foreign enterprise provides on-site services or other business interface at the customer's location.

Though it is not yet clear which option, if any, the OECD favours for addressing the challenges of the digital economy, the relatively cursory manner in which the OECD's discussion paper on action 1 contemplates virtual establishments[759] suggests that it is not an option which they are seriously contemplating. More likely, it is submitted, is the approach favoured by this thesis in chapter 7.

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[759] *Ibid*, p.66.

6.5 A pragmatic standard

Notwithstanding the apparent conceptual deficiencies of the permanent establishment standard, there remain a number of compelling arguments for its retention. These arguments primarily take three forms. The first, is that it is the near-uniform global standard for allocating jurisdiction to tax under tax treaties. The second, is that it works quite well as a proxy for taxing the actual source of income, notwithstanding its conceptual difficulties. The third, is that the permanent establishment standard has proved sufficiently flexible in the past in adapting to changes to the way that enterprises do business internationally – and there is no reason why this flexibility cannot be used to adapt the standard to contemporary challenges posed by virtualisation.

The first of these arguments is certainly the most persuasive. It is often the case that the respective merits and demerits of particular policies are outweighed by the broader virtue of consistency. Lepard explains this by reference to the obligation to drive on the right: that the virtues of driving on one side of the road or the other are less virtuous, generally, than ensuring that everyone drives on the same side of the road.[761] It is arguable that the risks of disrupting the near-uniform consensus on the

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[761] Brian D Lepard, 'Is the United States Obligated to Drive on the Right: A Multidisciplinary Inquiry into the Normative Authority of Contemporary International Law Using the Arm's Lenghth Standard as a Case Study' (1999) 10 Duke J Comp & Int'l L 43.

allocation of the jurisdiction to tax are too great to warrant a shift away from the permanent establishment standard.

Though it may once have been the case that the permanent establishment standard correlated reasonably well to the source of income, it is submitted that this correlation has diminished in recent decades, owing, in particular, to the advent of new technologies. Contemporary disquiet surrounding the permanent establishment standard is based upon a perception that the standard no longer adequately provides for taxation at source – a complaint which this thesis demonstrates is valid.

Finally, though the standard has proven to be adequately flexible in the past, it is submitted that two decades of amending the commentary to the Model Convention has failed to meet the challenges posed by new technologies.

Therefore, notwithstanding the virtues of consistency, where it is clear that a new consensus is emerging – favouring a shift away from the permanent establishment standard, as it is presently constituted, towards a standard that better reflects the conceptual basis for the allocation of jurisdiction to tax, then it is submitted that the pursuance of reform is merited.

6.6 Conclusion

It is too early to conclude that there is a consensus emerging that the permanent establishment standard is in need of replacement. However, there exists a growing body

of academic comment and public policy that suggests that reforming the standard is necessary. This thesis argues that the principle of permanent establishment is a flawed one, however, one that warrants supplementing, rather than replacement. A new virtual establishment fiction, discussed above, would be consistent with the benefit theory of taxation, and shift the jurisdiction to tax back towards the source of income. However, it is arguable that a standard that takes account of the intention of parties to trade substantially within a jurisdiction would be most consistent with the principles outlined in chapter 5.

Chapter 7: Purposeful direction – a qualitative standard

The practicability of the permanent establishment standard's bright-line test is detailed in chapter 6. The paucity of judicial precedent on what is or is not a permanent establishment is testament to the clarity that such a rule brings. Permanent establishments as they are presently defined are usually fairly easy to recognise. However, the fact that a rule is clear and results are predictable does not speak to the justness of such a rule. A perfectly clear and administratively simple rule can produce perverse and unjust results, even when such a rule produces satisfactory results in most instances.

It is clear from the foregoing conceptual analysis that the permanent establishment rule does produce unjust results. It is possible for, on the one hand, a jurisdiction to be deprived of the jurisdiction to tax profits arising as a result of activities within its territory; while on the other, another jurisdiction enjoys the jurisdiction to tax profits that are the product of the scarcest – if any – connections with that state. Furthermore, the jurisdictional threshold applicable to taxation of business profits appears to be far higher than that which applies to other forms of taxation.

There exists a significant body of opinion within academic literature that jurisdictional standards are in need of review.

A practical solution could involve the development of economic presence tests that impose liability on business intermediaries even though they may not have a physical presence within the borders of the relevant tax sovereign.[763]

It is clear from the foregoing analysis that a more conceptually sound approach to determining the jurisdiction to tax requires an inquiry into the economic connections between the jurisdiction in which the business of the enterprise is carried on and the resultant profits. Such an approach would, undoubtedly be a more subjective one. The difficulty associated with such an approach is that such standards depend upon a determination being made as to whether or not such connections are sufficient to warrant the exercise of jurisdiction. Such standards, almost inevitably, result in litigation.

However, parties to international disputes have far less recourse to courts than parties to national disputes. States that are parties to a tax treaty often place differing interpretations upon that treaty, with the result that a taxpayer is subject to double taxation. In such situations, the only avenues available to the taxpayer is recourse to the domestic courts of the contracting states – with no guarantee that the courts of the contracting states will reach the same conclusion; or else reliance upon the highly flawed Mutual Agreement Procedure. The prospect of a litany of differing interpretations emerging from the domestic courts of contracting treaty states would

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[763] Arthur J Cockfield, 'Jurisdiction to tax: A law and technology perspective' 38 Ga L Rev 85.

run fundamentally contrary to one of the core objectives of international fiscal cooperation – harmonisation of tax rules.

However, there appears to be a clear momentum towards improved arbitral structures in the settlement international tax disputes. Effectively implemented, such structures could negate the need for a clear-cut jurisdictional standard in favour of a standard based upon a more qualitative assessment of an enterprise's economic links with a state.

This chapter, therefore, proposes an alternative jurisdictional standard, which hinges upon whether or not an enterprise purposefully directs it activities towards a state. It considers the development of such a standard in the allocation of jurisdiction in the federal context of the United States. It further considers the institutional structures that would be necessary in order for such a standard to be effective, and outlines potential criteria that could be used in the determination of whether or not an enterprise purposefully directs its activities towards a state.

7.1 A (more) qualitative standard

Chapter 6 introduces the idea of a more qualitative approach to determining jurisdictional nexus. The standard proposed by this chapter involves a more subject-oriented inquiry into the relationship between an enterprise and a state. In determining whether or not a state enjoys the jurisdiction to tax the profits of an enterprise, the

competent authority will consider the extent of that enterprise's engagement with the marketplace in that state.

This is a fundamentally different from the approach taken by the permanent establishment standard. Under the permanent establishment standard, the determination of jurisdiction to tax takes no account whatsoever of the sustenance of the relationship between an enterprise and a state. In order to satisfy the permanent establishment standard, it must be shown that an enterprise has at its disposal a fixed place of business through which its business is carried on. Although, as is discussed above, the permanent establishment standard is intended to be a reasonable proxy for a qualitative inquiry into the level of interaction between the activities of an enterprise and the marketplace of a state, it is – as Chapter 6 demonstrates – an imperfect one. Modern business methods and new technologies mean that it is now entirely possible, and indeed commonplace, for an enterprise to have a substantial engagement with the marketplace within a state without any permanent establishment whatsoever.

It is quite likely that most substantive inquiries into the connection between the activities of an enterprise and the marketplace within a state would conclude that enterprises that conduct their business through a fixed place of business do indeed have sufficient connection with that state to justify the jurisdiction to tax. The threshold that must be met in order to satisfy the permanent establishment test is sufficiently high that it is difficult to envisage many permanent establishments as they are presently

constituted that would not also meet a substantive test – save, perhaps, for those which are artificially constituted for avoidance purposes.

However, it is highly likely that a substantive inquiry would reach the conclusion that many more non-resident enterprises fall with the jurisdiction to tax of source states than those that presently do. It is submitted that such a broadening of the jurisdiction of source states to tax the profits of non-resident enterprises is more consistent with the conceptual basis to tax than the permanent establishment standard is.

7.1.1 Subjectivity vs. objectivity

The distinction between the existing permanent establishment standard and a new, more qualitative standard, could be dichotomised as being between an objective and a subjective standard. However, this thesis is reluctant to do so. The standard that is therefore proposed by this thesis would be better described as a qualitative one (or, at the very least, a more qualitative one) whereas the existing permanent establishment threshold standard is a bright-line one. The reason for this is because, as chapter 5 outlines, the source of income is not an *a priori* fact. On that basis, all determinations of

the source of income are, in some way, subjective determinations – notwithstanding the fact that such determinations are made by reference to objective criteria.[765]

The source of income is ultimately a question of judgement. There is no objective truth as to what the source of income actually is. Therefore, as Searle describes,

> [w]e often speak of judgments as being 'subjective' when we mean that their truth or falsity cannot be settled 'objectively', because the truth or falsity is not a simple matter of fact but depends on certain attitudes, feelings, and points of view of the makers and hearers of the judgment.[767]

The lack of an *a priori* notion of the source of income makes a purely objective jurisdictional test impossible. That is why tax conventions do not seek to tax certain kinds of income at source by simply prescribing, for example, that 'the income of an enterprise shall be taxed in the state in which that income has its source'. However, the standard proposed by this chapter does seek to track the subjective intent of enterprises, but in common with all subjective standards, it seeks to do so by reference to objective criteria.

The permanent establishment threshold as it is presently constituted is a qualitative standard. The qualities of which an enterprise is required to be possessed

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[765] It is arguable that in the absence of any means of peering into the mind of a party, all determinations of substantive intention are impossible, and therefore only made by reference to objectively verifiable criteria.

[767] Searle, *supra* note 180.

before it satisfies that standard are detailed above and fairly limited: it must trade through a place of business; and that place of business must be fixed. This chapter simply proposes a *more* qualitative standard. That is to say, a standard that requires consideration of more qualities in the determination of whether or not that standard has been met.

7.1.2 Consistency with conceptual basis to tax

One of the defining characteristics of a permanent establishment is its physicality. The *German Pipeline Case*[769] confirmed that which was already generally accepted, that 'fixed place of business' means physically fixed. However, as Cockfield notes, 'there is no sacred reason why a physical presence requirement should be used to determine nexus for international income tax purposes.'[771]

It has been shown, above, that there exists a number of instances – even under the auspices of the existing permanent establishment threshold – where it is not necessary for an enterprise to have a fixed place of business in a jurisdiction in order for that jurisdiction to justify taxing the profits of that enterprise. Where an enterprise trades in a jurisdiction through a dependent agent, that agent need only habitually conclude contracts within that jurisdiction. It is not necessary for that agent to have a

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[769] *Supra* note 139.

[771] Cockfield, 'Jurisdiction to tax: A law and technology perspective', *supra* note 383.

fixed place of business within the jurisdiction. Furthermore, a number of fictions exist in tax treaties – such as those that apply to offshore oil exploration and extraction[773] – that do not require an enterprise to have a fixed place of business within the territory of a state in order to be subject to its jurisdiction to tax. Under the OECD Model, Article 17 provides that the earnings of non-resident Artistes and Sportsmen are taxable in the jurisdiction where those profits are earned, notwithstanding their lack of any residence or fixed place of jurisdiction within that state. Beyond the taxation of income the jurisdictional threshold under, for example, Europe's harmonised system of VAT is a simple turnover threshold – with absolutely no requirement that an enterprise have any physical presence in the taxing state whatsoever. Therefore companies such as Netflix, which engage in substantial trade within a number of EU Member States but without a permanent establishment in any of them find themselves liable to collect and remit VAT arising from their transactions in those Member States, but without any liability to pay tax on profits arising from those same transactions. It is difficult to divine any conceptual justification for requiring that an enterprise must have a physical presence in a state in order to justify that state exercising its jurisdiction to tax the profits of that enterprise, but that such a physical presence is not necessary to justify the payment of VAT.

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[773] See, for example, UK-Norway Double Tax Convention, Double Taxation Convention between the United Kingdom and Norway signed in London on 14th March 2013.

The permanent establishment standard is intended to reflect an enterprise's participation in the economic life of a state. However, the foregoing chapters have illustrated how easy it is for an enterprise to participate in the economic life of a state without any physical presence located therein. It follows, therefore, that physical presence is no longer the effective proxy for determining participation in the economic life of a state that it once was. A new proxy for such participation is therefore required.

7.2 Jurisdiction to Tax between U.S. States

Without reference to a public court, there exists comparatively little jurisprudence on the allocation of jurisdiction to tax between treaty states. Jurisdictional questions are invariably resolved between contracting states. However, a considerable body of jurisprudence on the allocation of jurisdiction between sub-sovereign states and territories in those states that have highly federalised constitutional arrangements, with multiple tax jurisdictions. With a large single market and numerous taxing jurisdictions,[775] the allocation of jurisdictional competence is the subject of a considerable amount of jurisprudence in the US, in particular.

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[775] All 50 US states levy a corporate income tax. In addition, there were 9,998 different sales tax jurisdictions in operation in the US in 2014, see Richard Borean Joseph Henchman, 'State Sales Tax Jurisdictions Approach 10,000' (*Tax Foundation*, 24 March 2014) <http://taxfoundation.org/blog/state-sales-tax-jurisdictions-approach-10000> accessed 26 August 2015.

The taxation of non-resident enterprises has always been problematic for US states. The Fifth and Fourteenth Amendments to the U.S. Constitution provides that no person shall be 'deprived of life, liberty or property without due process of law.' These are both known as 'Due Process Clauses'.

A further constitutional provision – the 'Commerce Clause' – also places restrictions upon the states' jurisdiction to tax.[777] The Commerce Clause permits the Federal Congress to 'regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes'. Although the Commerce Clause is permissive in nature, and does not explicitly place any prohibition on the actions of states, the clause has long been held to have a 'negative sweep' as well.[779] This restriction on the part of states is commonly referred to as the 'dormant' Commerce Clause.[781] However, such restrictions are rooted in the division of competences between states and the federal government, and not notions of justice or fair play as between the states and/or individuals. As such, the restrictions placed upon the jurisdiction to tax by the Commerce Clause are less analogous to the discourse of the proper allocation of tax jurisdiction between sovereign states than those imposed by the Due Process Clause.

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[777] Art. I, s.8, clause 3, Constitution of the United States of America.

[779] Though the now oft-quoted 'negative sweep' was articulated in *Quill v. North Dakota, supra* note 118, its genesis can be seen in *Leloup v. Port of Mobile* (1888) 127 US 640, 648 which provided that '[N]o state has the right to lay a tax on interstate commerce in any form.'

[781] James F. Murtha, 'Taxing Colonel Sanders: Re-examining constitutional nexus through the lens of KFC v. Iowa' (2013) 35 W New Eng L Rev 55.

The Due Process Clause prevents a state from imposing a tax upon persons over whom that state does not have jurisdiction.[783] These limitations are rooted in notions of justice and fairness, and are therefore worthy of consideration in an abstract discourse as to who should, or should not, have jurisdiction to tax in cross-border situations.

Purposeful availment is a long-standing doctrine of American Constitutional Law. Its purpose is to determine in what cases a state has personal jurisdiction over a party located in another state. An early conception of this doctrine can be seen in *International Shoe Co. v. Washington.*[785] The case concerned a payroll tax on employee wages within the state, and whether or not the jurisdiction to tax ought to extend to non-resident enterprises with employees within the state. The court held that in order to satisfy the Due Process Clause, the jurisdiction of the state could only extend over non-resident enterprises where that enterprise had 'certain minimum contacts with it such that the maintenance of the suit does not offend 'traditional notions of fair play and substantial justice.'"[787]

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[783] Shane Padgett Morris, 'Interstate Commerce and the Future of State Sales and Use Taxes' 54 Ala L Rev 1393, 1398.

[785] *International Shoe Co. v. Washington* (1945) 326 US 310.

[787] *Ibid.*, quoting *Milliken v. Meyer* (1940) 311 US 457, 311 US 463.

In *Hansen v. Denkla* the Supreme Court held that a corporation can be subject to the jurisdiction of a state where it 'purposefully avails itself of the privilege of conducting activities within the forum State.'[789]

Miller Bros v. Maryland[791] concerned a Delaware enterprise that sold merchandise solely through a shop in Delaware. The enterprise did not take orders by post or telephone. Nearby Maryland residents frequented this shop – some taking goods with them back to Maryland; while some other Maryland customers had their goods delivered, either by common carrier or the appellant's own vehicle. The appellant advertised through Delaware newspapers and radio stations which, though not intentionally directed so towards, often came to the attention of Maryland residents. Their periodic sales circulars posted to all former customers included former customers in Maryland.

Maryland imposed an excise tax on the 'use, storage or consumption' of articles of the kind sold by the appellant, and required every vendor to collect this tax. Maryland sought to enforce the collection of the tax against the appellant, and seized the appellant's vehicle while it was within the state. The court held that the attempt to exercise jurisdiction to tax over Miller was inconsistent with due process, which

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[789] *Hanson v. Denckla* (1958) 357 US 235.

[791] *Miller Bros v. Maryland* (1954) 347 US 340.

requires 'some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax.' The court found that this was

> not the case of a merchant entering a state to maintain a branch and engaging in admittedly taxable retail business but trying to allocate some part of his total sales to nontaxable interstate commerce.

The court distinguished *Miller Bros* from the earlier case of *General Trading Co. v. State Tax Commissioner of Iowa*[793] – which concerned an out-of-state enterprise engaging in a continuous local sales solicitation through dependent agents. The court held that

> there is a wide gulf between this type of active and aggressive operation within a taxing state and the occasional delivery of goods sold at an out-of-state store with no solicitation other than the incidental effects of general advertising.[795]

What is apparent from both of these cases is a distinction between passively accepting and fulfilling orders from a jurisdiction, and actively soliciting them. This is approach is, arguably, analogous to the approach adopted by the Scottish courts to jurisdiction over internet transactions, as is illustrated by *Crate & Barrel,*[797] discussed above.

The Supreme Court's judgement in *Wisconsin v. J.C. Penny*[799] is highly informative as to the conceptual basis upon which, in the court's opinion, jurisdiction

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[793] *General Trading Co. v. State Tax Commissioner of Iowa* (1944) 322 US 335.

[795] *Ibid,* 344.

[797] *Supra* note 92.

[799] *Wisconsin v. J.C. Penny* (1940) 311 US 435.

to tax is founded. Wisconsin sought to tax dividend income '[f]or the privilege of declaring and receiving dividends, out of income derived from property located and business transacted'[801] within the state. The use of terminology such as 'privilege' is a clear invocation of benefit theory of taxation. It is also clear that the court took the same view as the revenue authorities of Wisconsin, that the benefit theory founds jurisdiction to tax. This is evident in a number of passages. In declaring that the court is ill-concerned with the form of a tax, but rather its operation, Mr Justice Frankfurter stated that

> [a] state is free to pursue its own fiscal policies, unembarrassed by the Constitution, if, by the practical operation of a tax, the state has exerted its power in relation to opportunities which it has given, to protection which it has afforded, to benefits which it has conferred by the fact of being an orderly, civilized society.[803]

Justice Frankfurter held that the test for whether or not the jurisdiction of a tax is consistent with due process is 'whether the taxing power exerted by the state bears fiscal relation to protection, opportunities, and benefits given by the state.'[805]

The court took an expansive view, too, of the jurisdiction that a state enjoys once that benefit has been conferred: '[t]he fact that a tax is contingent upon events

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[801] *Ibid,* 446.

[803] *Ibid,* 444.

[805] *Ibid.*

brought to pass without a state does not destroy the nexus between such a tax and transactions within a state for which the tax is an exaction.'[807]

> the incidence of the tax, as well as its measure, is tied to the earnings which the State of Wisconsin has made possible, insofar as government is the prerequisite for the fruits of civilization.[809]

In *Wisconsin*, the Supreme Court concluded that the jurisdiction of the state did extend so far as dividend payments by out-of-state corporations provided the enterprise received some benefit from the state. The broad, diffuse conception of benefit employed in *Wisconsin* suggests that it is indeed possible for a state to satisfy due process in the exercise of its jurisdiction to tax over out-of-state enterprises provided that such enterprises enjoy some benefit from the state.

The case distinguished itself from the earlier case of *Connecticut General Life Insurance Company v. Johnson.*[811] In *Connecticut*, the Court took an entirely different approach, stating that

> the states' legislative jurisdiction to tax, prescribed by the Fourteenth Amendment, are to be ascertained by reference to the incidence of the tax upon its objects, rather than the ultimate thrust of the economic benefits and burdens of transactions within the state.[813]

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[807] *Ibid*, 445.

[809] *Ibid*, 446.

[811] *Connecticut General Life Insurance Company v. Johnson* (1938) 303 US 77.

[813] *Ibid*, 80.

The court in *Connecticut* took an approach to tax jurisdiction that was based in practicality, rather than theory. Here, we see the jurisdiction to tax founded not upon benefit, but upon control – with the court taking the view that 'it is that a state which controls the property and activities within its boundaries of a foreign corporation admitted to do business there may tax them.' Although this approach taken by the court is undoubtedly driven by practical considerations with respect to enforcement, *inter alia* – it is possible to construe some notion of benefit or privilege from the words 'admitted to do business there'. The use of 'admitted' appears to infer at least some notion that the state has permitted the enterprise to do business within its jurisdiction, and that jurisdiction is at least in some respect founded upon notions of a *quid pro quo.*

It is clear from the foregoing, however, that it is the benefits based approach articulated in *Wisconsin* and *International Shoe, et al.,* which dominates U.S. jurisprudence on the allocation of the jurisdiction to tax. It is this approach to the conceptual basis for jurisdiction that is evident in some of the more recent jurisprudence relating to taxation of out-of-state retailers.

An early progenitor to the highly virtual enterprise with which this thesis is concerned is the catalogue retailer. Such retailers would distribute catalogues in jurisdictions in which they need not have any physical presence in the jurisdiction – nor need they ever actually enter the jurisdiction in order to do business. Catalogues can be distributed by common carrier, orders could be placed either by post or telephone, and

fulfilled again by common carrier. This, in many respects, is analogous to our online ordering/offline delivery model of electronic commerce.

This situation was considered in *National Bella Hess v. Illinois.*[815] National was a catalogue retailer who traded as described above. The Illinois Department of Revenue sought to enforce collection by National of a use tax upon sales of goods sold to customers located within the jurisdiction. While the court primarily relied upon the Commerce Clause to hold that the enforcement of jurisdiction to tax was unlawful, it also considered the line of precedent concerning due process. The court held that there is a 'sharp distinction' between

> mail order sellers with retail outlets, solicitors, or property within a State and those who do no more than communicate with customers in the State by mail or common carrier as part of a general interstate business.[817]

In *Keeton v. Hustler Magazine, Inc.,* the court held that purposeful availment requires that a party will not be haled into a jurisdiction solely as a result of random, fortuitous, or attenuated contacts.[819] However, jurisdiction is proper where the actions of a party create a 'substantial connection' with that state.[821]

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[815] *Supra* note 335.

[817] *Ibid,* 757.

[819] *Keeton v. Hustler Magazine, Inc.* (1984) 465 US 770.

[821] *McGee v. International Life Insurance Co.* (1957) 355 US 220.

In *World-Wide Volkswagen v. Woodsen* – a product liability case – the U.S. Supreme Court held that it is not contrary to the Due Process Clause where a person 'delivers its products into the stream of commerce with the expectation that they will be purchased by consumers in the forum State'.[823]

In *Asahi Metal Industry v. Superior Court* Justice O'Connor elucidated a number of different conducts that could be used to determine whether or not an enterprise purposefully directs its activities towards a particular state, including

> designing the product for the market in the forum State, advertising in the forum State, establishing channels for providing regular advice to customers in the forum State, or marketing the product through a distributor who has agreed to serve as the sales agent in the forum State.

In this instance Justice O'Connor took the view that purposeful direction required more than merely making goods available for sale in a jurisdiction. The above list of conducts are, in her view, additional conduct that is necessary in order to form a substantial nexus with a state. However, the majority of the Supreme Court in *Asahi* disagreed with Justice O'Connor, and held that placing a product into the stream of commerce of a state is sufficient by itself to create that nexus provided that the enterprise is aware that their product is being marketed in the forum state.

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[823] *Asahi Metal Industry v. Superior Court* (1980) 444 US 286.

In *Burger King v. Rudzewicz* the court again affirmed the 'purposefully directed' test.[825] Though the court in this case found that a physical presence within a state enhanced the jurisdictional claim of that state, a physical presence is not necessary to found that jurisdictional link:

> Jurisdiction in these circumstances may not be avoided merely because the defendant did not physically enter the forum State. Although territorial presence frequently will enhance a potential defendant's affiliation with a State and reinforce the reasonable foreseeability of suit there, it is an inescapable fact of modern commercial life that a substantial amount of business is transacted solely by mail and wire communications across state lines, thus obviating the need for physical presence within a State in which business is conducted. So long as a commercial actor's efforts are 'purposefully directed' toward residents of another State, we have consistently rejected the notion that an absence of physical contacts can defeat personal jurisdiction there.[827]

However, it is in the seminal decision of *Quill v. North Dakota* that the United States' Supreme Court appears to have settled its position with respect to jurisdiction over out-of-state enterprises.[829] While the outcome of *Quill* is that it *is* unlawful for states to exercise their jurisdiction to tax over enterprises that lack a physical presence within their territory – this prohibition is the product of the Commerce Clause of the Constitution, and not the Due Process Clause.

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[825] *Burger King v. Rudzewicz* (1985) 471 US 462.

[827] *Ibid*, 469.

[829] *Supra* note 118.

With respect to due process, the Court in *Quill* took an altogether more permissive view of a state's jurisdiction to tax out of state vendors. The court found that the rationale in *Burger King* also justifies 'the imposition of the collection duty on a mail order house that is engaged in continuous and widespread solicitation of business within a State.' In placing such rules in a more contemporary commercial setting, the court held that

> [i]n 'modern commercial life' it matters little that such solicitation is accomplished by a deluge of catalogs rather than a phalanx of drummers: the requirements of due process are met irrespective of a corporation's lack of physical presence in the taxing State.[831]

Therefore, though in *Quill* North Dakota was prohibited from exercising its jurisdiction to tax Quill owing to its lack of physical presence, it was not because such an exercise of jurisdiction would be offensive to 'traditional notions of fair play and substantial justice.'[833] It would appear that the exercise of jurisdiction over an enterprise that trades in a jurisdiction without any physical presence is entirely compatible with the US Court's conception of due process, provided that such an enterprise purposefully directs its activities towards that jurisdiction.

This line of cases is a clear endorsement of the benefit principle for founding jurisdiction to tax. There is no reason why the jurisdiction of a sovereign state's right to

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[831] *Ibid.*

[833] *Supra* note 395.

tax ought to be founded on principles that are in any way different from those that found the tax jurisdiction of sub-sovereign state. Indeed, this thesis wholeheartedly endorses the benefit principle as conceptual basis for the allocation of jurisdiction to tax in chapter 5.

7.3 Proposed new Model Articles

Chapter 3 detailed the evolution in jurisprudential thinking with respect to how and when jurisdiction should be exercised over the Internet. Some approaches to online jurisdiction are the product of dated thinking about the way that communications media operate. These approaches conceive of the Internet as a mono-directional medium. However, as this thesis argues in Chapter 3, contrary to the approach taken in cases like *Yahoo! v LICRA*,[835] the content on the Internet does not radiate to every device with a network connection. Instead, this thesis endorses the approach articulated in *Crate & Barrel* by Jacobs J, with the analogy that

> using the Internet was more like the user focusing a super-telescope into the site concerned. [...] [T]he Internet conveys the idea of the user *going to* the site—'visit' is the word. Other cases would be different—a well-known example, for instance, is Amazon.com. Based in the U.S. it has actively gone out to seek world-wide trade, not just by use of the

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[835] *Supra* note 82.

name on the Internet but by advertising its business here, and offering and operating a real service of supply of books to this country.[837]

This approach to allocation of jurisdiction over the Internet bears some considerable similarity to the purposeful direction standard employed in the U.S. and advanced in this thesis.

Likewise, this thesis endorses the position of the British Government with respect to paragraphs 42.3-42.5 of the OECD Commentary to Article 5 that a server should never constitute a permanent establishment. At the conceptual level, a server does not perform income-producing activities sufficient to warrant the exercise of jurisdiction to tax. At a pragmatic level, computer hardware is easily movable, while the proliferation of ultra-high speed Internet means its physical location is largely irrelevant to the functions it performs – making it all the easier to use computer hardware as a means of tax avoidance.

This thesis endorses the argument of Klaus Vogel, that the allocation of jurisdiction to tax under tax treaties is based upon the benefit principle.[839] Furthermore, this thesis endorses the argument advanced by Arvid Skaar,[841] Dale Pinto,[843] and Arthur Cockfield,[845] among others, that it is not necessary to have a

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[837] *Supra* note 92.

[839] *Supra* note 176.

[841] *Supra* note 335.

[843] *Supra* note 224.

[845] *Supra* notes 216, 387.

physical presence within a state in order to benefit from the legal, economic, and technical infrastructure of that state.

Therefore, in the alternative, this thesis proposes a shift to a jurisdictional standard, not based solely on physical presence within a state – but with consideration, also, of whether or not an enterprise purposefully directs its activities towards that state. Such a standard, it is submitted, would better reflect the economic realities underlying 21st century commerce.

In implementing such a standard, it would be necessary to amend the OECD Model, and the bi-lateral tax treaties based thereupon. This could be done in one of two ways. The first, is to replace the permanent establishment standard with a purposeful direction standard – with the fixed place of business, and dependent agent standards, and new standards, being mere evidence of purposeful direction. The second, more conservative approach, is to supplement the fixed place of business and dependent agent permanent establishment standards with a third 'purposeful direction' standard – specifically intended to capture the activities of highly virtual enterprises.

The second approach mainly involves adding to, and not replacing, existing treaty provisions – which is by far a more achievable approach. It is therefore this second approach that this thesis proposes.

7.3.1 Qualitative criteria for determining jurisdiction

7.3.1.1 Location identification

Contrary to early fears about the anonymity the Internet affords, identifying the location of users is fairly straightforward. There are a number of reasons, unrelated to tax laws, why an enterprise might want to collect and use information about the location of its users. Often a website will use such information to tailor content to particular users. Furthermore, intellectual property restrictions, such as licence conditions for copyright material, may require such content only be available in particular jurisdictions.

At a basic level, many websites request that users select their jurisdiction upon accessing a website. At a more technical level, you can usually tell what country a user is accessing a site from by their IP address. Furthermore, it is entirely common for information about cellular towers and GPS data to be used to determine the location of users. Where a website uses location information to target content at users from a particular jurisdiction, then that website could be considered to be trading in the jurisdiction to which it targets content. If, on the other hand, a website uses such information to exclude users from particular jurisdictions, then it should not be considered to be trading in those jurisdictions.

7.3.1.2 ccTLDs

The use of country code Top Level Domains ('ccTLDs'), such as .co.uk and .ie, as opposed to generic Top Level Domains ('gTLDs'), such as .com and .net, could be used to determine an enterprise's intended market. Although principally aimed at users in the United States, gTLDs are widely used to target a general class of Internet users. However, the use of ccTLDs for a website indicates a specific target audience. Many enterprises trade through multiple ccTLDs in order to give users the impression that they are a domestic concern. While some ccTLDs (such as '.co.uk') are available to all applicants, an application for a '.ie' domain requires applicants to demonstrate a 'real and substantive link to Ireland'.[847]

7.3.1.3 Language

The language in which a website is written can provide some evidence of an online enterprise's intended market. A website written in English, Spanish, or Arabic tells you very little about its target audience (although combined with other factors it could be decisive). However, a website written in Polish, Finnish, or Swedish creates the – at least, rebuttable – presumption that the intended market for that content is Poland, Finland, or Sweden, respectively.

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[847] IE Domain Registry Ltd., 'IEDR Registrations Policy' <https://www.iedr.ie/registrations-policy/> accessed 9 December 2013.

7.3.1.4 Currency

The capability to accept payment in almost any currency is a common feature of most online enterprises. Most financial institutions offer the ability to make or accept payments in multiple currencies to both merchants and consumers. Accepting payment in a particular currency is not particularly determinative of the intended marketplace. However, the currency in which prices are displayed on a website can also be used to determine the intended marketplace, in particular where that currency is fairly limited in use. While the Euro or US Dollar may not be particularly definitive, it is reasonable to conclude where prices are displayed in Canadian Dollars or Swedish Krona that the intended marketplace is Canada or Sweden, respectively.

7.3.1.5 Critiquing the qualitative criteria

None of the above options for determining whether an enterprise is 'trading in' a jurisdiction rather than 'trading with' offers a definitive answer. The assumptions that can be made from each of the criteria are easily rebuttable. However, when taken together, the criteria can often provide a compelling case for determining that a particular enterprise trades in a particular jurisdiction. A website written in Spanish tells us little about its intended market – however a website written in Spanish which displays prices in Euro leads to the conclusion that the intended market is Spain. Consider the example of Rio Grande LLC, an American company that trades through riogrande.co.uk, which is written in English, and displays prices in Sterling. Rio Grande

might find it difficult to rebut the conclusion that they are trading in the UK. Conversely, notwithstanding the fact that it is possible for consumers from the Republic of Ireland to purchase through Rio Grande, it becomes difficult to argue that Rio Grande trades in Ireland on the strength of sales alone, even if sales in Ireland are quite substantial.

The inherent attractiveness of the permanent establishment standard is that it provides a relatively clear and objective test – a 'bright line' threshold. Though imperfect, it provides clarity and certainty to both traders and treasuries as to the level of contact necessary between an enterprise and a state before the state will subject the enterprise to tax. A qualitative standard for virtual establishments lacks that attractive certainty.

It would be relatively straightforward to manipulate a qualitative standard, as none of the applicable criteria relates to labour, property, or capital. Altering the domain through which a website operates, and the content thereupon, is a relatively straightforward exercise, which could open up considerable opportunities for tax avoidance.

Furthermore, a qualitative approach could create a fictional economic presence in one jurisdiction where none in-fact exists, whilst restricting the jurisdiction of another state in which an enterprise may have a substantial economic presence. In the

fictitious example of Rio Grande, above, the fiction that grants the UK jurisdiction to tax does nothing for Ireland, notwithstanding substantial sales within its borders.

7.3.2 Draft articles

It is proposed that Article 7 of the OECD Model would remain unchanged under the approach proposed by this thesis. However, Article 5 would require a number of amendments. It is proposed than an additional paragraph could be inserted after paragraph 3 as follows:

> 4. Notwithstanding the provisions of paragraphs 1 and 2, where an enterprise purposefully directs its activities towards a Contracting State, those activities shall be deemed to have taken place through a permanent establishment situated within that Contracting State.

Such a provision would therefore create a deemed permanent establishment within a state where an enterprise has purposefully directed its activities towards that contracting state. However, of crucial significance would be the definition of 'purposefully directs'.

For this, it is proposed that the criteria outlined in above for determining jurisdiction on the Internet ought to be used. It is proposed that 'purposefully directing' be defined as 'actively soliciting trade or custom from a Contracting State'. It is further proposed that such solicitation should include, especially:

a. directing marketing or advertising campaigns towards that State;
b. displaying or communicating information about products or accepting orders in the local language or languages of that State;

c. displaying or communicating prices or accepting payment in the local currency of that State;
d. offering favourable delivery terms to customers located within that State;
e. selling products or providing services that are uniquely suited to that State, in particular products or services that are licensed, controlled, or regulated by or within that State.

Other evidence of purposeful direction that might apply exclusively in an online context might include the use of ccTLDs,[849] or the tailoring of content to specific jurisdictions through geo-location.[851]

Finally, the proposed additions should be subject to an additional exception for passive commerce, where an enterprise holds itself out as capable of receiving offers without any significant effort to solicit trade, custom, or sales from that other Contracting State.

The distinction between passive and active engagement with a marketplace is not a novel one. The EU's Regulation on the application of Article 101(3) of the Treaty on the Functioning of the European Union to categories of vertical agreements and concerted practices (the Block Exemption Regulation) makes such a distinction. The Block Exemption Regulation provides a general exemption for vertical agreements from the EU's prohibition on cartels and anti-competitive agreements under Article 101. Article 4 of the Block Exemption Regulation excludes certain practices from the block exemption, including the "restriction of active or passive sales to end users by

[849] Such as a .co.uk domain, as opposed to a .com domain.

[851] For example, by only permitting people located within specific jurisdictions to access certain content.

members of a selective distribution system operating at the retail level of trade"[853] The Block Exemption Regulation also specifically permits "the restriction of active sales into the exclusive territory or to an exclusive customer group reserved to the supplier or allocated to the supplier to another buyer, where such a restriction does not limit sales by the customers of the buyer".[854] It therefore becomes necessary to distinguish between active sales and passive sales in a similar manner to that which this thesis proposes.

The Commission's guidelines on vertical restrictions provide that the two terms should be defined as follows:

> – 'Active' sales mean actively approaching individual customers by for instance direct mail, including the sending of unsolicited e-mails, or visits; or actively approaching a specific customer group or customers in a specific territory through advertisement in media, on the internet or other promotions specifically targeted at that customer group or targeted at customers in that territory. Advertisement or promotion that is only attractive for the buyer if it (also) reaches a specific group of customers or customers in a specific territory, is considered active selling to that customer group or customers in that territory.
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> – 'Passive' sales mean responding to unsolicited requests from individual customers including delivery of goods or services to such customers. General advertising or promotion that reaches customers in other distributors' (exclusive) territories or customer groups but which is a reasonable way to reach customers outside those territories or customer groups, for instance to reach customers in one's own territory, are passive sales. General advertising

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[853] Art. 4(c), Commission Regulation 330/2010 of 20 April 2010 on the application of Article 101(3) of the Treaty on the Functioning of the European Union to categories of vertical agreements and concerted practices [2010] OJ L102/1.

[854] Art. 4(b)(i), *Ibid.*

> or promotion is considered a reasonable way to reach such customers if it would be attractive for the buyer to undertake these investments also if they would not reach customers in other distributors' (exclusive) territories or customer groups.[855]

In essence, under EU law, where a supplier sets up an exclusive distribution network, that supplier may legitimately prevent its distributors from *actively* selling into a jurisdiction other than the jurisdiction they have agreed to, but the supplier may not prevent distributors from *passively* selling into another jurisdiction. The Commission has explicitly recognised the significance of this distinction where online selling is concerned.

The advantages of importing a pre-existing set of definitions are obvious. It provides a body of previously known jurisprudence and a common understanding of terms which, freshly defined, would otherwise take years to develop.

There is little denying the enormity of these proposals. Amendments to the core principles of the OECD Model Convention have – to date – been few and far between. Article 7 was amended in 2010, though the changes were semantic, while Article 5 was last amended in 1977 (and, again, these amendments were fairly minor). The fixed place of business and dependent agent permanent establishments has existed as the sole jurisdictional thresholds for the taxation of business profits since the model articles of the League of Nations agreed in 1928.

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However, the longevity of a rule ought not, of itself, perpetuate that rule. The evidence that the permanent establishment standard, as it is presently constituted, no longer reflects the realities of modern commerce, it is submitted, is overwhelming. The ongoing BEPS agenda of the OECD and G20, discussed below at 7.6, may well provide the both the political onus and the opportunity to review the permanent establishment standard. The OECD has already indicated that a review of Article 5 to include a virtual permanent establishment standard is one of the options under consideration.[856]

However, it is not the case that the permanent establishment standard is fundamentally flawed. It is simply that its scope is not wide enough. Those enterprises that trade in a jurisdiction through a fixed place of business situated therein all likely engage substantially with the economic life of that jurisdiction. Furthermore, it is not denied that when the permanent establishment standard was originally conceived of, it likely covered almost all instances where an enterprise engaged substantially in the economic life of a state. To do so without a fixed place of business or a dependent agent within that state would have been almost impossible. However, where the opportunities to participate in the economic life of a state expand beyond existing jurisdictional standards, it is right that those jurisdictional standards should expand too.

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[856] See 6.4.3.2.2, above.

7.4 Support for a more qualitative standard

The approach favoured by this chapter is not entirely theoretical. A more qualitative jurisdictional standard has been proposed in an early draft of the Model Convention, and enacted in at least one tax treaty.

An early progenitor of the OECD Model Convention prepared by the Fiscal Subcommittee of the League of Nations – the so-called 'Mexico Draft' – took an approach very similar to the one proposed. It included an expanded permanent establishment article, with a supplementary clause permitting a source state to tax the profits of a non-resident enterprise where it had substantial sales within a state, notwithstanding the absence of a permanent establishment located therein. Art. IV, para. 2 of the Mexico Draft provided that

> If an enterprise or an individual in one of the contracting States extend their activities to the other State, through isolated or occasional transactions, without possessing in that State a permanent establishment, the income derived from such activities shall be taxable only in the first State.[857]

The standard provided for in the above paragraph clearly has as its object a jurisdictional nexus over the sorts of activities that the standard advanced by this thesis seeks to capture. This standard, according to Skaar, hinges not upon the 'significance or

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[857] Fiscal Committee, *Mexico Draft Model Convention for the Prevention of International Double Taxation of Income and Property* (League of Nations, Doc D/Fiscal/128, 1942).

location' of the activities of the enterprise, but instead upon 'regularity or location' for the activities.[859]

Furthermore, as Cockfield notes, the majority of the subcommittee responsible for this draft were drawn from Latin American countries – who sought to strengthen taxation at source under the model articles. Given that, as this thesis argues, source taxation best befits the benefit theory of taxation, it is highly arguable that this approach better reflects the core principles of international taxation.

The subsequent London Draft of the League of Nations Model Articles reverted to the earlier form of permanent establishment that focused on the need for a fixed place of business. Unlike the Mexico draft, the London Draft subcommittee was dominated by capital exporting nations – which might explain the reversion to a more restrictive sourcing provision.

However, there is also at least one tax treaty presently in-force in which a broader jurisdictional standard is employed than that which exists under the OECD Model Convention. Under the Multilateral Double Taxation Convention of the Andean Community, source states enjoy a far broader jurisdictional basis on which to tax business profits, of which a permanent establishment is only one example.

Article IV of the Andean Tax Convention provides that

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[859] *Supra* note 335.

> [r]egardless of the nationality or domicile of the persons, income of any nature obtained by them will only be taxable in the Member Country in which such income has its source of revenue, except for exceptional cases provided in this Convention.[861]

Article VII further provides that '[p]rofits resulting from business activities will only be taxable in the Member Country where such activities took place.'[863] Article VII provides a non-exhaustive list of examples where an enterprise has business activities within a Member State, which largely resembles the list provided for in paragraph 2 of Article 7 of the OECD Model – with the additional inclusion of an 'agent or representative'.

There exists, too, other examples of add-ons to jurisdictional threshold standards within double taxation conventions. Such examples can be seen in the UK-Norway Double Taxation Convention. Under the UK-Norway convention, Article 5 contains an additional paragraph, which provides that

> where an enterprise of a Contracting State performs services in the other Contracting State through an individual who is present in that other State for a period or periods exceeding in the aggregate 183 days in any twelve month period, and more than 50 per cent of the gross revenues attributable to active business activities of the enterprise during this period or periods are derived from the services performed in that other State through that individual, the activities carried on in that other State in performing these services shall be deemed to be carried on

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[861] Convenio para evitar la doble tributación entre los Países Miembros, Decision 40, 7th Session, Commission of the Cartagena Agreement (1971).

[863] *Ibid.*

through a permanent establishment of the enterprise situated in that other State.[865]

The object of such a provision is clearly to allow a state to capture the activities of an enterprise where such an enterprise conducts the major proportion of its business activities in that state without having a fixed place of business situated therein. Combined with the special provisions contained within Articles 21-23, these provisions of the UK-Norway Convention are designed to accommodate offshore mineral exploration and extraction in the North Sea. Further such 'deeming' provisions can be seen in the Nordic Double Taxation Convention,[867] the UK-Denmark Double Taxation Convention,[869] and the UK-Ireland Double Taxation Convention.[871]

Offshore oil exploration an extraction is an example of an industry that was barely existent during the formation of present-day jurisdictional rules. As a consequence of advent of this new industry, jurisdictional standards were expanded to accommodate it. These examples all illustrate that there is no conceptual reason why the permanent establishment standard cannot be expanded beyond the bounds currently provided for in the OECD Model where new industries and practices emerge.

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[865] *Supra* note 388.

[867] Article 21, Agreement between the Nordic Countries oer the avoidance of double taxaiton with respect to taxes on income and capital, signed at Helsenki on 12 September 1989.

[869] Article 28A, Double Taxation Convention between the United Kingdom and Denmark signed on 17 December 1980.

[871] Article 5(5), Double Taxation Convention between the United Kingdom and Ireland signed in Dublin on 2 June 1976.

However, while these examples demonstrate why there is no practical reason why the permanent establishment standard cannot be expanded, it does not necessarily follow from this that it should be expanded to include a substantive standard. However, support for a more substantive standard does exist.

In *Piedras Negras*[873], a company incorporated and resident in the Republic of Mexico operated a radio station at Piedras Negras, just south of the border with the United States. While the station's broadcasts radiated in all directions, the majority of the station's listener base appeared to be in the United States, and 95% of its revenue derived from advertisers within the US. The company had no physical presence within the United States, and its advertising contracts were handled by an independent agent. Notwithstanding the fact that the overwhelming majority of the commercial activity of this enterprise took place in the United States, the Federal Court of Appeals declined to hold Piedras Negras US sourced income as taxable under Federal Tax law. Pinto cites the US *Piedras Negras* case as evidence that a tax nexus cannot be founded on the basis of a customer base.

However, it is apparent from the judgement in this case that the exercise engaged upon by the court was solely an interpretation of Federal Tax law and not of treaty principles. A different outcome can be seen in the French court's application of the permanent establishment principle to a case with similar facts.

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[873] *Commissioner of the Internal Revenue v. Piedras Negras Broadcasting Company* (1942) 127 F2d 260.

In the *French Radio Case*, discussed above, the French Council of State held that, notwithstanding the broadcaster's lack of any physical presence in France, the broadcaster should be liable for tax on the profits derived from advertising sales in France.[875] The rationale being that the Monegasque broadcaster traded through a permanent establishment located in France because a complete commercial cycle took place therein – an extremely broad interpretation of the permanent establishment standard, to say the least.

Elgard Allix expressed support for a broad conception of a state's jurisdictional nexus over those who participate in the economic life of that state:

> L'Etat a jurisdiction fiscale, en vertu de l'allégeance économique, sur tous ceux qui participent à sa vie économique ou sociale.[877]

Allix' notion of economic allegiance is evident in the works of other notable European authors, including Georg Schanz and Klaus Vogel.

Georg Schanz, in 1982, rejected both residence and mere physical presence as the criterion by which we should determine jurisdiction to tax. Schanz took the view that both of these criteria lead to jurisdiction to tax being awarded to jurisdictions provide no or little benefit to the taxpayer in question.[879] The corollary of this is,

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[875] *Supra* note 365.

[877] 'The state has tax jurisdiction, under economic allegiance, over all of those involved in its economic or social life.' (author's translation), Elgard Allix, 'La condition des étrangers au point de vue fiscal' (1937) 61 Recueil des Cours 541.

[879] Georg Schanz, 'Zur Frage der Steuerpflicht' FinanzArchiv/Public Finance Analysis 1.

according to Schanz, that a burden is therefore placed upon those taxpayers to the benefit of those who enjoy the full benefits provided by the state which, in Schanz' view, would be unfair.

Schanz proposes, as an alternative to the permanent establishment threshold standard, a new test of 'economic allegiance'. Schanz' new standard can be based upon either consumption, or business activity. Schanz proposes that while residence is a reasonable proxy for consumption, it cannot be the sole criterion. Where a person is economically allied not only to the state in which they are resident, but also to a state in which they engage in business activities or earn income, then it is to that source state that the person's primary economic allegiance is owed.[881] Schanz therefore proposes a division of the jurisdiction to tax, with the lions' share being allocated to the jurisdiction of source. Under Schanz' proposal, the source state would levy three-quarters of the tax it would charge had the taxpayer also been resident in the jurisdiction, while the state of residence would only levy one-quarter of the tax it levies on residents whose income derives from within its territory.

Schanz acknowledges that his proposal, and the justification for it, bears a striking resemblance to the benefit principle, which at the time had not undergone its more recent reassessment in the eyes of the academy. Schanz defends his proposal

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[881] Ibid.

against the argument that it undermines the principle of progressive taxation, by distinguishing between the rationale for the basis of a tax and its progressivity:

> indeed there is no tax for which no benefit relation relates [...] I, likewise, cannot admit that by limiting tax liability according to economic allegiance of persons, a proportional tax rate [...] would ensue. Tax basis and tax rate are two different subjects. [...] Tax liability is made dependent upon an economic relation; after the circle of taxable persons has thus been determined, [...] society may say: each person economically bound to me is taxed [...] to exonerate the economically weak [...] according to a progressive system.

Schanz proposal is strongly endorsed by Klaus Vogel, who laments the fact that it has never been put into practice.[883] Vogel contends that Schanz proposal is an 'equitable solution' where only income taxes are concerned. However, where the residence state also levies a litany of indirect taxes, as most developed states do, then Vogel argues that Schanz' proposal should be taken even further, allowing the source state to tax the entirety of the income derived within its territory. Vogel contends that 'indirect taxes already compensate for the services the state provides, and that, therefore, taxation exclusively by the state of source would be fully legitimate.'[885]

Cockfield too expresses support for expanding the permanent establishment standard, arguing that

> governments could get together to negotiate a solution to [the challenges of the new economy] through the development of, for

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[883] *Supra* note 176.

[885] *Ibid.*

example, a test that would permit source states to exert their tax jurisdiction over significant incoming profits even without a permanent establishment.[887]

While recognising that theoretical arguments on balance favour the existence of a customer base as a basis upon which jurisdiction to tax should be founded, Dale Pinto does not see any scope for such a basis under existing permanent establishment rules. Pinto cites *Piedras Negras* in support of this conclusion.

It is certainly difficult to see how the existing rules could be re-interpreted, by the Commentary, or otherwise, to include a standard as broad as that which is proposed by this thesis. It is for this reason, therefore, that this thesis proposes amending, rather than re-interpreting Article 5 of the OECD Model Convention.

However, though there is a strong conceptual case to be made for a more qualitative standard for determining jurisdiction to tax, and though there is no reason why a broadening of the jurisdictional rules contained within treaties cannot work in practice – it remains to be seen whether or not a qualitative rule which has as its object the determination of a subjective intention to engage in the economic life of a state can actually work in practice.

The clarity offered by existing rules requires little in the way of institutional framework in order to operate. However, a shift to a more qualitative rule would, it is

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[887] Cockfield, 'Jurisdiction to tax: A law and technology perspective', *supra* note 334, 109.

submitted, require greater recourse to an arbitral body than the permanent establishment standard does, as it is presently constituted.

7.5 Necessary features for a substantive standard to work in practice

There is an inevitable trade-off when deciding whether to move away from a relatively clear rule like permanent establishment towards a more substantive standard. The trade-off is an inherently practical consideration.

The permanent establishment rule, however imperfect, is extremely clear-cut. It is, in most cases, fairly obvious when a permanent establishment is in existence. One explanation for the relative paucity of jurisprudence considering whether or not a permanent establishment exists could quite plausibly be that it is a question that very seldom arises. Notwithstanding the failings of the permanent establishment standard as a jurisdictional rule, one of its overwhelming virtues is its clarity.

The alternative proposed by this chapter is, admittedly, far less clear-cut. Qualitative rules inevitably involve a largely subjective assessment of individual circumstances in each case. That is not to say that in every case the outcome will be disputable – however it is undoubtedly the case that the scope for dispute is far wider in the application of a more qualitative rule.

Such substantive inquiries are not unusual in international taxation law. Within the subject matter of the OECD Model Convention there are a number of standards

that are determined by a subjective assessment of numerous factors. The determination of the domicile of a person in common law jurisdictions involves an assessment of numerous factors, including birth, residence, and the intention of the person – which is highly subjective. Similarly, the common law test of corporate residence hinges upon the corporation's place of effective management.[889] Such subjective assessments are not confined to the common law either. A desire to restrict the number of 'loopholes' available for exploitation in taxation law has led to the utilisation of less formalistic and more flexible statutory rules. One such example would be General Anti-Avoidance Rules (GAARs), which hinge upon the intentions of both the legislature that enacted the rule and the party who seeks to gain a tax benefit from it. According to Krever and van Brederode, GAARs amount to legislation by interpretation.[891]

It does not follow, therefore, that such substantive rules are incompatible with the international tax legal order. However, while the subtle contours of domicile and corporate residence are well understood, such a new standard would not benefit from the long history that our tests of domicile and corporate residence enjoy. It is arguable, therefore, that in order for a new substantive rule to be introduced and to work effectively, recourse to an effective dispute resolution mechanism is necessary.

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[889] *De Beers Consolidated Mines, supra* note 234.

[891] R. F. W. van Brederode and Richard E. Krever, *Legal interpretation of tax law* (Kluwer 2014), p.10.

7.5.1 Characteristics of effective dispute resolution

Dispute resolution under tax treaties has a number of objectives. However, it is worth noting, as Altman does,[893] that the objectives of governments and taxpayers with respect to dispute resolution are not necessarily aligned.

On the government side, Altman identifies three objectives of government in the way disputes are settled under tax treaties. First, is a determination by state governments to maintain their hegemony over tax collection, tax policy, and tax legislation. Second, is the need to protect their revenue sources while simultaneously co-ordinating the allocation of the tax base and maintaining good relations with other states. Third, the need to balance, on the one hand, the desire to avoid conflicts with other states, with, on the other, the need to protect their own taxpayers from excessive taxation in other states, all the while attracting inward investment.

The taxpayer, however, favours compliance, stability, predictability, and low risks and costs. The taxpayer is obviously less concerned with the state's hegemony over its public finances and more with ensuring that states cannot change the rules of taxation *ex post.*

Altman also holds the view that taxpayers and tax administrators share a number of objectives, such as the desire to resolve disputes expeditiously, cheaply, and

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[893] Zvi Daniel Altman, *Dispute resolution under tax treaties*, vol 11 (IBFD 2005), pp.444-251.

in a manner which helps prevent future disputes from arising.[895] However, Altman also identifies the inherent tension between taxpayers, who will naturally wish to limit their liability to pay tax, and administrators, who generally seek to maximise revenues.

Park identifies four elements that are fundamental to effective tax arbitration.[897] The first, is that contracting states must make irrevocable commitments to arbitrate, rather than merely making expressions of good will from which they might later recant if the outcome does not suit them. The second, is that the process must be capable of being initiated by taxpayers, as well as the competent tax authorities. The third, is that the outcome must bind both taxpayers and tax authorities, with no possibility of decisions being overturned by national courts. The fourth, is that some control mechanism must exist in order to safeguard the integrity of the arbitral process.

In addition to these characteristics, it is desirable that the outcomes of such processes, and the rationale, in particular – be made public. While it is obviously important not just that justice is done, but that justice also is seen to be done; it is also important for the development of our understanding of international tax rules.

The fact that settlement of international tax disputes is done largely informally, or in secret, means that there is a scant body of precedent in the interpretation of tax treaties. The development of a body of precedent would bring greater certainty to

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[895] Although this is questionable. See below at 7.5.2.2.

[897] William W Park, 'Income Tax Treaty Arbitration' (2001) 10 Geo Mason L Rev 803.

questions of international taxation – and, arguably, greater consistency too. Even if the body of precedent is not binding upon the arbitrating authority – it is likely that any arbitral body would attempt to answer questions of international tax law in a manner that is consistent, with a solid conceptual base. Therefore, in order for us to fully understand the contours of our international tax rules, a body of jurisprudence should be allowed to develop through appeals to a public arbiter.

7.5.2 Interpretation of tax treaty rules

Double taxation – or double non-taxation – is a product of overlapping jurisdiction. Tax treaties are designed to eliminate that double taxation. In giving effect to a tax treaty, the contracting states will have to interpret its provisions. In the case of taxes on income, the source country will seek to determine whether or not the jurisdictional provision of the treaty[899] applies and if so tax the profits in accordance with the distributive provision.[901] Provided that the jurisdiction of residence reaches the same conclusion as the source jurisdiction, the jurisdiction of residence will offer double taxation relief over those profits in accordance with the provisions of the treaty.[903] However, where the contracting states place differing definitions upon the jurisdictional provision, either the jurisdiction of residence will not provide double

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[899] In the case of treaties based on the OECD Model, Article 5.

[901] In the case of treaties based on the OECD Model, Article 7.

[903] In the case of treaties based on the OECD Model, in accordance either with Article 23A or Article 23B.

taxation relief, resulting in double taxation; or the jurisdiction of residence will grant double taxation relief while the jurisdiction of source does not tax the income, resulting in double non-taxation.

In an international context, the likelihood that the two authorities will place differing interpretations on these treaty rules is quite high, as compared to the domestic context.[905] Van Raad identifies a number of reasons why this might be the case.

First, in common with most international agreements, tax treaties are generally composed of broad statements of principle, without very much detail. By contrast, domestic tax tends to be extensive and detailed. The inevitable consequence is that where the two come into conflict, there is far more scope for the interpretation of the international rule to move towards the domestic rule rather than for the domestic rule to move towards the international.

The second, is that domestic tax law is usually accompanied by far more extensive interpretive aids than international tax rules. In addition to those published by revenue authorities,[907] the overwhelming body of independent professional and academic commentary is focused upon domestic tax laws. While the OECD Model is

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[905] Kees Van Raad, 'International coordination of tax treaty interpretation and application' (2001) 29 Intertax 212.

[907] For example, in Ireland the Taxes Consolidation Act 1997 is accompanied by an extensive collection of Tax and Duty Manuals published under the Freedom of Information Act, in addition to published Revenue Statements of Practice. Such manuals, and their publication, are modelled extensively on the manuals maintained and published by HMRC under a similar scheme in the United Kingdom.

accompanied by a commentary, it too is relatively brief, when compared to domestic tax manuals. Furthermore, the status of the OECD Commentary in domestic legal orders remains inconsistent and unclear.[909]

The third, is that while domestic taxing rules are part of the legal order with which the legal community of that country are familiar, treaty rules are relatively unfamiliar, with their application and scope not being fully appreciated by the participants in the domestic legal sphere.

Where interpretation of treaty rules is so difficult, the attraction of rules which leave little scope for interpretation becomes apparent. However, as is discussed below, as the inclusion of mandatory arbitration provisions into bi-lateral tax treaties becomes increasingly commonplace, the necessity of adhering to an imperfect but clear-cut jurisdictional standard diminishes.

7.5.2.1 Interpreting international rules in a domestic context

In the first instance, interpretation of international rules will be done by the taxpayer and the revenue authority. In the case of a non-resident enterprise, either the enterprise, or the revenue authority, or both, will make a determination as to whether or not the activities of the enterprise falls under any charge to tax under either the domestic law or the treaty rule. In general, the determination that will need to be made is whether or not the activities of the business within the jurisdiction of the state are

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[909] Baker, *supra* note 6.

done through a permanent establishment. Where the two parties do not agree as to how the international rule should be applied, the parties have two options available to them. The first, is to refer their dispute to a domestic court. The second, is to utilise the mutual agreement procedure outlined in Article 25 of the OECD Model.

If the parties elect to take the issue to a domestic court, three issues arise. The first, is that while many jurisdictions have specialised tax courts, in many others it is general or administrative courts that are designated to hear such cases. This could create a disparity between the technical quality of the interpretation of treaty obligations between contracting states. The second, is that internal constitutional arrangements might negate the efficacy of tax treaties. This is less of a problem in highly monist jurisdictions, however in those jurisdictions where treaty obligations rank alongside primary legislation it is possible that conflicts might arise between the domestic law and treaty obligations. The third, and most salient issue, is that when considering a case that falls within the ambit of a tax treaty 'courts will typically deal with the case without regard to the viewpoint of the other state on the pertinent issue'[911] with the potential consequence being double taxation, or double non-taxation.

All of the above factors increase the risk that a domestic court may do little to actually resolve the question of what state ought to have jurisdiction over an enterprise. There remains the risk that domestic courts exacerbate the problem further.

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[911] Van Raad, *supra* note 452 at 213.

7.5.2.2 Interpreting international rules in an international context

Disputes as to the interpretation of a tax treaty in an international context can take any one of three forms. The first, is that while both parties to a tax treaty agree upon an interpretation of the treaty, an affected taxpayer does not. The second, is that the two parties to a tax treaty place a differing interpretation over a treaty. The third, is that neither party to a tax treaty, nor an affected taxpayer, agrees as to the interpretation of a treaty. In all of these instances, the primary method of resolving the dispute is the mutual agreement procedure provided for in the OECD Model.

7.5.2.2.1 Disputes between taxpayer and state(s)

An affected taxpayer might request that the relevant revenue authorities address a potential double taxation issue through the mutual agreement procedure, or one of the revenue authorities may seek to do so of its own initiative. The 'mutual agreement procedure' is provided for by Article 25 of the OECD Model:

> (1) Where a person considers that the actions of one or both of the Contracting States result or will result for him in taxation not in accordance with the provisions of this Convention, he may, irrespective of the remedies provided by the domestic law of those States, present his case to the competent authority of the Contracting State of which he is a resident or, if his case comes under paragraph 1 of Article 24 [non-discrimination], to that of the Contracting State of which he is a national. [...]
>
> (2) The competent authority shall endeavour, if the objection appears to it to be justified and if it is not itself able to arrive at a satisfactory solution, to resolve the case by mutual agreement with the competent

authority of the other Contracting State, with a view to the avoidance of taxation which is not in accordance with the Convention.[913]

The mutual agreement procedure requires revenue authorities to seek agreement with their correspondents where the non-harmonious application of treaty provisions result in taxation which is not in accordance with treaty principles. By far, the most prolific source of international tax disputes is transfer pricing.[914] For example, where one revenue authority makes an adjustment to the accounts of a non-resident enterprise that results is lower costs being incurred in that jurisdiction, and therefore larger profits being earned, that enterprise may be subject to partial double taxation unless the revenue authority of the jurisdiction in which it is resident makes a corresponding adjustment. In such a circumstance, the revenue authorities are obliged to seek – but not necessarily reach[915] – a mutual agreement as to how the costs incurred by that enterprise should be priced.

This procedure has been the subject of considerable criticism. As can be seen from the example considered above, the taxpayer that is the subject of the dispute is

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[913] Art. 25, OECD Model.

[914] Organisation For Economic Co-Operation and Development. Committee on Fiscal Affairs, *Transfer Pricing and Multinational Enterprises: Report of the OECD Committee on Fiscal Affairs* (OECD Publishing 1979). It is, perhaps, for this reason that the European Communities' Arbitration Convention is limited exclusively to transfer pricing and associated allocation issues.

[915] Lotfi Maktouf, 'Resolving International Tax Disputes Through Arbitration' (1988) 4 Arbitration International 32.

relegated to the penumbra. The opportunities for the taxpayer – whose tax liability will ultimately be affected by the mutual agreement procedure – to state their case is limited.

There is also a considerable imbalance in the process. Typically, when the tax liability calculated by a revenue inspector differs from that of a taxpayer, the two parties will often seek to reach a negotiated agreement – with one party seeking to maximise that tax liability, while the other seeks to minimise it. In the case of the mutual agreement procedure in treaties, the parties to the process might both seek to maximise their tax receipts, which could result in a maximisation of the overall tax liability of the enterprise.

A related complaint about the mutual agreement procedure is the observation by some commentators that authorities often resolve cases by way of 'package deals'[916] – where multiple cases are considered together by the authorities.[918] This complaint appears to have been acknowledged in their discussion paper on dispute settlement as part of the BEPS agenda.[919] The resolution of cases might be reached on the basis of the overall balance between the authorities irrespective of the individual merits of particular cases. A taxpayer in one case might be sacrificed as a bargaining chip in another. Such horse-trading is easily facilitated by the mutual agreement procedure, which is largely shrouded in secrecy.

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[916] *Supra* note 157.

[918] Park, *supra* note 448.

[919] OECD, *BEPS Action 14: make dispute reolution mechanisms more effective, supra* note 157.

7.5.2.2.2 Disputes between states

Where states that are party to an international agreement disagree as to how that agreement should be interpreted or applied, the states concerned have three options available to them. The first is that their plenipotentiaries, or agreed competent authorities, negotiate with a view to seeking agreement over the contentious issue. The second is that the states concerned agree to be bound by the decision of an independent arbitrator. The third is that the parties submit their dispute to an international court. In the context of tax treaties, disputes between states are settled exclusively by the first method.

Though there is no reason why a dispute between states on the interpretation of tax treaties cannot be referred to, for example, the International Court of Justice – no such case has ever been so referred. It could be argued that this is testament to the clarity of existing rules. However, in reality transfer pricing disputes are not entirely uncommon.

The reluctance of states to refer disputes between them under tax treaties to third party arbitration might be explained by the desire of states to preserve their hegemony over matters of fiscal policy.[921] It may well be the case that states consider

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[921] This can be seen in the attitude of EU Member States towards bringing matters of direct taxation under the auspices of the EU treaties. For example, the Arbitration Convention was originally a proposed Commission Directive, however it was eventually agreed as a separate convention between the then-15 Member States, thus keeping such matters beyond the reach of the ECJ. Further evidence of states' reluctance to surrender their hegemony over matters of direct taxation can be seen in statements of

occasionally unsatisfactory resolution of disputes a price worth paying in order to avoid setting a precedent of referring such disputes to third parties.

7.5.3 Essential features of effective dispute resolution

Park identifies four elements that are fundamental to effective tax arbitration.[923] The first, is that contracting states must make irrevocable commitments to arbitrate, rather than merely making expressions of good will from which they might later recant if the outcome does not suit them. The second, is that the process must be capable of being initiated by taxpayers, as well as the competent tax authorities. The third, is that the outcome must bind both taxpayers and tax authorities, with no possibility of decisions being overturned by national courts. The fourth, is that some control mechanism must exist in order to safeguard the integrity of the arbitral process.

Arguably the greatest concern about the MAP, in particular in the context of this chapter, is the secrecy under which the MAP is shrouded. Aside from the obvious concerns about justice only ever being done in secret, this secrecy inhibits the development of international taxation law, as no body of precedent as to how tax treaties should be interpreted. As Christians observes,

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otherwise enthusiastic supporters of closer EU integration, such as Tony Blair. See Tony Blair and Juhan Parts, 'An Enlarged Europe Needs Competition' (*Government of Estonia Communications Unit* 11 March 2003) <http://valitsus.ee/en/news/prime-ministers-speeches-and-statements/14423/joint-article-by-prime-ministers-juhan-parts-and-tony-blair-> accessed 20 January 2014.

[923] Park, *supra* note 448.

> [t]he MAP process seems to fall short in enabling taxpayers and observers to learn about the tax law as it is implemented in practice. [...] [T]he competent authority process seems obscure, not well understood, unaccountable to those other than the competent authorities themselves, susceptible to administrative and procedural issues, and resistant to study. How can we learn about tax law if it is administered through the competent authority? The answer is that we can learn whatever a particular administration chooses to teach us, for example by issuing guidance or statistics.[925]

This, as Christians argues, compares unfavourably to other fields, such as judicial review. Under judicial review, though the particulars of a dispute between an individual and a public body might remain confidential, many factual details, as well as legal argument and judicial reasoning are made public. The MAP offers none of this. These flaws in the MAP have not gone unnoticed, with many scholars long calling for the introduction of mandatory arbitration to the OECD Model.[927] The 2008 update to the OECD Model therefore added an additional paragraph to Article 25. Paragraph 5 provides that where a taxpayer has presented a case to the competent authorities of a contracting state, and the states have been unable to resolve the matter within two years,

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[925] Allison Christians, 'Your Own Personal Tax Law: Dispute Resolution Under the OECD Model Tax Convention' 17 Willamette J Int'l L & Dis Res 172, pp.179-180.

[927] See, for example, Chloe Burnett, 'International Tax Arbitration' (2007) 36 Australian Tax Review 173; Lotfi Maktouf, 'Resolving International Tax Disputes Through Arbitration' (1998) 4 Arbitration International 32; Park, *op. cit.*; Aurora Ribes, 'Compulsory Arbitration as a Last Resort in Resolving Tax Treaty Interpretation Problems' (2002) 49 European Taxation 400; Mario Züger, *Arbitration Under Tax Treaties: improving legal protection in international tax law*, vol 5 (IBFD 2001).

> any unresolved issues arising from the case shall be submitted to arbitration if the person so requests. These unresolved issues shall not, however, be submitted to arbitration if a decision on these issues has already been rendered by a court or administrative tribunal of either State. Unless a person directly affected by the case does not accept the mutual agreement that implements the arbitration decision, that decision shall be binding on both Contracting States and shall be implemented notwithstanding any time limits in the domestic laws of these States.

While the introduction of arbitration into bi-lateral tax treaties undoubtedly improves the process for the taxpayer, it does little to further the development of international tax law more generally. As with the MAP, arbitration as is provided for by paragraph 5 remains confidential. Gangulay takes the view that

> the lack of precedent that effectively flows [from confidentiality] has both benefits and liabilities in the realm of tax arbitration. As noted earlier, states may have interests beyond neutral enforcement of law and treaty, especially with regard to creating precedent that might prevent them from neutrally adjudicating an international tax issue in court. Arbitration both creates the necessary neutrality and removes the threat of a potentially costly or far-reaching precedent arising out of a court case. The downside is that the lack of precedent prevents the creation of settled law that might be sufficiently clear to avoid future disputes altogether.[929]

In order to address these concerns, Lindencrona and Mattsonn therefore propose that in the context of tax arbitration, confidentiality should not exist.[931] This is the case where bilateral investment treaties are concerned, and it is arguable that the public

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[929] Maya Ganguly, 'Tribunals and Taxation: An Investigation of Arbitration in Recent US Tax Conventions' (2011) 29 Wis Int'l LJ 735.

[931] Gustaf Lindencrona and Nils Mattsson, *Arbitration in taxation* (Kluwer 1981).

interest would be served by adopting a similar approach to tax disputes arising under tax treaties.

A jurisdictional standard based upon multiple factors with the aim of determining a subjective intention to engage in the economic life of a state would inevitably lead to disputes as to the level of contact, the types of behaviour, and the intention necessary to meet that standard. A system of mandatory arbitration would facilitate the settlement of such disputes. However, settlement of these disputes in secret will do nothing to mitigate the large number of disputes that would inevitably arise.

Mandatory public arbitration would allow a body of judicial precedent on the interpretation of tax treaties to emerge. While the shift to a more qualitative standard would likely initially spur a large amount of litigation as to the correct interpretation and application of such a standard, such litigation would likely decrease in quantity significantly once the contours of that standard become clearer through the publication of judgments and the development of a body of jurisprudence.

7.6 BEPS agenda

One option contemplated by the OECD under is BEPS agenda is the introduction of a new, alternative, threshold standard based upon a significant digital presence. Under the option being contemplated by the OECD

an enterprise engaged in certain 'fully dematerialised digital activities' would have a permanent establishment if it maintained a "significant digital presence" in the economy of another country.[933]

The OECD identifies a number of potential elements for such a test, including

a. The core business of the enterprise relies completely or in a considerable part on digital goods or digital services;
b. No physical elements or activities are involved in the value chain other than the existence, use, or maintenance of servers and websites or other IT tools and the collection, processing, and commercialisation of location-relevant data;
c. Contracts are concluded exclusively remotely via the Internet or by telephone;
d. Payments are made solely through credit cards or other electronic payments using on-line forms or platforms linked or integrated to the relative websites;
e. Websites are the only means used to enter into a relationship with the enterprise; no physical stores or agencies exist for the performance of the core activities other than offices located in the parent company or operating company countries;
f. All or the vast majority of profits are attributable to the provision of digital goods or services;
g. The legal or tax residence and the physical location of the vendor are disregarded by the customer and do not influence its choices; or
h. The actual use of the digital good or the performance of the digital service do not require physical presence or the involvement of a physical product other than the use of a computer, mobile devices or other IT tools.[935]

However, though this criteria would be highly effective in determining whether or not an enterprise is a highly virtual one of the sort contemplated by this thesis, it

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[933] OECD, *BEPS Action 1: address the challenges of the digital economy, supra* note 155, p.65.

[935] *Ibid.*

does little, if anything to determine whether or not such an enterprise has a substantial presence within a state.

In order to determine whether or not an enterprise of the sort detailed above has a significant digital presence with a jurisdiction, the OECD therefore proposes that such a presence might exist where

a. a significant number of contracts for the provision of fully dematerialised digital goods or services are remotely signed between the enterprise and a customer that is resident for tax purposes in the country;
b. digital goods or services of the enterprise are widely used or consumed in the country;
c. Substantial payments are made from clients in the country to the enterprise in connection with contractual obligations arising from the provision of digital goods or services as part of the enterprise's core business; or
d. An existing branch of the enterprise in the country offers secondary functions such as marketing and consulting functions targeted at clients resident in the country that are strongly related to the core business of the enterprise.[937]

This criteria, it is submitted, is not satisfactory for a number of reasons. Though a threshold based upon 'a significant number of contracts' or 'substantial payments' has the attraction of relative clarity that comes with a quantitative standard, it does little to tell us what the quantitative threshold ought to be. A definition of 'significant' that was relative to the scale of the enterprise would better reflect the objectives identified in this thesis, however it may result in significant collection costs for relatively small

[937] *Ibid.*, pp.66-67.

enterprises. A relative quantity, combined with a *de minimis* threshold may therefore be more appropriate.

Another flaw in the criteria proposed by the OECD is that it creates a force of attraction rule for profits of digital enterprises where none exists for offline enterprises. A holistic approach to the challenges posed by the digital economy should seek to maintain, so-far as is, possible neutral treatment between online and offline enterprises.

A third criticism of the proposed criteria is that it appears to capture only the activities of those enterprises whose business in conducted wholly or mostly through digital means. Consequently, this standard would not apply to those enterprises the activities of which are composed of significant offline, as well as online commerce.

Nonetheless, the OECD's proposals under action 1 demonstrate that an alternative or supplementary jurisdictional nexus standard may well be the solution to the challenges posed by the digital economy.

7.7 **Conclusion**

A jurisdictional standard that better reflects an enterprise's participation of the economic life of a state is obviously desirable – and at a conceptual level appears to have broad support. Bright-line standards fail to adequately reflect genuine links with the marketplace of a state, as well as presenting opportunities for abuse. A standard based upon whether or not an enterprise purposefully directs its activities into a state better

reflects the nature of the Internet as a communications medium, enhances the principle of taxation of income at its source, and therefore better serves the benefit theory taxation which underlies the jurisdiction to tax in international law.

A standard based upon whether or not an enterprise purposefully directs its activities towards a state has a lengthy providence in the United States, as well as being evident in some recent UK jurisprudence with respect to the Internet. However, a jurisdictional standard that is designed to determine the purpose of someone's actions is highly subjective, and inevitably leads to disputes. Such a standard could therefore only work effectively where there exists recourse to effective dispute resolution. Though the mutual agreement procedure that presently exists in most tax treaties is not well suited to resolving disputes of this nature, it is clear that there is at least some momentum towards more effective dispute resolution. The increasingly common inclusion of mandatory arbitration provisions in tax treaties may well provide the effective dispute resolution necessary for a subjective standard to work.

Chapter 8: Alternative Threshold Standards

8.1 Introduction

This chapter briefly outlines alternative approaches to determining jurisdiction to taxing the profits of highly virtual enterprises. It considers India's business connection jurisdictional standard, which though extant long before the advent of the Internet, it is arguable provides a more suitable standard for the determination of jurisdiction to tax highly virtual enterprises than the permanent establishment standard. It further considers the UK's recently enacted Diverted Profits Tax, which, though presented as a new tax, effectively acts as an extension of the jurisdictional reach of the UK's Corporation Tax. Finally, this chapter considers other proposed alternatives to the permanent establishment threshold – in particular Richard Doernberg's 'base erosion approach', Arthur Cockfield's 'quantitative economic presence' test, and residence basis taxation. This chapter concludes that while some of these approaches are more suitable than others, none are as attractive as the standard proposed in chapter 7.

8.2 India's 'business connection' standard

India has long been ambivalent towards the permanent establishment jurisdictional standard. Though the standard is typically present in Indian double taxation conventions, for those enterprises resident in non-treaty partner states India's domestic

jurisdictional rule applies. Under Indian tax law, India will exercise its jurisdiction to tax over

> all income accruing or arising, whether directly or indirectly, through or from any business connection in India, or through or from any property in India, or through or from any asset or source of income in India, or through the transfer of a capital asset situate in India.[939]

Explanation 2 of s9(1)(i) provides that a business connection should exist whereby a person acts on behalf of a non-resident and

> (a) has and habitually exercises in India, an authority to conclude contracts on behalf of the non-resident, unless his activities are limited to the purchase of goods or merchandise for the non-resident; or
>
> (b) has no such authority, but habitually maintains in India a stock of goods or merchandise from which he regularly delivers goods or merchandise on behalf of the non-resident; or
>
> (c) habitually secures orders in India, mainly or wholly for the non-resident or for that non-resident and other non-residents controlling, controlled by, or subject to the same common control, as that non-resident.

While scenario (a) bears some resemblance to the agency permanent establishment contained within the OECD Model, scenarios (b) and (c) represent a considerable divergence. Under the OECD Model, the maintenance of a stock of goods or merchandise 'solely for the purpose of storage, display, or delivery' is specifically excluded from the definition of permanent establishment under article 5(4)(b). More

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[939] s9(1)(i) Income Tax Act 1961 (India).

significantly, however, the physical presence requirement for permanent establishments appears not to be necessary to establish a business presence under s9(1)(i) of the Act, as illustrated by scenario (c). On this basis, it appears that India employs a jurisdictional standard that is more akin to the dependent agency standard than a fixed place of business.

The use of the word 'habitually' again mirrors the dependent agency standard, suggesting that more than the occasional transient foray into Indian jurisdiction is necessary in order to establish a business connection. A single transaction does not create a business connection – there must be some continuity in the relationship between the parties.[941] In *CIT v RD Aggarwal*, the Supreme Court of India held that business connection

> means something more than business. It presupposes an element of continuity between the business of the nonresident and his activity in the taxable territory, rather than a stray or isolated transaction.[943]

However, while s9(1) is the default rule of Indian tax law, the business presence standard is excluded where an alternative standard is required by a DTC. As the overwhelming majority of India's DTCs follow the OECD Model, the PE standard is the dominant one in Indian international taxation law.

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[941] *CIT v. Metro Goldwyn Mayer (India) Ltd* [1939] 7 ITR 176 (Bom).

[943] *CIT v. RD Aggarwal* (1965) 56 ITR 20.

Although India's business connection standard is not an expanded version of the permanent establishment standard, as is advocated by this thesis, it would appear to be similar in effect. Rao argues that insofar as electronic transactions are concerned

> the business connection concept contained under Indian domestic law and described in *RD Aggarwal* may prove to be a more suitable indicator of nexus because it would bring the business income of [non-resident enterprises] to tax in India if it is attributable to any continuous, real, and close connection of [that enterprise] in India.[945]

On the basis of the foregoing arguments of this thesis, there is certainly some merit to this assertion. In many respects, India's business connection standard bears some resemblance to the approach discounted by chapter 7 – wholesale replacement of the permanent establishment standard with a more qualitative one. Although this thesis does not advocate such a shift – primarily for pragmatic reasons – it does illustrate that there is no reason why such a standard cannot work in practice.

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[945] Shreya Rao, 'Nexus Matters: India's Right to Tax' (2008) 49 Tax Notes International 75.

8.3 Diverted Profits Tax

On 3 December 2014, the British Chancellor of the Exchequer announced plans for a new Diverted Profits Tax.[947] In his Autumn Statement, the Chancellor informed the House of Commons that

> we will make sure that big multinational businesses pay their fair share. Some of the largest companies in the world, including those in the tech sector, use elaborate structures to avoid paying taxes. Today, I am introducing a 25% tax on profits generated by multinationals from economic activity here in the UK which they then artificially shift out of the country.[949]

The intended purpose of the tax is primarily to capture two kinds of offending behaviour. The first, is exploitation of mismatches between the tax systems of different countries in order to secure a deduction for tax purposes form UK profits for a transaction with a related non-resident enterprise that is not matched by a corresponding increase in the profits of said related non-resident enterprise. This could be said to be an issue of allocation of profits – much like transfer pricing – discussed above. The second kind offending behaviour that the diverted profits tax seeks to address is that which is the primary focus of this thesis, which is the attribution of substantial profits earned within a jurisdiction to enterprises that lack a permanent

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[947] 'UK targets multinationals with "diverted profit" tax' (*Financial Times*, 3 December 2014) <http://www.ft.com/intl/fastft/245411/uk-targets-multi-nationals-with-diverted-profit-tax> accessed 4 December 2014.

[949] HC Deb 2 Dec 2014, vol. 79, col. 309.

establishment within that jurisdiction. Both such practices are perceived as being commonplace amongst highly-virtual enterprises, in particular, and led to the Diverted Profits Tax almost instantly being labelled the 'Google Tax'.[951]

The Diverted Profits Tax is designed to address both transactions which, in the opinion of HMRC, lack economic substance, as well as contrived arrangements which avoid a UK permanent establishment. Where an arrangement is deemed to be so contrived, a charge to tax is applied upon the profits that would otherwise be chargeable to UK Corporation Tax but for the existence of the contrived arrangement. The tax was introduced in the Finance Act 2015 and becomes chargeable upon 'diverted profits' when four conditions are met: the participation condition; the mismatch condition; the tax avoidance condition; and the no economic substance condition.

The participation condition requires that the parties to a transaction or series of transactions be connected. The wording of the participation is similar to that used in the transfer pricing rules in the Taxation (International and Other Provisions) Act 2010, requiring that one of the parties be directly or indirectly participating in the management, control, or capital of the other.

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[951] Rupert Neate, 'What is the 'Google tax'?' *The Guardian* (29 September 2014) <http://www.theguardian.com/politics/2014/sep/29/what-is-google-tax-george-osborne> accessed 12 August 2015; Nick Robinson, 'Osborne - Benefit freeze and 'Google tax'' (2014) <http://www.bbc.com/news/uk-politics-29411686> accessed 12 August 2015; Vanessa Houlder Elizabeth Rigby, Murad Ahmed, 'Osborne plans crackdown on tech groups with new anti-avoidance rules' *Financial Times* (London, 29 Spetember 2014) <http://www.ft.com/cms/s/0/f0564d62-4803-11e4-b5ad-00144feab7de.html#axzz3itarL08w> accessed 12 August 2015.

The mismatch condition requires that 'the material provision results in an effective tax mismatch outcome'[953] between the UK and foreign parties. Where, as a result of a transaction or series of transactions with a foreign party, the expenses of a UK party increase, and the taxable income of that party decreases, that decrease ought to result in a corresponding increase in the taxable income of the foreign party. Where the reduction in the tax liability (not the taxable profits) of the UK party are not met by a corresponding increase in the foreign party's tax liability (including withholding tax), the mismatch condition is satisfied. However, the mismatch condition is not satisfied where the amount paid by the second party[955] exceeds 80% of the reduction in the UK party's tax liability.

The tax avoidance condition is met where the main purpose of an arrangement is deemed to be the avoidance of a charge to tax in the UK.

The insufficient economic substance condition requires that a comparison be made between the value of the tax reduction resulting from the tax mismatch outcome and any other financial benefit that results from the transaction or series of transactions. The condition can be satisfied where the tax reduction referable to the transaction or series of transactions is greater than any other financial benefit and that it is reasonable to assume that the transaction was designed to secure that reduction.

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[953] s.86(2) Finance Act 2015.

[955] Or the amount that would have been paid but for the application of loss relief.

The condition is also satisfied where the overall contribution of value to a transaction is less than the value of the tax reduction, and it is reasonable to assume that the transaction(s) was or were designed to secure the reduction.

There are two parts to the Diverted Profits Tax nexus: a qualitative standard – the 'avoided permanent establishment' (avoided PE) – and a quantitative turnover threshold. An avoided PE is deemed to exist where an enterprise that is non-resident in the UK carries on a trade, and that that enterprise

> whether or not UK resident, is carrying on activity in the United Kingdom in that period in connection with supplies of services, goods or other property made by the foreign company in the course of that trade
>
> and that it is
>
> reasonable to assume that any of the activity of the avoided PE or the foreign company (or both) is designed so as to ensure that the foreign company does not, as a result of the avoided PE's activity, carry on that trade in the United Kingdom for the purposes of corporation tax.

Perhaps most remarkably, the avoided PE is also deemed to exist regardless of whether or not the activity of the foreign company is also designed to secure any other objective.

s.87 of the Act provides that an avoided PE does not exist where the value of the sales of the enterprise generated from the United Kingdom does not exceed £10,000,000, or where the value of the expenses of the enterprise incurred in the United Kingdom does not exceed £1,000,000.

Rather than modifying existing permanent establishment rules, the Act instead creates a new PE fiction in the form of an 'avoided PE'. A unilateral action by the United Kingdom to amend permanent establishment rules across the board would certainly place it in breach of its obligations under the numerous Double Tax Conventions to which it is a party. It is therefore certainly questionable whether or not the avoided PE standard is consistent with the United Kingdom's treaty obligations.

8.3.1 Commencement and enforcement

The provisions of Part 3 of the Finance Act 2015 providing for the Diverted Profits Tax came into effect on the 1 April 2015. At the time of writing this thesis therefore the operation and effects of the tax are not entirely clear.

Perhaps the key challenge for the Diverted Profits Tax is that of enforcement. Though academic scrutiny of the Diverted Profits Tax is somewhat limited at present, a number of practitioners have questioned how effectively HMRC can enforce the tax against enterprises that lack a permanent establishment in the United Kingdom. However, this seems somewhat specious for two reasons. First, it is not necessary for an enterprise to have a UK permanent establishment in order to be subject to UK VAT, yet this appears to pose few problems to the operation of VAT. Second, there is little reason to believe that companies will seek to break the law.

Schedule 16 of the Act provides for the collection and enforcement of the Diverted Profits Tax. Part 1 of the Schedule applies the provisions of Chapter 6 of Part 22 of the Corporation Tax Act 2010 to the collection and enforcement of the Diverted Profits Tax, with 'permanent establishment' to be read as 'avoided permanent establishment'.[957] Part 2 of Schedule 16 allows for the revenue to enforce the collection of the tax against related companies. A company is deemed to be a related company where the company is a member of the same group as the taxpayer company, of a consortium which at that time owned the taxpayer company, of the same group as a company which at that time was a member of a consortium owning the taxpayer company.

However, one of the most striking characteristics of the Diverted Profits Tax is its rate. While in the financial year commencing 1 April 2015 the UK's headline rate of Corporation Tax is 20%, the Diverted Profits Tax is chargeable at a rate of 25%. It would appear from this that the objective of the Diverted Profits Tax is not simply to capture profits that are being diverted out of the UK and bring them within a charge to tax, but to actively discourage companies from diverting profits in the first place. A company can avoid paying the Diverted Profits Tax by instead accounting for those diverted profits as chargeable to UK Corporation Tax, thereby subjecting those profits to a charge of 20%, rather than 25%. If the DPT is successful in encouraging companies

[957] Sched. 16, para. 1(3).

to account for profits in the UK, rather than diverting them elsewhere, then it is likely that the DPT itself will raise very little revenue, and result in very little enforcement.

The DPT is notable for its broad scope. However, the breadth of the DPT's application raises questions as to the enforceability of the tax, as well as its compatibility with the UK's obligations under its Double Tax Treaties. Clifford Chance highlights the possibility that unilateral action by the United Kingdom may trigger a response from other countries:

> if this is not part of a coordinated action then other governments may take a dim view of the UK taking such a dramatic unilateral action. We could see retaliatory measures introduced, particularly in the US.[959]

In some respects the Diverted Profits Tax represents something of an historical re-tread – albeit this time on the other side of the Atlantic. In the mid 1980s, amidst concerns about the tax practices of MNEs, no fewer than a dozen US states had enacted a system of unitary taxation – including California. This attracted the ire of numerous foreign government ministers – most prominent among them being the British Prime Minister, Margaret Thatcher. Mrs Thatcher is reported to have considered US states' systems of unitary taxation to be a 'serious' issue, having raised the matter with President Reagan on a number of occasions.[961]

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[959] Clifford Chance, *The UK diverted profits tax: final legislation published* (2015) p.9.

[961] Peter T. Kilborn, 'Unitary Tax Under Fire' *New York Times* (New York, 28/11/1983) D 2, Alex Brummer, 'US President encouraged to ban unitary taxation' *The Guardian* (London, 1/8/1984), David E.

Such was the United Kingdom's opposition to unitary standards adopted in the US that enacted retaliatory provisions in the Finance Act 1985. s54 of the Act reduced the entitlement of companies (or associates of companies) with a taxable presence in unitary jurisdictions to double taxation relief under a Double Taxation Convention to half of that which it would be were they resident in the United Kingdom or other water's edge jurisdiction.[963]

What can be gleaned from US states' dabblings with unitary taxation is that it is highly unlikely that other governments will simply ignore the attempts by one state to extend their fiscal reach into the jurisdiction of another. After all, it is usually more than mere accident that it is those states to which companies are purportedly 'diverting' their profits in which such companies find themselves resident. Usually, those countries have structured their tax systems specifically in order to facilitate such diversions. That being the case, it is unlikely that those jurisdictions will be any happier with the erosion of their tax base or inward investment any more than the UK is with the erosion of theirs. The United Kingdom was the most vocal opponent of such action in the 1980s,

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Rosenbaum, 'U.S. Expected to Act to Limit Unitary Taxation' *New York Times* (New York, 23/10/1985) D 2.

[963] 'This section applies to a company which has, or is an associated company of a company which has, a qualifying presence in a unitary state and, at any time when it or its associated company has such a qualifying presence, is entitled by virtue of arrangements having effect under section 497(1) of the Taxes Act (relief by agreement with other countries) to a tax credit under section 86 of the Finance Act 1972 (tax credit for certain recipients of qualifying distributions) in respect of qualifying distributions made to it by companies which are resident in the United Kingdom which is equal to one half of the tax credit to which an individual resident in the United Kingdom would be entitled in respect of such distributions.'

and it is highly likely that the UK Treasury will face similar criticism from treaty partners whose corporate residents will be subject to the DPT.

However, it might also be the case that other states – in particular those for whom base erosion is an increasing problem – will be looking keenly upon the United Kingdom's experiment with the DPT, in the hope that it provides a solution to their own base erosion problems. Australia has already indicated that intends to follow the UK in implementing similar arrangements. If other major economies were to follow suit, it could well be that some of the onus to implement the OECD's BEPS agenda is removed.

8.3.2 Compatibility with OECD Model

Of some question is the compatibility of the Diverted Profits Tax with the United Kingdom's tax treaty obligations. The typical UK tax treaty is closely modelled on the OECD Model convention, with most Articles 5 and 7 (or their equivalents) being either verbatim transpositions of their OECD Model counterparts, or else containing only minor modifications.[965]

The typical UK Double Tax Convention therefore provides that the

[965] For example, the UK-Ireland and UK-Norway DTCs both contain additional permanent establishment thresholds in order to provide for offshore extraction of natural resources.

> [p]rofits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein.

The typical definition of a permanent establishment contained therein closely resembles the OECD definition discussed at length, above. The threshold standard contained within the Finance Act 2015 effectively supplements accepted permanent establishment definitions with an additional threshold standard – the 'avoided PE'. In this respect, the 'avoided PE' standard is not dissimilar from other permanent establishment fictions – such as the offshore oil fictions that exist in the UK-Norway and UK-Ireland treaties. Installations that would not otherwise fall within the scope of one or the other's state's taxation by virtue of not meeting all of the criteria necessary to constitute a permanent establishment (such as being 'fixed') are brought within the scope of that state's taxation by defining a permanent establishment fiction. However, unlike other fictions, the 'avoided PE' fiction is not created by statute, but by the unilateral action of the Parliament of the United Kingdom,

HMRC takes the (unsurprising) view that the Diverted Profits Tax is compatible with the United Kingdom's obligations under Double Tax Conventions, for two reasons. The first, is that

> the entry conditions for the diverted profits tax mean that it will only be applied to arrangements designed to exploit the provisions of tax

> treaties to avoid tax. Therefore the arrangements it targets are the kind where there is no obligation to provide relief under international law.[967]

There are two potential entry conditions, satisfaction of either of which will result in a charge to tax.[969] The first entry condition is the mismatch condition – that is to say that in order for the charge to tax to apply a reduction in the profits of the avoided PE has taken place that is not matched by a corresponding increase in profits of the corresponding related party.[971] In this instance, the position of HMRC is somewhat convincing, as such mismatches normally occur as a consequence of the exploitation of gaps between the tax systems of the two contracting jurisdictions, which has not been addressed by the treaty. For example, where the United Kingdom offers a deduction an enterprise's UK profits for a transfer made to a related Irish enterprise, but Ireland considers that transfer to be attributable to the profits of the UK enterprise, no tax will be payable on those profits at either end. This is an example of profits 'falling through the gap' between the parties' respective tax systems. As such arrangements seek to exploit gaps in the parties' respective tax systems and the treaty between them, it would therefore appear that such arrangements do indeed fall outwith the ambit of Double Taxation Conventions, and as such contracting states are at liberty to extend whatever tax treatment they so wish to such arrangements.

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[967] HMRC, 'Diverted Profits Tax' (The Royal Society, London, 8 January 2015)

[969] Provided that certain other criteria are met.

[971] s.107.

However, the submission that the entry conditions for the Diverted Profits Tax place the tax outwith the ambit of Double Taxation Conventions is more difficult to sustain where the tax avoidance condition is concerned. The tax avoidance condition is met where 'main purpose or one of the main purposes of which is to avoid or reduce a charge to corporation tax.'[973] In the first scenario, the charge to tax only applies where there is a mismatch in the tax treatment of the avoided PE and the non-resident enterprise – in effect, a gap in the treaties – then it is the case that Diverted Profits Tax falls outwith the scope of Double Tax Conventions. However, in the second scenario, there need not necessarily be a mismatch in the treaties, but merely that the purpose of the arrangement is to avoid a charge to UK corporation tax. Where the tax avoidance condition is concerned, it is entirely possible (indeed likely) that an arrangement that has as its purpose or one of its main purposes to avoid or reduce a charge to corporation tax is nonetheless an arrangement that falls within the ambit of both states' tax systems and of the Double Tax Treaty between them. The tax avoidance condition is satisfied not by reference to fact, but to purpose. However, neither the OECD Model Convention, nor any of the UK's Double Taxation Conventions provide for any consideration of purpose. Determinations as to the jurisdiction to tax under tax treaties are entirely the product of a factual inquiry. It is difficult, where the tax avoidance condition is concerned, to see how a charge to tax that applies where there is no

[973] s.86(3).

mismatch in the parties respective tax treatment, but simply that the arrangement is a contrived to minimise a party or the parties' tax liability, is not in breach of treaty obligations.

HMRC further argues that notwithstanding the above concerns, the Diverted Profits Tax falls outwith the scope of the relief available under the UK's Double Tax Treaties, as such treaties offer relief only insofar as Income Tax, Corporation Tax, and Capital Gains Tax is concerned.[975] HMRC takes the view that the Diverted Profits Tax is a new tax, and not merely an extension of the scope of one or more of the aforementioned taxes, it therefore falls outwith the scope of the tax treaties.

However, the Association of Chartered Certified Accountants (ACCA) has questioned this defence, stating that '[j]ust because the UK says the DPT is not corporation tax, this does not mean that other jurisdictions will accept it as such'.[977] Indeed, the position of HMRC in this respect is difficult to sustain. A great many of the UK's Double Taxation Conventions – including those between the UK and France, Germany, the U.S., Ireland, and the Netherlands – provide that those conventions

> shall also apply to any identical or substantially similar taxes which are imposed by either Contracting State after the date of signature of this Convention in addition to, or in place of, the taxes of that Contracting State referred to in paragraph (1) of this Article.

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[975] HMRC, 'Diverted Profits Tax', *supra* note 485.

[977] Calum Fuller, "Google tax' may be extra-territorial, warns ACCA' (*AccountancyAge*, 10/12/2014) <http://www.accountancyage.com/aa/news/2386020/-google-tax-may-be-extra-territorial-warns-acca> accessed 27/07/2015.

As the Diverted Profits Tax is a supplement to Corporation Tax, it is therefore necessary to consider whether the Diverted Profits Tax is 'identical or substantially similar' to Corporation Tax.

The question of whether or not a supplementary tax charge was so substantially similar to Corporation Tax as to fall within the scope of the UK's Double Taxation Conventions was considered in *Bricom v Commissioners of the Inland Revenue.*[979]

Bricom concerned the UK's implementation of controlled foreign corporation (CFC) rules. In general, the UK levies corporation tax over companies that are resident in the United Kingdom[981], and non-resident companies who trade in the UK through a permanent establishment. It would not normally levy corporation tax over companies that are neither resident or who lack a permanent establishment in the UK. However, under the UK's CFC rules, HMRC may impute the profits of such non-resident corporation where it

(a) is resident outside the United Kingdom, and

(b) is controlled by persons resident in the United Kingdom, and

(c) is subject to a lower level of taxation in the territory in which it is resident.[983]

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[979] *Bricom v. Commissioners of the Inland Revenue* [1997] BTC 471.

[981] That is, where the company's place of effective management is located in the UK, as opposed, necessarily, to its place of incorporation. See *De Beers supra* note 234.

[983] s.747(1) Income and Corporation Taxes Act 1988 [hereinafter 'ICTA'].

The test is not a mechanical one based simply on, for example, shareholding or voting rights. The test is intended to establish whether a person has the power to ensure that the affairs of a company are conducted in accordance with his wishes. If such power is exercisable only as a result of share holding, it is to the shareholdings that one would look to determine control but it will not be a simple mechanical or mathematical test.[985] In the case of *Bricom,* however, it was not disputed that the subsidiary in question was a CFC.

The CFC rules require that where a non-resident company is found to be a CFC, the chargeable profits and creditable tax of that company

> shall each be apportioned [...] among the persons (whether resident in the United Kingdom or not) who had an interest in that company at any time during that accounting period.[987]

s.747(4) requires that where such an apportionment is to take place, the controlling resident company shall have imposed upon it a charge equivalent to the corporation tax that would be payable by the CFC were it resident in the UK. Schedule 24 provides for the fictional assumption that the company is resident in the UK.

In *Bricom,* the CFC in question was resident in the Netherlands. The taxpayer (Bricom) contested its liability under the above provisions on the basis of the Double

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[985] HMRC, 'INTM202020 - Controlled Foreign Companies: definitions' <http://webarchive.nationalarchives.gov.uk/+/http://www.hmrc.gov.uk/manuals/intmanual/INTM202020.htm> accessed 3 August 2015.

[987] s.747(3).

Taxation Convention between the United Kingdom and the Kingdom of the Netherlands. The basis for this contention was that the under Article 11 of the convention, the income imputed to the CFC (in this case interest income derived and beneficially owned by a resident of a Contracting State) is taxable only in the State in which the company is resident. *Bricom* further contested that as the CFC charge was 'identical or substantially similar' to corporation tax, under Article 2(1) it fell within the scope of the Convention and was therefore prohibited.

The basis for the taxpayer's contention in *Bricom* is the fact that the apportionment under s.747(3) is not 'a sum equal to the chargeable profits' but the chargeable profits themselves. The court, however, queried that contention, viewing the chargeable profits as a 'purely notional sum', finding that

> [t]hey do not represent any of the profits of [the CFC] on which corporation tax is chargeable, for there are no such profits. [...] They are merely the product of a mathematical calculation made on a hypothetical basis and making counterfactual assumptions. [...]What is apportioned to the taxpayer and subjected to tax is not [the CFC's] actual profits but a notional sum which is the product of an artificial calculation.[989]

The court makes a semantic distinction between assessment of profits actually accrued, and assessment of notional sums deemed to represent profits actually accrued. The court therefore held that the charge to tax under the CFC rules was not 'identical

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[989] *Supra* note 491.

or substantially similar' to corporation tax and was therefore not prohibited by the UK-Netherlands Double Taxation Convention.

However, it is submitted that at a conceptual level this is an unsatisfactory decision. The court distinguishes between actual accrued profits and notional imputed profits. In the context of multi-national enterprises, this appears to be an odd distinction to make – as the assessed profits of most multi-national enterprises are, in fact, notional sums – the product of assumptions and fictions in order to calculate what the profits of that enterprise *would be* if it traded with its non-UK parts on an arm's length basis. The distinction between the imputed profits of a non-resident but controlled foreign corporation, and the assessed profits of a resident subsidiary appears to be a question of accuracy. The profits of the latter may well be a more sophisticated fiction than the profits of the former, but nonetheless, they are both a fiction.

However, notwithstanding the unsatisfactory nature of the decision in *Bricom* it remains highly arguable that applying the same approach to the Diverted Profits Tax may well produce a different outcome.

s.747(4) ICTA provides for the recovery of 'a sum equal to corporation tax at the appropriate rate on that apportioned amount of profits' . s.747(6) defines the profits that are to be attributed to the CFC as

> the amount which, on the assumptions in Schedule 24, would be the amount of the total profits of the company for that period on which,

> after allowing for any deductions available against those profits, corporation tax would be chargeable.

However, the charging provisions in the Finance Act 2015 are arguably less circumspect than the CFC provisions of the ICTA. s.88(5) of the Finance Act 2015 provides that the taxable profits of the 'avoided PE' are

> the profits which would have been the chargeable profits of the foreign company for that period, attributable (in accordance with sections 20 to 32 of [Corporation Tax Act] 2009) to the avoided PE, had the avoided PE been a permanent establishment in the United Kingdom.

The approach of the Finance Act 2015 is to directly the charging provisions from the Corporation Tax Act 2009. This approach is therefore somewhat less reliant upon assumptions and fictions than the approach taken to CFCs. It is therefore arguable that accepting the court's distinction in *Bricom* between actual accrued profits and notional imputed profits – the profits subject to the Diverted Profits Tax are closer in character to the former kind of profits than the latter. HMRC might well find it considerably more difficult to defend the position that a tax payable upon the base defined by the Corporation Tax Act 2009 is not identical or substantially similar to Corporation Tax itself.

While HMRC maintains that the Diverted Profits Tax is formally distinct from Corporation Tax, the only discernable differences between them appear to be the jurisdictional standard triggering the charge to tax, which is problematic with respect to the UK's tax treaty obligations; and the rate at which the tax is payable – 25%, as

opposed to a 20% rate of Corporation Tax in 2016-16, which might also be problematic with respect to European Union Law.

8.3.3 Compatibility with European Union Law

The courts of the European Union have consistently and repeatedly impugned laws that treat a company differently because they have shifted their residence, establishment, or source of income – even when such relocations have as their objective the minimisation or avoidance of tax. It is settled case law that as a matter of European Union Law, direct taxation falls within the competence of the Member States. However, Member States must nonetheless exercise that competence in accordance with the broader requirements of European Union Law.[991] Of particular relevance is Article 110 TFEU which provides that

> [n]o member state shall impose, directly or indirectly, on the products of other Member States any internal taxation of any kind in excess of that imposed directly or indirectly on similar domestic products.[993]

Of further relevance to corporations, in particular, is the provisions of Article 49 TFEU, which prohibits restrictions upon freedom of establishment of nationals of Member States in the territory of another Member State. This includes establishment

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[991] Case C-311/97 *Royal Bank of Scotland* [1999] ECR I-2651; Case C-319/02 *Manninen* [2004] ECR I-7477; Case C-446/03 *Marks & Spencer* [2005] ECR I-10837.

[993] Art. 110, Consolidated Version of the Treaty on the Functioning of the European Union, 2008 O.J. C 115/47

and management of undertakings, including companies.[995] Furthermore, Article 63 TFEU provides for the free movement of capital within the Union.

It is arguable that the Diverted Profits Tax may well breach EU Law in this respect. In a similar fashion to CFCs, the nature of the Diverted Profits Tax is such that it can only apply to a non-resident company.

The decision of both the ECJ and of the Advocate General in *Sandoz* are informative in this respect. *Sandoz* concerned the requirement to pay Austrian stamp duty on loans. A distinction existed between loan agreements drawn up and executed within Austria, and those executed outwith Austria. Austrian legislation further provided that where a loan was drawn up outwith Austria, and not recorded in a written instrument that is chargeable for the purposes of stamp duty, that company books kept in Austria in which the loan is recorded shall be deemed to be such an instrument for the purposes of stamp duty. This 'deeming' of transactions concluded outwith Austria to be chargeable upon the books of the Austrian enterprise could be argued to be analogous to the deeming of transactions to be attributable to an avoided PE under the Diverted Profits Tax. It is worth noting that the Austrian legislation in *Sandoz* did not impose a higher duty on loans arranged outwith Austria, or even less

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[995] Art. 54, TFEU.

favourable terms.[997] Nonetheless, the Court in *Sandoz* found that Austria's extension of its jurisdiction to tax such loan transactions was a breach of Article #.

In his opinion on the case, Advocate General Leger took the view that

> [t]he principle of the free movement of capital was introduced *inter alia* in order to enable Community nationals to enjoy the most favourable conditions for investing their capital available to them in any of the States which make up the Community.

It is difficult to conclude that Advocate General Leger's opinion is anything other than an endorsement of tax competition between Member States. The Court agreed with the Advocate General's position, holding that the measure

> deprives residents of a Member State of the possibility of benefiting from the absence of taxation which may be associated with loans obtained outside the national territory. Accordingly, such a measure is likely to deter such residents from obtaining loans from persons established in other Member States.
>
> It follows that such legislation constitutes an obstacle to the movement of capital within the meaning of Article [63 TFEU].[999]

If the very purpose of free movement is to ensure the allocation of resources to their most efficient location, it logically follows that measures which inhibit 'shopping around' for the most favourable environment for those resources must surely be unlawful.

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[997] If anything, the charging provisions for loans arranged outwith Austria were more favourable than those arranged within Austria – being payable only at the point at which the loan instrument is brought into Austria, rather than the point at which the loan instrument is executed.

[999] Case C-439/97 *Sandoz* [1999] ECR I-07041.

The question of whether or not the UK's CFC rules are compatible with EU Law was considered by the ECJ in *Cadbury Schweppes.*[1001] At issue in the case was the question of whether or not the UK's taxation, under certain conditions, of the profits of subsidiaries established outside of the United Kingdom is compatible with EU Law.

Much like the Diverted Profits Tax, the CFC rules are designed specifically to target attempts to take advantage of lower tax rates in other jurisdictions. Similarly, much like the Diverted Profits Tax, the CFC rules do not apply where a 'motive' test is satisfied. In the case of CFCs, the motive test is satisfied when two cumulative conditions are met. The first, is that where the transactions which are attributable to the CFC produce a reduction in the UK tax payable compared to that which would have been payable absent those transactions, and where that reduction exceeds a certain threshold, the company must show that the reduction to UK tax was not the main purpose, or one of the main purposes, of those transactions. The second criterion is that the company must show that it was not the main reason, or on of the main reasons, for the CFC's existence to achieve a reduction in UK tax by diverting profits thereto.[1003]

The Diverted Profits Tax becomes chargeable under s.86 of the Finance Act 2015 where a non-UK resident company avoids a UK taxable presence and, among

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[1001] Case C-196/04 *Cadbury Schweppes* [2006] ECR I-8031.

[1003] s.748(3) ICTA.

other criteria, either the tax avoidance condition or the mismatch condition is satisfied. The mismatch condition occurs where the arrangements between the two enterprises results in an effective tax mismatch outcome. This effective tax mismatch outcome is remarkably similar to the CFC provisions contained within ICTA. An effective tax mismatch outcome exists where there has been a deduction from the taxable profits of a UK enterprise that is not matched by a corresponding increase in the taxable profits of the related non-UK company, and the 80% payment test is not met. This 80% payment test is met where the resulting increase in relevant taxes payable by the non-UK company as a result of the attribution of aforementioned payment to it is at least 80% of the amount of the resulting reduction in the amount of the relevant tax payable by related UK enterprise.

The decision in *Cadbury Schweppes* is of considerable significance insofar as the 80% payment test is concerned. The Court in *Cadbury Schweppes* reiterated its earlier pronouncement in *Barbier* that

> a Community national cannot be deprived of the right to rely on the provisions of the Treaty on the ground that he is profiting from tax advantages which are legally provided by the rules in force in a Member State other than his State of residence.[1005]

The Court had previously held that the right of freedom of establishment guaranteed by the EU Treaties means that the fact that an enterprise has sought to

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[1005] Case C-364/01 *Barbier* [2003] ECR I-15033, para. 71.

establish itself in a Member State in order to take advantage of a more favourable legislative environment does not, of itself, constitute an abuse of that freedom.[1007]

In *Commission v. France* the Court held that the fact that a company gains a tax advantage by establishing in a Member State cannot of itself justify the imposition of disadvantageous tax treatment by another Member State.[1009] Furthermore, the Court took an unequivocal view of Article 54 TFEU, stating that the objective of preventing tax avoidance does not permit a state to restrict a company's right of freedom of establishment:

> [t]he risk of tax avoidance cannot be relied upon in this context. Article [54 TFEU] does not permit any derogation from the fundamental principle of freedom of establishment on such a ground.[1011]

The ECJ appears to have taken a fairly consistent approach to the conflict that arises between, on the one hand, the right of freedom of establishment enshrined within Article 54 TFEU; and, on the other, national rules which are designed to combat tax avoidance but incidentally infringe upon Article 54.

In *ICI* the Court held that

> diminution of tax revenue occurring in this way is not one of the grounds listed in Article [52 TFEU] and cannot be regarded as a matter of overriding general interest which may be relied upon in order to

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[1007] Case C-212/97 *Centros* [1999] ECR I-01459, para. 27.

[1009] Case 270/83 *Commission v. France* [1986] ECR 273, para. 21.

[1011] *Ibid*, para. 25.

> justify unequal treatment that is, in principle, incompatible with Article [49 TFEU].[1013]

This unequivocal approach is further elaborated by the Court in *Cadbury Schweppes*:

> the mere fact that a resident company establishes a secondary establishment, such as a subsidiary, in another Member State cannot set up a general presumption of tax evasion and justify a measure which compromises the exercise of a fundamental freedom guaranteed by the Treaty.[1015]

It is clear, therefore, that the objective of preventing tax avoidance does not justify any restriction upon an enterprise's right to freedom of establishment. Furthermore, the objective of reducing liability to pay tax cannot, of itself, be considered to be abusive of that right. The test provided for in *Cadbury Schweppes* therefore has two constituent elements: a subjective element (an intention to avoid tax); and an objective element (that the objectives of freedom of establishment have not been breached). Under the second element, such anti-avoidance rules may not be applied, even where there is an explicit *intention* to avoid tax, where the taxpayer nonetheless carries on genuine economic activities.[1017]

[1013] Case C-264/96 *ICI* [1998] ECR I-04695, para. 28.

[1015] *Supra* note 502, para. 50.

[1017] Brady Gordon, 'Tax Competition and Harmonisation under EU Law: Economic Realities and Legal Rules' [2014] 39 European Law Review 790, 802.

Indeed, it is highly arguable that competition between jurisdictions to attract businesses by way of favourable regulatory and taxation regimes is not only compatible with the core principles of the Internal Market, but encouraged by them.[1019]

It is further arguable, therefore that the objective of the Diverted Profits Tax is not so much the elimination of abusive practices or tax avoidance, but of lawful tax competition between states. A position that is made all the more indefensible by virtue of the Chancellor of the Exchequer's continued cuts to the UK's main rate of Corporation Tax.

However, even if the Diverted Profits Tax were to survive challenges on the basis of the UK's obligations under International and EU Law – the question remains as to whether or not the tax will have any serious practical effect. As it is quite clear that EU Law permits the scope of such a tax to be only so wide as to capture wholly artificial arrangements, it is arguable that, in fact, very few companies will ever be required to pay it. Under the two-part test outlined in *Cadbury Schweppes* and discussed *supra,* even prohibitions on arrangements that have as their intention the avoidance are not compatible with EU law where such arrangements are nonetheless rooted in economic reality. The test of whether or not an arrangement is based upon economic reality

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[1019] *Ibid.*

> must be based on objective factors which are ascertainable by third parties with regard, in particular, to the extent to which the [company] physically exists in terms of premises, staff and equipment.[1021]

While the relevant provisions of the Finance Act 2015 are drafted deliberately narrowly, it may well be the case that, if subjected to the scrutiny of the ECJ, the scope of the tax narrows even further. On that basis, it is entirely possible that many of the arrangements that the tax is purportedly designed to target fall outwith its scope by virtue of being rooted in economic reality.

While the diverted profits tax may have attracted the moniker of 'the Google Tax', the reality is that the arrangements of Google, like so many other enterprises who have been the subject of much public and political ire, are not, in fact, artificial at all. As of end 2013 Apple has 4,000 employees in Ireland; Google has over 2,000; Facebook approximately 500. These are hardly brass-plate companies, but real and substantive establishments within Ireland.

It is difficult to see how the practice of lawfully 'booking' profits in a jurisdiction in which an enterprise has thousands of employees could nonetheless be construed as being artificial. By contrast, notwithstanding the arguments made by this thesis in chapter 5, above, it is arguable that to exercise tax jurisdiction over an enterprise which, by contrast, has as its sole connection with that jurisdiction the fact that it makes sales within it is, in fact, highly artificial.

[1021] Cadbury Schweppes, *supra* note 502.

Furthermore, it is difficult to envisage how the DPT will be enforced, in practice, over enterprises with absolutely no presence in the United Kingdom whatsoever. Compelling compliance from enterprises that have no physical presence within the UK and conduct their dealings entirely through the Internet and independent agents may well prove extremely problematic – in particular if those enterprises contest the legality of the DPT under double tax treaties.

8.4 Base Erosion Approach

Another proposal is Richard Doernberg's 'base erosion approach'.[1023] Doernberg proposes that direct tax nexus should exist whenever a foreign enterprise receives a payment from a taxpayer located within its territory. Under Doernberg's proposal, any payment to a foreign enterprise that a domestic taxpayer is entitled to deduct from their taxable income would be subject to a withholding tax charge. According to Doernberg, such a regime would supplement, rather than replace, the traditional permanent establishment standard. States would therefore retain the right to tax all nonresident enterprises with a permanent establishment within their territory. Furthermore, under Doernberg's proposal, the foreign enterprise would be permitted to establish and account for such payments as business profits within that state notwithstanding its lack

[1023] Richard L Doernberg and Luc Hinnekens, *Electronic commerce and international taxation* (Kluwer Law International 1999).

of a permanent establishment, and avoid the charge to withholding tax.[1025] Payments made by private parties to foreign enterprises would be unaffected by this regime, as the party making the payment would not normally be entitled to deduct the payment from their income. Unlike deductible payments to foreign enterprises, payments from private parties do not erode the tax base of the jurisdiction in which that private party is resident.

India's High-Powered Committee Electronic Commerce and Taxation also advocates a base erosion approach. However, under the Indian Committee's approach, the permanent establishment standard should be scrapped altogether, and replaced with a base erosion nexus.[1027] In the view of the Indian Committee, simultaneous operation of the permanent establishment standard and the base erosion withholding tax would simply present further opportunities for avoidance. However, the Committee did accept Doernberg's approach, provided that it is applied to all payments to foreign enterprises, and not just electronic commerce – a more consistent approach which, it is highly arguable, is preferable.

What is notable about the base erosion approach is that it is quite clearly the existence of a marketplace or customer base that justifies jurisdiction to tax. This represents a significant alternative view as to the source of income from cross-border

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[1025] As withholding tax is charged on gross payments, it may well be to the advantage of the enterprise to account for its profits within the source state – thereby paying tax on net profits instead.

[1027] *Supra* note 286.

transactions. It is quite clear that a supply-side approach to the source of income has been favoured, in particular, by the OECD Committee on Fiscal Affairs.[1029] Doernberg's proposal represents a significant alternative perspective on the source of income.

The base erosion approach would be easy to enforce, as only those payments that are deductible from the income of a domestic taxpayer would be subject to the charge to tax. By making the availability of the deduction contingent upon the withholding tax charge, domestic taxpayers would be incentivised to deduct the withholding tax at source. In this respect, the base erosion withholding tax is similar to VAT. Thus, it is highly arguable that the base erosion approach would be largely self-enforcing.

The OECD contemplates a withholding tax on digital transactions, on the basis that

> it may be possible to maintain substantial economic activity in a market without being taxable in that market under current permanent establishment rules due to lack of physical presence in that market.[1031]

This approach implicitly recognises the role of a marketplace in founding jurisdiction to tax. However, unlike Doernberg's approach, the OECD's proposals are not limited to business-to-business transactions, but includes all transactions within that marketplace.

[1029] See, *supra* note 242.

[1031] OECD, *BEPS Action 1: address the challenges of the digital economy*, *supra* note 155.

This creates inevitable questions as to enforceability, with one option contemplated by the OECD being enforcement inn the hands of payment providers such as banks and credit card companies.

8.5 Quantitative economic presence test

The approaches to a virtual permanent establishment standard, either at 6.4.3, or in Chapter 7, are qualitative in nature. Arthur Cockfield argues that the US experience with sub-federal sales tax demonstrates the difficulties in operating a subjective test of economic presence.[1033] Such concerns correlate, at least in part, with those expressed by this thesis, above. Cockfield therefore proposes a new permanent establishment fiction based on a quantitative, rather than qualitative, economic presence test.

Cockfield argues that a quantitative economic presence test is consistent with the historic rationale for the permanent establishment principle. Source countries would continue to enjoy tax revenues from significant economic activity taking place with their borders. It would also be, like the fixed place of business test, simple in conception and practice. Businesses could be certain when their activities within a state amount to a taxable presence.

[1033] For example, in *Quill*, the state of North Dakota enacted a so-called 'long arm' statute to force out of state vendors to collect tax on sales within the state. The US Supreme Court had previously employed a 'facts and circumstances' test to determine whether persons had a sufficient connection to state and local laws in order for authorities to exercise jurisdiction. The court held that given the inordinately large number of state and local taxes potentially applicable within the United States, such a qualitative test created unacceptable uncertainty, and ultimately imposed a bright line 'physical presence' test.

Cockfield further argues that a quantitative economic presence test would be neutral in its treatment of electronic commerce. Such a test would apply equally to all enterprises engaged in activity in another state, and does not attempt to create special rules for particular types of business. Though Cockfield concedes that some distortion will remain insofar as those enterprises that trade in another jurisdiction but fall below the threshold will be taxed at residence, such distortion is likely to be minimal.

Cockfield cites a potential difficulty with the quantitative approach being the need for greater information sharing amongst revenue authorities, and the corollary sovereignty implications. However, in recent years there have been significant moves towards improving information sharing amongst revenue authorities.[1035] Information sharing has appeared, so far, to be the principal method by which states have sought to halt the erosion of national tax bases. There is little to suggest that states would be reluctant to share the information necessary to operate a quantitative economic presence test.

A quantitative approach could potentially halt the proliferation of withholding taxes which the OECD Model seeks to discourage. Cockfield argues that

> an economic presence [test] would permit the OECD to argue for a continued reduction in withholding taxes that, in the view of many

[1035] 'G7/8 Lough Erne Declaration HTML Version' (*GOV.UK*) <https://www.gov.uk/government/publications/G7/8-lough-erne-declaration/G7/8-lough-erne-declaration-html-version> accessed 2 February 2014.

OECD countries, undermine cross-border trade and investment efforts.[1037]

A quantitative test is not the blunt instrument that a withholding tax is. It provides a trigger for the application of treaty provisions, rather than applying a blanket tax on turnover.

It is submitted that there is little conceptual difficulty in applying a quantitative test for tax jurisdiction. In Europe, a quantitative test for tax jurisdiction is already used for determining liability for VAT.[1039] Given that permanent establishment is transactional, rather than personal, in nature it seems there is little conceptual difficulty in applying a quantitative standard to income taxes as well as consumption taxes. If tax harmonisation in EU continues, in particular CCTB, then we could potentially see a special scheme similar to that which exists for VAT.

A number of difficulties with such an approach do remain, however. The question as to what level such a threshold should be set would need to be addressed. If set too low, the prospect of tax compliance in multiple jurisdictions might discourage small firms from engaging in cross border transactions. Set too high then significant revenue could be lost to source states, as well as exacerbating the neutrality problem.

[1037] Cockfield, 'Reforming the Permanent Establishment Principle through a Quantitative Economic Presence Test' (n 51).

[1039] For example, Sch. 2 Value Added Tax Act 1994 requires that taxable persons established in non-UK Member States must register and account for VAT where they make supplies of goods or services in the UK of a value in excess of £70,000.

Furthermore, a number of inter-nation equity issues are raised by the question of the level at which the threshold should be set. Prescribing the threshold in treaties has the desirable qualities of certainty and uniformity –ensuring that the same rules apply in both or multiple jurisdictions. Conversely, without regular revision the effect of inflation would be to lower the threshold over time. The logical solution to this problem is to prescribe that there shall be a threshold which is set by domestic legislation. This raises a further equity consideration, which is whether or not it is more equitable to set the same threshold for all states, or to provide for thresholds that are commensurate with the size of the marketplace. A million euro in sales in Ireland amounts to a considerable economic presence, while the same level of sales across the whole of the United States is comparatively low-level.

Cockfield acknowledges that a quantitative approach does not solve the problems of transfer pricing or income characterisation. The schedular approach adopted by the OECD Model provides for differing treatment of income derived from business activity, service provision, and royalties. Electronic commerce transactions blur these lines considerably. However, if it is accepted that some form of virtual permanent establishment ought to exist then such issues arise regardless of whether a qualitative or quantitative approach is taken.

8.6 Residence-based taxation

Chapter 5 outlines the case for taxation at source. This thesis takes the view that a regime based upon taxation of income at source is conceptually sound. This thesis further takes the view that, while such a system is practically more difficult, those difficulties are not insurmountable. However, this is not a universally held view. There are those, as is noted in chapter 5, who advocate a shift to a wholly residence-based system of taxation.

According to this view, most types of income have more than one source, and therefore attempting to attribute income to a single source is both economically inappropriate and distorting.[1041]

Bradford offers three justifications for taxation on a residence, rather than a source basis. The first, is that 'the concept of income as consumption plus change in net worth implies that attribution of income by source is inappropriate. Income, by this definition, is an attribute of individuals, not of places.'[1043] The second, is that if owners of factor services are much less mobile internationally than the factor services they supply, variations in taxation levels between residence jurisdictions will be less distorting than variations between places of factor employment. The third, is that the

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[1041] Bradford *supra* note 186, 99-101.

[1043] *Ibid.*

principle of progressive taxation necessitates taxation of a person's entire global income.

A further argument in favour of residence-based taxation is that it is more democratically legitimate. The jurisdiction in which taxpayers are resident is usually the jurisdiction in which taxpayers are engaged politically. In those residence jurisdictions that are in some way democratic, taxpayers have at least some say in the level of taxation that they must pay and the services received in return. However, it is for this very reason that the taxation of non-residents is highly attractive to policymakers. Non-residents are 'easy prey' for lawmakers, as they wield no electoral power and can therefore be taxed with little political retribution.[1045] However, this argument is undermined somewhat by the fact that corporations do not generally enjoy democratic rights.[1047] The beneficial owners of a corporation may be (and often are) located somewhere entirely different.

The United States, in particular, favours a shift towards a residence basis for taxation. In their 1996 white paper, the US Department of the Treasury addressed the

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[1045] See Avi-Yonah, *International tax as international law: an analysis of the international tax regime*, at 39, and Prussak, at 58.

[1047] One example of a political community in which corporations exercise democratic rights would be the City of London, where businesses operating out of the City, as well as residents, vote in elections to the City of London Corporation. See the City of London (Various Powers) Act 1957 and the City of London (Ward Elections) Act 2002.

issues posed to taxation rules by electronic commerce. It's heading entitled 'The ascendency of residence based taxation' proposed that

> [i]n situations where traditional source concepts have already been rendered too difficult to apply effectively, the residence of the taxpayer has been the most likely means to identify the jurisdiction where the economic activities that created the income took place, and thus the jurisdiction that should have the primary right to tax such income.[1049]

This reflected the sentiments of the Treasury's earlier work, authored by David F. Bradford 'Blueprints for Basic Tax Reform'.[1051]

The white paper predicted the continued erosion of source based taxation, and saw residence basis taxation as a more suitable alternative. The white paper anticipated that this trend 'will be accelerated by developments in electronic commerce where principles of residence-based taxation will also play a major role.'[1053]

The white paper has, to a large extent, proven to be correct. There is little doubt that electronic commerce has accelerated the continued erosion of the principle of taxation at source. However, the white paper was, as Avi-Yonah points out,[1055] highly conservative in its approach to electronic commerce. Its proposed response to the challenges posed by electronic commerce was, save for some minor revision to

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[1049] US Department of the Treasury Office of Tax Policy, 'Selected Tax Policy Implications of Global Electronic Commerce', *supra* note 331, p.28.

[1051] *Supra* note 186.

[1053] Op. cit.

[1055] Avi-Yonah, 'International taxation of electronic commerce', *supra* note 204, 24.

taxation rules, to effectively do nothing. This response may indeed be the most appropriate one if the objective is the erosion of the principle of taxation at source and to shift the jurisdiction to tax towards residence. This is the US' stated objective. However, though the U.S.' preference for residence basis taxation is, perhaps, unsurprising (the U.S. remains, after all, the world's largest exporter of capital), this thesis takes the opposite view.

Amongst the heaviest criticism of the white paper comes from Avi-Yonah. Avi-Yonah argues that the U.S. position of moving towards a residence basis for taxation of business profits is 'inconsistent with the generally accepted international consensus, as embodied in tax treaties and in the U.S. international tax regime.'[1057] Avi-Yonah disputes the assertion of the white paper that the permanent establishment threshold standard represents a preference for residence basis taxation. As Graetz and O'Hear previously pointed out, the 'original intent' of U.S. international tax policy was clearly to tax income at source.[1059]

Avi-Yonah further argues that the argument advanced by the white paper that profits derived from online activity should be treated the same as profits derived from oceans or outer space is logically fallacious. This approach could be seen as similar to

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[1057] *Ibid*, 525.

[1059] Graetz and O'Hear, *supra* note 197.

David Post's proposed approach to jurisdiction on the Internet generally,[1061] by regarding all such transactions as taking place outwith conventional jurisdictional bounds. However, as Avi-Yonah argues, profit derived from online activities

> does have a source in the traditional sense because both the production activities and the consumption that produce it take place in a physical location outside cyberspace. In that sense, income from cyberspace is more like international communications income, which under a rule enacted at the same time as the rule for space and ocean activities, is taxed on a source basis.[1063]

Finally, Avi-Yonah argues that the relative meaninglessness of corporate residence to online enterprise makes a residence basis particularly unsuitable for electronic commerce. The two dominant definitions of corporate residence are the place of incorporation test, favoured by the U.S.; and the 'place of effective management' standard – and numerous variants thereof[1065] – originating out of *De Beers Consolidated Mines.*[1067] Both of these standards are highly susceptible to manipulation. The place of incorporation standard is particularly easy to manipulate, by simply incorporating a holding company in a law-tax jurisdiction. Furthermore, the horizontal integration of business functions which network technology enables facilitates the decentralisation of corporate management to multiple jurisdictions. It is

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[1061] *Supra* note 71, discussed above at Chapter 3.

[1063] *Supra* note 204.

[1065] Maisto, *supra* note 296.

[1067] *Supra* note 234.

no longer necessary for corporate directors to meet in a single location, nor do the management functions of a company need take place at a single corporate headquarters.

However, notwithstanding these, in essence, utilitarian arguments against a shift to taxation at residence, the principle of residence basis taxation at a conceptual level remains fundamentally unjust. The appropriateness of the principle of taxation of business profits at source has not eroded simply because the rules designed to implement it have struggled to keep pace with modern business practices. The benefit principle remains, as this thesis has demonstrated, the only logical justification for taxation in an international context – therefore taxes are levied as a *quid pro quo* for benefits received from a state. Given that, as this thesis has demonstrated conclusively, the Internet has provided far greater opportunities for enterprises to benefit from the economy and infrastructure of a state in which that enterprise is not resident, the solution must surely be the reinforcement of the principle of taxation at source, rather than the abandonment of it. For all of the foregoing reasons, both practical and conceptual, this thesis therefore rejects a shift to residence-basis taxation, as the answer to the challenges posed by highly virtual enterprises.

Chapter 9: Conclusions

This thesis commenced with an overview of the normative background applicable to the taxation of highly virtual enterprises in international law. The starting point for such an inquiry is the jurisdiction to tax in international law. Chapter 2 illustrates the first facet of the problems associated with the taxation of highly virtual enterprises – that jurisdictional overlap is a consequence of the normal operation of international law. Double taxation treaties, and the jurisdictional threshold rules which flow therefrom, are therefore the product of positive intervention to suspend the normal operation of law. However, while such intervention alleviates the problematic nature of the normal operation of international law, in doing so these interventions often create new problems. These problems include the mis-allocation of jurisdiction to tax, or, worse still, the non-allocation of jurisdiction to tax.

However, these problems are not particularly new, nor are they peculiar to the sorts of enterprise that are the subject. In the present instance, these enterprises present further jurisdictional challenges. These challenges arise as a consequence of the advent of the Internet, and the modern business practices facilitated thereby.

Early approaches to applying jurisdictional norms to online activity produced jurisprudence of questionable merit. These approaches were based upon a flawed

understanding of the nature of the Internet, and reflected a degree of hysteria about the legal consequences of this new technology. However, as understandings of this new technology improved, so too to the jurisprudence pertaining to how jurisdictional norms should be applied. It was recognised by courts, in cases such as *1-800* Flowers,[1069] *Bonnier Media v.* Smith,[1071] and *Euromarket Designs v Peters Crate & Barrel*[1073] that the Internet is not a lawless frontier, nor does content radiate, pervasively, into every jurisdiction in which it is potentially accessible. This thesis endorses the approach seen in these cases, and therefore synthesises a set of principles for the application of jurisdiction to the Internet. These principles are based upon the better elements of the foregoing jurisprudence.

Chapter 4 outlines how the foregoing conceptual issues have manifested themselves in practice. It details the new business models that have emerged as a consequence of the advent of the Internet, as well as the efforts that have been taken so far to apply and adapt existing tax rules to these new models.

Chapter 5 provides the basis of this thesis' evaluation of the permanent establishment principle, and proposed alternatives, in subsequent chapters. Chapter 5 seeks to found the conceptual basis for the allocation of jurisdiction to tax in international law. It argues that the intended purpose of jurisdictional rules with

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[1069] *Supra* note 89.

[1071] *Supra* note 94.

[1073] *Supra* note 92.

respect to taxation is to effect taxation at source. It does so on two bases, which form a core component of the methodology outlined by this thesis in chapter 1.

The first basis for the allocation of jurisdiction to tax at source is that it reflects sentiments broadly held amongst policymakers and the public alike, and that it is, therefore, legitimate. There is a clear desire that taxes should be payable on business profits where they are earned.

The second basis for the allocation of jurisdiction to tax at source is that it is the only approach to allocation of jurisdiction that satisfies the benefit theory of taxation. Under the benefit theory of taxation, the conceptual justification for authority to tax is that taxes are a just *quid pro quo* for benefits received from the state. This principle is most famously espoused by Mr Justice Holmes in as 'taxes are what we pay for civilized society.'[1075] The evidence for this submission is, it is argued, considerable. Vogel contends that no amount of 'trading in' a jurisdiction can justify a jurisdictional claim on the basis of 'sacrifice'[1077] in an international context.[1079] Evidence of this can be seen in, *inter alia*, the schedular nature of the allocation of jurisdiction to tax under treaties. A system underpinned by notions of 'sacrifice' or 'ability to pay' would not allocate jurisdiction in the manner done by the OECD Model.

[1075] *Supra* note 192.

[1077] The alternative approach to founding jurisdiction to tax.

[1079] *Supra* note 191.

Chapter 5 also sets out a broader approach to the source of income than that which has dominated mainstream thought in this respect. It argues that historic notions of the source of income are out of kilter with contemporary business practices. Chapter 5 argues that notions of the source of income that focus heavily on the location of the factors of production are arcane, an fails to take adequate account of the role of upstream value creation – such as through research and development, know how, *etc.* – or of downstream value creation – such as sales strategies and the marketplace – in generating income.

Therefore, the evaluation of jurisdictional standards undertaken in subsequent chapters is with reference to the extent to which of those standards best allocate jurisdiction to source states.

Chapter 6 provides a detailed analysis of the predominant jurisdictional rule in international taxation law – the permanent establishment principle, found in Article 5 of the OECD Model Convention. It considers, in particular, the physicality requirement of the 'fixed place of business' permanent establishment, and argues that that requirement is inconsistent with the principle of taxation at source. It further considers the difficulties posed by the OECD's attempts at applying the permanent establishment standard to computer hardware such as servers. It is clear that this approach fails to take account of the fundamental nature of the Internet, which is that of a communications medium.

Chapter 6 makes the case for the adoption of a virtual permanent establishment standard to supplement the existing standard. Though not the approach favoured by this thesis, such an approach would nonetheless represent a marked improvement on the *status quo*. Furthermore, given that the approach proposed by this thesis in chapter 7 is largely dependent upon the adoption of improved dispute resolution mechanisms, the virtual permanent establishment approach may well represent a more acceptable compromise.

Chapter 7 proposes the adoption of a new or supplementary standard to the existing permanent establishment standard. The proposed standard is based upon the allocation of jurisdiction to tax amongst US states – and hinges upon whether or not an enterprise purposefully directs its activities into a state.

Such a provision would therefore create a deemed permanent establishment within a state where an enterprise has purposefully directed its activities towards that contracting state. For this, it is proposed that the criteria outlined in chapter 3 for determining jurisdiction on the Internet ought to be used. It is proposed that 'purposefully directing' be defined as 'actively soliciting trade or custom from a Contracting State'. It is further proposed that such solicitation should include, especially:

a. directing marketing or advertising campaigns towards that State;
b. displaying or communicating information about products or accepting orders in the local language or languages of that State;

c. displaying or communicating prices or accepting payment in the local currency of that State;
d. offering favourable delivery terms to customers located within that State;
e. selling products or providing services that are uniquely suited to that State, in particular products or services that are licensed, controlled, or regulated by or within that State.

Other evidence of purposeful direction that might apply exclusively in an online context might include the use of ccTLDs, or the tailoring of content to specific jurisdictions through geo-location.

Finally, the proposed additions should be subject to an additional exception for passive commerce, where an enterprise holds itself out as capable of receiving offers without any significant effort to solicit trade, custom, or sales from that other Contracting State.

This standard would, it is submitted, better reflect best practice in the allocation of jurisdictional competence over online acts, generally, that were outlined in chapter 3. This approach befits the Internet's nature as a communications medium, by allocating jurisdiction to source states where an enterprise has used the Internet to trade in that source state, but excluding jurisdiction where customers have merely used the Internet to visit that enterprise in another state. Thus, this approach achieves neutrality of treatment between tax and non-tax situations.

Crucially, this standard also satisfies the benefit theory of taxation. As a marketplace within a state is a source of income, it is appropriate that the state that has provided, or at least facilitated, that market ought to have jurisdiction to tax enterprises

that benefit from the existence of that market. By allocating jurisdiction to tax to a state where an enterprise has engaged in a significant way with the marketplace of that state, this standard therefore satisfies the key evaluative criterion of this thesis – the taxation of income at source.

Chapter 8 considered a number of alternative threshold standards which have either been proposed, or already exist in either domestic tax rules. It considers India's business connection test in its domestic tax law. It is submitted that India's business connection standard illustrates that there is no reason why a broader jurisdictional standard than the permanent establishment standard cannot work in practice.

Chapter 8 gives particular consideration to the United Kingdom's new Diverted Profits Tax – dubbed the 'Google Tax' – which has amongst its objects the establishment of a new threshold standard where companies are deemed to have artificially avoided trading through a permanent establishment within the UK. This thesis concludes that the Diverted Profits Tax compatibility with the UK's obligations under its Double Taxation Conventions, and with European Union Law, is highly questionable.

This thesis does not endorse the 'base erosion approach' proposed by Richard Doernberg, notwithstanding the fact that such an approach is implicitly intended to tax income arising from the existence of a customer base or marketplace within a state.

Chapter 8 further argues that a purely quantitative standard suffers from many of the same defects that afflict the permanent establishment standard; and that a residence basis for taxation of business profits is fundamentally incompatible with the benefit theory of taxation, highly susceptible to abuse, and entirely contrary to the clearly expressed objectives of both policymakers and the general public.

This thesis has not sought to radically alter jurisdictional standards as they apply to highly virtual enterprises under international law. Such an approach might take the form of the wholesale abolition of taxation at source and unitary taxation of worldwide income in the jurisdiction of residence. Instead, this thesis acknowledges the long-term success of existing jurisdictional rules in international tax law, in particular as they apply to offline enterprises. This thesis therefore proposes modest amendments to extant jurisdictional rules in order to accommodate the revolution in business practices that has taken place in recent decades. The fact that only modest modification to century-old jurisdictional rules is necessary in the face of such radical changes to the business economy is testament to the robustness of these rules. The amendments endorsed by this thesis are intended to ensure that the core principle underlying the allocation of jurisdiction to tax in international law – that of taxation of business profits at source – is maintained in the digital economy.

It can be seen in this thesis how little progress has actually been made in addressing these challenges thus far. However, there recently appears to be some

considerable momentum towards finally addressing the challenges posed by the Internet and highly virtual enterprises, including the jurisdictional challenges that are the subject of this thesis. If this momentum results in the adoption of some of the modest proposals contained within this thesis, then principle of taxation of business profits at source may well endure for another century.

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