INTERNATIONAL DIRECT TAXATION AND E-COMMERCE: A CATALYST FOR REFORM?

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This article critically analyses the challenges e-commerce poses to the traditional source- and residence-based taxation systems. It presents an exploratory study of two fundamental taxation principles that apply to international transactions in general and, more specifically, to e-commerce: the choice of residence-based or source-based taxation in governing the tax treatment of both domestic income accruing to non-residents and foreign income accruing to residents; and use of permanent establishment (PE) status in instituting the economic nexus required to assert jurisdiction over tax business profits. It is argued that in the interpretation and application of the rules, a clear distinction should be made between conceptual and practical issues. While there may be overlap between them, distinct issues exist regarding the normative questions of how and where profits arising from e-commerce should best be taxed as a matter of principle, as well as how such taxes should be implemented. The formulary apportionment of income earned by e-commerce business based on an economically justifiable formula provides a viable solution.

I. INTRODUCTION

The international tax system has not kept pace with technological development. Many countries around the world have become concerned about the extent to which e-commerce companies legally avoid taxes through carefully designed company structures.[1] For example, Google managed to cut its overall tax rate almost in half, by transferring $9.8b to Bermuda, around

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[1] Subhajit Basu, *International Taxation of E-Commerce: Persistent Problems and Possible Developments*, 1 J. Info. L. & Tech, 1-25 (2008).

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80% of its 2011 pre-tax profits.[2] However, the problem is not new.[3] Difficulties have long been associated with the application of the traditional international tax regime to multinational, non-traditional businesses, and the development of e-commerce has exacerbated the problem even further. Although international taxation[4] is one of the most important areas of tax law, it is one of the least studied tax topics. Indeed, it may be one of the most undeservedly ignored topics in all of the law,[5] even though its influence over global commerce, and particularly e-commerce, cannot be underestimated.[6]

This article begins with an analysis of the challenges posed by e-commerce[7] to the traditional source- and residence-based taxation systems. It then explores: first, the choice of specific principles (e.g., residence and source-based taxation) for governing the tax treatment of both domestic-source income accruing to non-residents and foreign-source income accruing to residents; and second, the use of the concept of a permanent establishment ('PE') in establish-

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[2] International Centre for Tax and Development, *A world upside down? New approach to international tax*, February 21, 2013, available at http://www.ictd.ac/blogs/entry/a-world-upside-down-new-approach-to-international-tax (Last visited on January 24, 2017) (Amazon paid considerably less UK corporate tax between 2009 and 2011, on sales of over £7.6 billion); *see* Library of the European Parliament, *Corporate tax avoidance by multinational firms*, September 23, 2013, available at http://www.europarl.europa.eu/RegData/bibliotheque/briefing/2013/130574/LDM_BRI(2013)130574_REV1_EN.pdf (Last visited on January 24, 2017) (The amount of corporation tax that some multinationals pay is the subject of intense public and political debate, which has significantly intensified since Brexit); *see also* Christiana HJI Panayi, Advanced Issues in International and European Tax Law (2015).

[3] Christian Keuschnigg & Michael Devereux, *The arm's length principle and distortions to multinational firm organization*, 89(2) Journal of International Economics. 432-440 (2013); *see* Michael Devereux & J. Vella, *Are we heading towards a corporate tax system fit for the 21st century?* (Oxford University Centre Business Taxation Working Paper, Paper no. 1425, 2014).

[4] International taxation acknowledges the 'tax sovereignty' of nations. The rules and practices are captured in domestic legislative, regulatory, and administrative measures concerned, for example, with foreign tax credit, non-resident withholding tax, the taxation of non-residents with an income-earning connection that is equivalent to (though more limited than) that of a resident, the taxation of foreign source portfolio income, and the taxation of foreign investment and business income earned by controlled foreign corporations. The theoretical underpinnings of the international tax system are the cost and benefit theories of taxation (equivalence theory); *see* Arvid Skaar, Permanent Establishment: Erosion of a Tax Treaty Principle 24 (1991); *see also* Stephen J. Kobrin, *Territoriality and the Governance of Cyberspace*, 32(4) Journal of International Business Studies 687-704 (2001).

[5] Michael Lebovitz & Theodore Seto, *The Fundamental Problem of International Taxation*, 23(4) Loyola of Los Angeles Intl. & Comp. L. Rev. 529 (2001).

[6] A report for the French government recommended that it should take unilateral action to impose taxes on Digital Economy companies, as a step towards concerted multilateral measures. However, there is clearly a limit to what can effectively be done by unilateral action.

[7] In this article, the term 'e-commerce' refers to transactions facilitated through or by the use of the Internet or similar media, and 'e-commerce context' refers to e-commerce transactions where the seller and the purchaser are not residents of the same tax jurisdiction and the seller has no physical presence or agents in the tax jurisdiction of the purchaser in connection with the transaction, including App Stores, Online Advertising, Cloud Computing and Participative networked platforms.

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ing the economic nexus required to assert jurisdiction over tax business profits.[8] The article argues that questions provoked by the present debate (on how to tax e-commerce) provide a cogent focus to consider the ability of national tax regimes to capture their share of the international tax base fairly, in the face of pressures and uncertainties brought about by e-commerce.[9] The article concludes with the argument that the formulary apportionment[10] of income from an e-commerce business based on an economically justifiable formula provides a viable solution.

The analysis of international tax law is heavily dominated by economic thought.[11] Even the legal analysts look to guiding principles that are typically broken down into categories of efficiency and equity.[12] The efficiency concerns tend to dominate in part because there is very little agreement on the normative foundations for equity issues.[13] It has been argued that interna-

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8 OECD, Addressing Base Erosion and Profit Shifting (2013), available at http://dx.doi.org/10.1787/9789264192744-en (Last visited on January 24, 2017) (Since the beginning of the economic crisis, considerable discussion has taken place globally in forums such as the G20 World Economic Forum for large corporations to pay back their 'fair share' of tax to the communities in which they earn their profits. The Organisation for Economic Co-operation and Development (OECD) undertook a detailed study of the existence and magnitude of base erosion and profit shifting and presented its progress report, 'Addressing Base Erosion and Profit Shifting,' (BEPS) to the G20 at its February 2013 meeting. The report was followed by an 'Action Plan' published in July 2013 with a view to addressing perceived flaws in international tax rules. It 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 it was endorsed by G20 leaders and finance ministers at their summit in St. Petersburg in September 2013. It was expected that the completion of these '15 Actions' will take at least two years. However, solving the digital issue by specifically identifying appropriate tax rules to deal with digital business has been designated the 'number-one action' in the 'Action Plan.' In October 2015, the OECD presented the final package of measures for a comprehensive, coherent and co-ordinated reform of the international tax rules in Lima, Peru. Following the G20 Leaders' endorsement of the '15 Actions' of the OECD/G20 BEPS project, the OECD was called on to prepare an inclusive monitoring and implementation framework by early-2016. In January 2016, the inclusive framework for BEPS was established (as requested by Leaders in Antalya), therefore all interested countries and jurisdictions can join the OECD and G20 countries on an equal footing, with a status of "BEPS Associate" in the Committee on Fiscal Affairs. The OECD is also actively supporting the AEoI implementation process through dedicated training seminars, and guidance for governments as well as for the affected financial institutions. To date, more than 25 countries have already identified an additional 48billion USD in tax revenues through voluntary disclosure and similar initiatives).

9 In the area of direct taxation there are three main tax policy concerns: "nexus", ability to have significant digital presence without being liable to tax; "data", How to attribute value created from the generation of data through digital products and services and determining the share of profit attributable to these value drivers; "characterization", proper characterization of income in the context of new business models.

10 Formulary apportionment was first proposed in 1923 through the Rome Resolutions of the International Chamber.

11 *See* Nancy Kaufman, *Fairness and the Taxation of International Income*, 29 L. & Pol. in Intl. Business 145 (1998).

12 *Id*.

13 M. Graetz, *Taxing International Income: Inadequate Principles, Outdated concepts and Unsatisfactory Policies*, 54 Tax L. R. 261-336 (2001).

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tional tax law is both excruciatingly complex[14] and fundamentally arbitrary,[15] and world tax regimes remain largely parochial[16] and are to a large extent a coordination game.[17] It was not until after the First World War[18] and the rise of globalisation[19] that it became necessary for governments to broaden the existing principles upon which taxation was based, in order for them to reap the dividends of global development without disabling trade. A careful balancing act ensured that enterprises were not 'double taxed' due to occupying more than one 'fiscal jurisdiction.'[20] A fundamental principle of international taxation is that "all incomes would be taxed once and only once."[21] In other words, the international tax norms should not only avoid double taxation, but should also prevent double non-taxation.[22] This problem addressed the employment of a great many (currently estimated to number over three-thousand)[23] bilateral treaties on tax,[24] which prescribe precisely the amount of income each state may derive from the trade.[25]

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[14] *See* Subhajit Basu, *Direct Taxation and E-Commerce: Possibility and Desirability* in Digital Economy Innovations and Impacts on Society 27, 26-48 (2012); *see also* Subhajit Basu, Global Perspectives on E-Commerce Taxation Law 30 (2007).

[15] *Id.*; J. Roin, *Competition and Evasion: Another Perspective on International Tax Competition*, 89 Geo. L. J. 543 (2001); D.M. Ring, *One Nation among Many: Policy Implications of Cross-Border Tax Arbitrage*, 44 Boston College of Law R. 79 (2005).

[16] It is based on the concept of 'fiscal sovereignty,' which allows those with jurisdiction over the territory in question to apply taxes as the national sovereign; *see* Stephen Kobrin, *Territoriality and the Governance of Cyberspace*, 32(4) J. of Intl. Business Studies 687-704 (2001).

[17] *See* Gabriel Zucman, *Taxing Across Borders: Tracing Personal Wealth and Corporate Profits*, 28(4) J. of Econ. Perspectives 121-148 (2014).

[18] For historical account *see supra* note 14.

[19] Alfredo Saad Filho, From Washington Consensus to Inclusive Growth: The Continuing Relevance of Pro-Poor Policy Alternatives (2010) Background paper for the World Economic and Social Survey; For a detailed discussion on effects of globalisation *see* M. Montes & R. Vos, Retooling Global Development and Governance (2014).

[20] Sol Picciotto, International Business Taxation: A Study in the Internationalisation of Business Regulation (1992) (The United States Revenue Act of 1918 for the first time in the world allowed a credit instead of a deduction against U.S. income taxes for taxes paid by a U.S. citizen or resident to a foreign fiscal revenue body for income earned outside the United States).

[21] League of Nations, Committee of Technical Experts on Double Taxation and Tax Evasion, *Double Taxation and Tax Evasion*, 23, C.216.M.85 (April 1927).

[22] (Double non-taxation where income that is not taxed in the source country is exempt in the residence country) *see* Antony Ting, *iTax—Apple's International Tax Structure and the Double Non-Taxation Issue*, 1 British Tax R. 41 (2014).

[23] Sunita Jogarajan, *Prelude to the International Tax Treaty Network: 1815–1914 Early Tax Treaties and the Conditions for Action*, 31(4) Oxford J. Legal Studies 679 (2011).

[24] "The development of treaty law has been influenced by the aim of minimising the overlap (and more recently the gap) of territorial circles drawn by competing countries in order to promote cross-border trade and investment." The treaties limit a country's tax jurisdiction and represent the compromises that two countries have reached with respect to the sharing of the tax base arising from cross-border transactions; *see* Jinyan Li, International Taxation in the Age of Electronic Commerce: A comparative study 31-32 (2003); Richard M. Bird & Scott Wilkie, *Source vs Residence based taxation in the European Union: The Wrong Question?* in Taxing Capital Income in the European Union: Issues and Options for Reform 91, 78-109 (2000).

[25] Jogarajan, *supra* note 23.

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Many of the bilateral tax treaties[26] have their geneses in publications of the Organisation for Economic Co-operation and Development (OECD), the foremost international tax policymaker,[27] which was formed as a successor to the League of Nations with the goal of finding internationally acceptable solutions to problems caused by the conflicting nature of national tax laws.[28] The OECD Model Tax Convention on Income and on Capital (OECD Convention)[29] provides a template, or framework, from which new bilateral treaties may be drawn up. The OECD itself acts as an 'aggregator of best practice', rather than a tax-collection service or an arbiter of disputes.[30] However, this procedure, which is used by most countries to allocate the tax base between jurisdictions and to avoid double taxation, is not merely cumbersome but has also come under increasing pressure as the scope and volume of cross-border activities have sharply expanded. This is because the double taxation treaties are based on the assumption of national sovereignty in tax policy,[31] which has become less relevant with the progress of globalisation.[32]

Considering the high degree of rigidity and political unwillingness, it is nothing short of a miracle that a consensus has emerged among developed countries in the post-war period regarding the use of these concepts in governing the allocation of worldwide income.[33] However, a more sceptical view would be that this apparent OECD consensus was really a 'Washington consensus,'[34] and that the concepts largely served the self-interests of large

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[26] For a discussion on bilateral tax treaties *see* OECD, *Model Tax Convention on Income and on Capital 2014*, October 30, 2015, available at http://dx.doi.org/10.1787/9789264239081-en (Last visited on January 25, 2017); For example a list of US tax treaties can be found in IRS website https://www.irs.gov/businesses/international-businesses/united-states-income-tax-treaties-a-to-z; (UK has an extensive network of double taxation treaties, for an historical account of double tax treaties) *see* Klaus Vogel, *Double Tax Treaties and Their Interpretation*, 4 INTL TAX & BUS. L. 1 (1986).

[27] *See* Arthur Cockfield, *The Rise of the OECD as Informal World Tax Organization through National Responses to E-Commerce Tax Challenges*, 8 YALE J. L. & TECH. 136 (2006).

[28] ANDREW LYMER & JOHN HASSELDINE, THE INTERNATIONAL TAXATION SYSTEM 8 (2002).

[29] OECD, *supra* note 26.

[30] LYMER, *supra* note 28.

[31] Despite widespread reliance on sovereignty arguments, little attention has been directed at what precisely is meant by sovereignty and what place it has in international tax policy.

[32] *See example* Michael Graetz & Michael Hear, *The Original Intent of U.S. International Taxation*, 46 DUKE L. J. 1021, 1066-1089 (1997) (describing the historical development of tax treaties); Graetz, *supra* note 13 (history and growth of tax treaties).

[33] Basu, *supra* note 14; *see also* R.S. AVI-YONAH, INTERNATIONAL TAX AS INTERNATIONAL LAW: AN ANALYSIS OF THE INTERNATIONAL TAX REGIME (2007); *see* R.S. Avi-Yonah, *The Structure of International Taxation: A Proposal for Simplification*, 74 TEXAS L. R. 1301 (1996).

[34] (From the mid-1970s on, European powers through the OECD launched a new wave of liberalisation-cum-globalisation that was soon backed by the US, which by means of the international institutions, namely the International Monetary Fund, the World Bank, and the GATT, was able to impose a set of ideological principles that underpinned and justified the adoption of neoliberal policies in countries around the world. These principles later came to be known as the Washington consensus. The Washington consensus made economic growth the main goal of development) *see* J. Williamson, *What Washington Means by Policy Reform* in LATIN AMERICAN ADJUSTMENT: HOW MUCH HAS HAPPENED? (2002).

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capital-exporting countries.[35] Whatever the political forces that have accounted for and shaped these concepts, over the years, they have come under increasing critical scrutiny in light of the burgeoning internationalisation of most markets, changing technologies, aggressive tax planning, and concerns over the equitable allocation of worldwide income among capital-exporting and capital-importing countries. It is further argued that even before the advent of e-commerce, it was not always easy to determine where income arose.[36] Countries might differ over whether the presence of a facility, the location of customers, the passage of title or the number of other factors determines where income arises.[37] As a result, tax considerations routinely drive the structuring of international businesses and transactions.[38]

The proliferation of e-commerce has led many commentators to question the effectiveness of some of the existing international taxation principles, particularly as e-commerce facilitates cross-border transactions and, as a mechanism, has particular relevance to international taxation.[39] While e-commerce may not necessarily introduce any new problems, it is apparent that any problems already associated with an inability to synchronise or inter-relate a variety of disparate taxing systems became exacerbated by a model that facilitates the very types of transactions that result in such problems in the first place.[40] It is undeniable that e-commerce has made it more difficult to implement efficient and equitable taxation. Most discussions with respect to income taxes for e-commerce transactions to date have focussed on three problems: How can we attribute income arising from the 'Internet' to a particular jurisdiction? How can we characterise such income? And, most importantly, how can it be taxed?[41] Income tax treaties do not provide easy answers to these questions because they were developed in a non-digital era when transactions and commercial law dealt primarily with tangible property.[42]

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[35] Basu, *supra* note 14, 31; *see* Jinyan Li, International Taxation in the Age of Electronic Commerce: A Comparative Study (2003).

[36] Basu, *supra* note 14; *see also* Basu, *supra* note 1 1-25.

[37] Richard Doernberg et al, Electronic Commerce and International Taxation (1999).

[38] Basu, *supra* note 14.

[39] Charles McLure Jr., *Taxation of Electronic Commerce: Economic Objectives, Technological Constraints, and Tax Laws*, 52 Tax L. R. 269 (1997); Walter Hellerstein, *State Taxation of Electronic Commerce*, 52 Tax L. R. 425 (1997); Arthur Cockfield, *Designing Tax Policy for the Digital Biosphere: How the Internet is Changing Tax Laws*, 34 Conn. L. R. 333 (2002); Catherine Mann, *Balancing Issues and Overlapping Jurisdictions in the Global Electronic Marketplace: The UCITA Example*, 8 Wash. U. J.L. & Pol'y 215 (2002); Reuven Avi-Yonah, *International Taxation of Electronic Commerce*, 52 Tax Lawyer 507 (1997); Benjamin Hoffart, *Permanent Establishment in the Digital Age: Improving and Stimulating Debate through an Access to Markets Proxy Approach*, 6(1) Nw. J. Tech. & Intell. Prop. 106 (2007).

[40] Li, *supra* note 35.

[41] Basu, *supra* note 14; For a broad outline on how e-commerce presents a major challenge for tax administrators *see* Out-law.com, *Introduction to taxation of E-Commerce: A guide*, available at http://www.out-law.com/page-7512 (Last visited on January 25, 2017).

[42] *See* Annette Nellen, *Internet Taxation and Principles of Good Tax Policy*, 1(4) Policy & Internet (2012).

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How does the international taxation system currently operate in terms of source and residence-based approaches? International taxation revolves around the coordination and allocation of taxing rights among countries.[43] Taxation based on the source principle presupposes that taxing authorities can determine the geographical source of income, while taxation based on the residence principle requires information about the identity and residency status of those engaged in income-producing activities.[44] The methods of establishing whether a company is technically a resident vary from jurisdiction to jurisdiction. In the UK, for example, §14 of the Corporation Tax Act, 2009 provides that any company incorporated in the UK is a *de jure* resident for the purposes of tax, regardless of whether a different country of residence is claimed by the company. Similarly, in the US, residency status may also be attributed to an individual even if the individual does not actually reside in the country but merely holds citizenship and either operated from the country previously or intends to do so in future. The UK[45] also employ a more complex test in addition to the one used in the US, which is known as the 'place of effective management'[46] rule.[47] This rule is not defined in the 'OECD Convention' itself, but guidance is given in accompanying commentary as to the way in which it operates.[48] This test aids governmental revenue services as a 'tie-breaker' tool for determining whether corporate residency should, in fact, be established in one country rather than another. It is based on the theory that the place in which key management decisions are made is where a company should be considered

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[43] European Parliament, Directorate General for Internal Policies, *The Role of the Financial Sector in Tax Planning*, IP/A/TAXE2/2016-01 PE 578.980 (May 2016).

[44] Michael Devereux & Rita de la Feria, *Designing and Implementing a Destination-Based Corporate Tax*, (Oxford University Centre for Business Taxation, Working Paper no. 1407, 2014) (Devereux and de le Feria argue current international tax system based upon the principles of source and residence is no longer suited to a globalised world economy, and the fundamentals of the international tax system need to be re-examined).

[45] For a broad overview of the UK Tax law relating to corporate residency *see* Watson Farley & Williams, *A Guide to Corporate Residence in the UK*, available at http://www.wfw.com/wp-content/uploads/2015/11/WFW-AGuideToCorporateResidenceInTheUK.pdf (Last visited on January 25, 2017); *see also* Laerstate BV v. Revenue & Customs, 2009 UKFTT 209 (TC) (The one of most recent corporate residency case in the UK).

[46] In India the concept of 'place of effective management' was only recently introduced by the Finance Act, 2015 and has been defined as has been defined to mean 'a place where key management and commercial decisions that are necessary for the conduct of the business of an entity as a whole are, in substance made'.

[47] Lymer, *supra* note 28, 6.

[48] OECD, *supra* note 26, 24;

> "The place of effective management is the place where key management and commercial decisions that are necessary for the conduct of the enterprise's business are in substance made. The place of effective management will ordinarily be where the most senior person or group of persons (for example a board of directors) makes its decisions, the place where the actions to be taken by the enterprise as a whole are determined; however, no definitive rule can be given and all relevant facts and circumstances must be examined to determine the place of effective management. An enterprise may have more than one place of management, but it can have only one place of effective management at any one time."

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to be based.[49] In order to assess the way in which the rule is used, one must look to decisions of the UK domestic courts on similar concepts, such as the 'central management and control' test.[50] However, an analysis of materially similar cases suggests that each case is assessed on its own facts, and outcomes may not be predictable or demonstrably consistent.[51]

Source-based taxation works on the principle that non-residents of a country may still be taxed on their economic activity and capital gains within that country's borders, despite the fact that they are not a resident of the country.[52] The source country will ordinarily be able to claim priority over another country's residence-based claims to income, assuming that the taxable entity "participates accordingly in the economic life."[53] As a result, it first becomes necessary to consider the minimum level of activity a company can engage in before it becomes liable for taxation.[54] In pursuit of this consideration, countries use the test of PE, which is defined in Article 5 of the OECD Convention as "a fixed place of business through which the business of an enterprise is wholly or partly carried on."[55] This definition may be dissected into its three constituent elements, namely: 'place of business,' 'fixed' and 'carrying on.' However, under most tax treaties, merely having a fixed place of business in any country may not be enough to create a taxable presence.[56] Each and every one of these elements requires its own test to be fulfilled before PE can be held to exist. These tests have been termed, respectively: the 'place-of-business test'– the

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[49] *See* Klaus Vogel, Double Taxation Conventions (4th ed., 2015).

[50] De Beers Consolidated Mines Ltd. v. Howe, 1906 AC 455.

[51] *See* North Australian Pastoral Co. Ltd. v. FCT, (1946) 71 CLR 623; Malayan Shipping Co. Ltd. v. FCT (1946) 71 CLR 156; Unit Construction Co. Ltd. v. Bullock, 1960 AC 351 : (1959) 3 WLR 1022 : (1959) 3 All ER 831.

[52] *See* Benjamin Hoffart, *Permanent Establishment in the Digital Age: Improving and Stimulating Debate Through an Access to Markets Proxy Approach*, 6 Nw. J. Tech. & Intell. Prop. 106, 110 (2007) (According to Hoffart, the "social contract" view of source-based justification for taxation is based on the principle of cost and benefit theories of taxation, which argue that taxpayers should pay the state for the cost of state-provided services or in accordance with specific benefits received by the taxpayer).

[53] Anne Schäfer & Christophe Spengel, *ICT and International Corporate Taxation: Tax Attributes and Scope of Taxation* 14 (Centre for European Economic Research, Discussion Paper no. 02-81, 2002).

[54] *Id.*

[55] OECD, *supra* note 26, Article 5, ¶1 (The OECD Model lists the conditions that must be satisfied in order to qualify as a permanent establishment: a) there must be a fixed place of business (situs test); b) the fixed place of business must be located at a certain territorial area (locus test); c) the use of the fixed place of business must last for a certain period of time (tempus test); d) the taxpayer must have a certain right of use of the fixed place of business (ius test); and e) the activities performed through the fixed place of business must be of a business character, as defined in the treaty law and in the domestic tax laws (business activity test).

[56] *See* HMRC Revenue & Customs, *HMRC issue briefing: taxing the profits of companies that are not resident in the UK*, March 1, 2016, available at https://www.gov.uk/government/publications/issue-briefing-taxing-the-profits-of-companies-that-are-not-resident-in-the-uk/hmrc-issue-briefing-taxing-the-profits-of-companies-that-are-not-resident-in-the-uk (Last visited on January 25, 2017).

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existence of premises, machinery or equipment;[57] the 'permanence test'– the location must be distinct and fixed with a certain degree of permanence; and the 'business-activities test'– (usually) personnel conducting business in that place.[58]

E-commerce breaks down the necessary and clear connection between territory and commerce and makes this type of information more difficult to obtain, thus complicating the task of taxing income based on 'source or residence'. It further questions the OECD's use of PE as the defining nexus by which a country may tax the business profits of a non-resident entity. To complicate matters further, there is a real difference of opinion between developed and developing countries as to the appropriate approach in allocating taxable jurisdiction.[59] Developed countries generally prefer to allocate taxable jurisdiction based on the enterprise's residence. Hence, if the residence is used as the principal criterion to decide the taxable nexus for e-commerce, the bulk of the revenues generated from such commerce will accrue to the developed countries. If, however, the taxable nexus is based upon the site of the server, it is entirely possible that the developing countries might attach some revenues on the basis of the fact that the source of the income is within their jurisdiction. Residence-based taxation creates further problems because of the difficulties in the placement of the central mind and management of an enterprise, particularly with e-commerce, which by its very nature is mobile. It is undeniable that the traditional concepts of PE, residence, and source of income do apply to e-commerce transactions. However, forcing their application onto transactions which are undertaken through a radically different medium necessarily results in uncertainty in the application of traditional source- and residence-based taxation models to e-commerce.[60] Although the OECD is examining the problem, its solutions to date fall short of suggesting significant changes to the basis of international taxation.

[57] OECD, *supra* note 26 (Under the OECD Model Tax Convention, the term PE does not include: the use of facilities solely for the purpose of storage, display of or delivery of goods or merchandise belonging to the enterprise; the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery; the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise; the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information for the enterprise; or 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).

[58] Basu, *supra* note 14, 48.

[59] *Id*., 109.

[60] *See* Li, *supra* note 35.

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II. IMPLICATION FOR TAX POLICY AND TAX ADMINISTRATION

The OECD clearly believes that perceived weaknesses in the territorial tax system and the international tax rules as a whole require changes to the tax rules in order to cope with e-commerce business practices.[61] Should we abandon traditional taxation principles? In order to answer this question, it is important to determine what (if anything) has changed because of e-commerce that presents new challenges requiring changes to the existing international tax regime. OECD's paper on base erosion and profit shifting argues that existing tax treaty principles strive to ease the incidence of double taxation, but it does not address double non-taxation.[62] Even though governments and international organisations appear to be concerned about the potential challenges posed by e-commerce and its digital appurtenances, many industrialised nations believe that existing taxation principles can be extended to include e-commerce transactions.[63] The discussion draft released by the OECD confirms the view that tax measures designed exclusively for the digital (e-commerce) economy are likely to prove problematic, primarily because of the difficulties in identifying a specific digital sector.[64] Nonetheless, to bring e-commerce within the scope of prevailing tax rules and norms, tax authorities must invoke inadequate definitions and inappropriate analogies under the present system.

Effective enforcement of tax laws, as with other laws, requires accurate identification of a party and evidence that can be linked to the party. In fiscal matters, this equates to identifying a taxpayer, obtaining evidence of income, and linking the income to the taxpayer. There are two major methods tax authorities use to verify disclosed income tax liabilities.[65] The first, the specifics method which examines transactions that have been disclosed to the revenue authorities and seeks to establish by an examination of the relevant facts and law whether or not a particular item is taxable or is a legitimate tax deduction is unlikely to change under the e-commerce environment, however the techniques used to apply this method must be adapted to take into account technological developments.[66] The second method which is technically not a single method but a collection of non-specific methods relating to the measurement of

[61] *See* OECD, *BEPS ACTION 1: Address the Tax Challenges of the Digital Economy*, March 24, 2014, available at https://www.oecd.org/ctp/tax-challenges-digital-economy-discussion-draft-march-2014.pdf (Last visited on January 26, 2017) (OECD has identified four main challenges raised by the digital economy: minimisation of tax in the source country, either by avoiding a taxable presence or by maximising deductions where there is such a presence, low or no withholding tax at source, low or no tax at the level of the recipient, and no current taxation of low tax profits at the level of ultimate parent).

[62] OECD, supra note 8, 16.

[63] Basu, supra note 1.

[64] OECD, supra note 61.

[65] Basu, *supra* note 14, 248.

[66] *Id*.

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assets or spending and funds over time, frequently supplemented by inspection of particular matters.[67] The growth in unaccounted electronic payment systems has created problems in the application of this method.[68] However, non-specific methods depend critically on tax authorities' ability, under powers conferred by law, to obtain information and evidence compulsorily, both from taxpayers and third parties.[69]

E-commerce poses a number of practical evidentiary problems for both taxpayers and tax administrators in the areas of identity and transaction verification.[70] This is particularly relevant, as it could preclude the enforcement of a tax with respect to business activities by residents and even between residents. Identification and registration requirements will have limited success, given the growing ease with which websites are located offshore. However, complications due to online shopping are only the beginning. Search engine optimisation services sometimes pay e-commerce firms when clients seek to have their names appear in search results. E-commerce companies also earn profits from data mining, which includes activities such as tracking users' Internet searches, online posts and shopping habit for the purpose of directing advertising to browsers based on the data obtained. The location of such activities raises issues that have not yet been addressed under current tax law.[71]

The process of 'incorporating' a company is merely a formal one, which establishes a synthetic connection to one country over another.[72] Pinto argues that e-commerce may cause the already artificial 'place of incorporation test' and the 'place of effective management' to become more artificial.[73] In fact, as reported by the Dutch government, there is no longer any need to maintain a physical business presence in any one location. Generally, managers can live and work in different countries without damaging effects to a business.[74] It is currently an easy task for members of a board to remain residents in different countries[75] and communicate using video-conferencing software, and in fact,

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[67] *Id.*, 249.

[68] *Id.*

[69] *Id.*

[70] Basu, *supra* note 14.

[71] KPMG, Future Focus: Tax and Transformation in Asia Pacific's New Business Reality, November 2011, available https://www.kpmg.de/docs/future-focus-tax-asia-pacific.pdf (Last visited on January 26, 2017).

[72] Basu, *supra* note 14, 110.

[73] Dale Pinto, *A New Three-Tier Proposal for Determining Corporate Residency Based Principally on Individual Residence*, 11 Asia-Pacific Tax Bulletin 14, 15 (2005).

[74] Netherlands Ministry of Finance, *Taxes in a World without Distance*, May 1998, available at http://download.belastingdienst.nl/itd/beleid/taxworld.pdf (Last visited on January 26, 2017).

[75] The problem cannot solely be directly to e-commerce. For example, since 1988, all UK-incorporated companies have been automatically treated as residents (Finance Act, 1988, §66) subject to some transitional provisions. However, the statutory rule is superimposed on the common law rules. The leading common law authority is De Beers Consolidated Mines Ltd. v. Howe, 1906 AC 455 : (1906) 5 TC 198. Lord Loreburn CJ held that the residence of a company was 'where the central control and management actually abides.' However, the House of

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managerial decisions can now be made by directors whilst in transit between countries using e-commerce technologies.[76]

In a particularly well-documented example, Google Inc. has produced a complex system of distributing and reallocating its profit which has been widely termed the 'Double Irish Dutch Sandwich'.[77] Using a number of tax avoidance techniques, the company is able to legally ensure that much of its profit is taxed in Bermuda, where the corporation tax rate is an incomparably attractive zero per cent.[78] Although this method of tax avoidance is technically replicable by enterprises in any sector, Google, as the archetypal web-based enterprise, requires far fewer resources to be in the vicinity of the business when compared to traditional commercial activities. In fact, the commercial operations of some web-based enterprises may be produced, controlled and supplied from another country and may totally lack any employee presence in the tax haven.[79] While revenue authorities typically have extensive powers to compel disclosure of information and production of documents, their writ usually runs exclusively within their own jurisdiction, and they must rely on co-operation under applicable treaty provisions with other jurisdictions. However, even when such cooperation is forthcoming, difficulties arise while attempting to obtain information and evidence with respect to documents or payments in encrypted digital form. New technologies have created solutions to some of these problems. For example, digital certificates make it possible to verify the identity of an online entity, and digital notarisation makes it possible to verify that electronic records have not been altered.[80]

Lords' decision in Unit Construction Co. Ltd. v. Bullock, 1960 AC 351 : (1959) 3 WLR 1022 : (1959) 38 TC 712 also suggests that a company's residence can be put in doubt if a parent company usurps the power of a local board of directors. Lord Radcliffe added that "The question where control and management abide must be treated as one of fact or 'actuality.'" See also Wood v. Holden (HMIT), 2006 EWCA Civ 26.

[76] Basu, *supra* note 14, 110.

[77] Edward Kleinbard, *Stateless Income's Challenge to Tax Policy* 1441 (USC Gould School of Law, Centre in Law, Economics and Organisation Research Paper Series, Paper no. C12-14, 2011).

[78] *Id*.

[79] *See* Basu, *supra* note 14, 121 (The fact that, for instance, a clothing retailer's electronic catalogue resides on a server in a given country does not give the clothing retailer a fixed, vested economic interest in the same manner that a factory or office would. […] If the clothing retailer's only physical presence in a country is through a server, the clothing company would not particularly care about the country's workforce, whether the country's transportation system is functional or whether the country is politically stable).

[80] *See* European Commission, *Proposal for a Council Directive amending Directive 2011/16 as regards mandatory automatic exchange of information in the field of taxation*, 2016/0010 (January 28, 2016) (On 28 January 2016, the European Commission launched its Anti-Tax Avoidance Package to coordinate the European Union's response to aggressive tax planning (ATP) and subscribe to the standards developed by the OECD in its action plan on Base Erosion and Profit Shifting (BEPS). As a first element in that package, on 8 March 2016 the Council drafted a directive to implement the OECD Action 13 requiring MNC to report tax-related information on a country-by-country basis, and requiring national tax authorities to automatically exchange such information).

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There are other substantive issues of law involved in the area of taxation of e-commerce. Current tax concepts, PE and source of income concepts were developed in a different technological era. Pascal St Amans, Director of the Centre for Tax Policy and Administration at the OECD, said in a recent interview:

> "Are we in a position to design a specific solution for a specific sector, which would be a digital permanent establishment for online sales or online services? Or is, actually, the question more about the digitalisation of the whole economy, and what is at stake there for the architecture of the international tax system?"[81]

The principle of neutrality between physical commerce and e-commerce requires that existing principles of taxation be adapted to e-commerce, taking into account the borderless nature of the Internet. Different tax rates or other distinctions related to income taxation require legal definitions of different sources and different allowances. If these definitions do not correspond to basic economic thinking, there are clear incentives for avoidance. Another advantage of an approach based on existing principles in addition to neutrality is that such an approach is suitable for adoption as an international standard. Existing principles are, in broad outline, common to most countries' tax laws. However, it would not be unjustified to argue that digital technology has completely destroyed the economic and legal basis for the existing rules of international taxation, implying the necessity for a complete overhaul. Extending the existing rules to the digital era, as suggested by developed countries, will increase the revenue shares of developed countries to the detriment of developing countries.[82]

III. PERMANENT ESTABLISHMENT: BACK TO THE FUTURE?

The importance of PE within the contemporary international taxation system cannot be underestimated.[83] The OECD Model Tax Convention on Income and on Capital establishes fundamental criteria for determining if a PE exists.[84] In 2000, the OECD revised its commentary on the Model Tax

[81] Pascal St Amans, *BEPS Action Plan: Action 1 - The Digital Economy*, February 21, 2014, available at http://www.pwc.com/gx/en/services/tax/tax-policy-administration/beps/the-digital-economy.html (Last visited January 25, 2017).

[82] Cockfield, *supra* note 39.

[83] OECD, Addressing the Tax Challenges of the Digital Economy, Action 1-2015 Final Report (2015).

[84] For a PE to exist, there must be a fixed place of business; the fixed place of business must be located [in a] certain territorial area; the use of the fixed place of business must last for a certain period of time; the taxpayer must have a certain right of use [over] the fixed place of business; and the activities performed through the fixed place of business must be of a

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Convention in light of the advent of e-commerce and concluded that a website does not in itself constitute a PE, as it is composed of software and data, not tangible property, and therefore cannot be considered a 'place of business.'[85]

The discussion draft released by the OECD suggested revisiting the borderline between what is to be counted as crossing the PE threshold rule and what is treated as not creating a tax nexus for the purposes of the rule because of the potential for the digital economy to penetrate a market with minimal physical presence.[86] It has been argued that the PE concept does not seem to be relevant for purposes of taxing e-commerce and that servers and websites can constitute PEs under traditional interpretation.[87] One of the fundamental questions with which the OECD grappled is whether or not a server can constitute a PE, and its answer so far has been shrouded in uncertainty.[88] OECD rules suggest that in most cases, the location of a server in a particular jurisdiction, by itself, will not give rise to a PE under a treaty. However server may rise to the level of a PE because it is tangible property requiring a physical location; this can be a 'fixed place of business,'[89] although its practical application raises a number of issues[90] but also where it functions at the particular place goes beyond what is preparatory or auxiliary.[91]

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business character, as defined in the treaty law and in the domestic tax laws; s*ee* OECD, *Model Tax Convention on Income and on Capital 2003*, January 28, 2003, Arts. 5(1), 7(1) available at http://www.oecd.org/tax/treaties/1914467.pdf (Last visited on January 25, 2017).

85 The OECD states that websites are composed of software and data, not tangible property, and therefore cannot be considered a place of business sufficient for characterisation as a PE; a server may rise to the level of a PE since it is tangible property that requires a physical location, and that location can be considered a fixed place of business regardless of whether the server is owned or leased by the business operating the server; however, the presence of business personnel at the location of the server is not necessary to create a PE; *see* OECD Committee on Fiscal Affairs, *Clarification on the Application of the Permanent Establishment Definition in E-Commerce: Changes to the Commentary on the Model Tax Convention on Article 5*, ¶ 42.2-42.10 (December 22, 2000), available at http://www.oecd.org/tax/treaties/1923380.pdf (Last visited January 25, 2017).

86 OECD, *supra* note 61 (OECD BEPS project, under Action 7: Preventing the Artificial Avoidance of Permanent Establishment Status, and Action 1: Tax Challenges of the Digital Economy is specifically looking into equitable allocation of taxing rights).

87 *See* Arvid Skaar, *Erosion of the Concept of Permanent Establishment: Electronic Commerce* in International Studies in Taxation: Law and Economics, 307, 320 (1999).

88 OECD *supra* note 83.

89 On 7th of February 2012 India's Authority for Advance Rulings (AAR) ruled that a foreign company's server constitutes a PE for tax purposes, and the profits arising from it are taxable in India.

90 OECD Committee on Fiscal Affairs, *supra* note 85.

91 In October 2012, the OECD released proposed amendments to 'auxiliary activity' within the Model Treaty, allowing for additional activities to create PE. The October 2014 discussion draft proposed further changes to art 5(4) on the definition of preparatory or auxiliary. Amazon was able to avoid establishing PE under the previous definition because of the exclusionary principles of Art 5(4); *see also* OECD, *Revised Discussion Draft: BEPS Action 7: Preventing The Artificial Avoidance of PE Status*, 21 (2015), available at http://www.oecd.org/tax/treaties/revised-discussion-draft-beps-action-7-pe-status.pdf (Last visited on January 25, 2017).

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A comprehensive study of the PE principle conducted before the emergence of e-commerce concluded that modern commercial practices had already eroded the PE concept to a large extent.[92] The PE concept does not envision or encompass the existence of a nexus between intangible business activities and foreign markets.[93] Support for the 1920s compromise that sacrificed tax revenues in favour of administrative simplicity has deteriorated. Nonetheless, while the PE concept may be a relic of early trade practices, it continues to be the prevailing standard for the determination of tax jurisdiction for international business income.

The fundamental concept underlying current OECD nexus and income attribution rules, that income should be attributed to the location where the value is created, is obsolete. For e-commerce companies, the nexus should not be based solely on the location of manufacturing, research, marketing, and other wealth-creating activities. Rather, the place of consumption should also give rise in some way to a direct tax nexus. It can be argued that the required changed could be implemented either as a matter of tax policy or as a matter of economic development policy.[94] In some cases the demands for change are presented in quite persuasive terms. Due to this weakening connection between physical and economic presence, the current definition of a PE, which largely relies on physical manifestations of an economic presence, might give rise to anomalous results and to violations of the tax principles outlined above.[95] Various suggestions have been made on how to overhaul the PE-based system

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[92] Skaar, *supra* note 4 (PE as an international fiscal concept emerged at a time when production factors were relatively immobile).

[93] OECD states that regardless of whether the server is owned or leased by the business operating the server, the presence of business personnel at the location of the server does not necessarily create a PE. If the server is not at the disposal of business but rather is operated by a web provider, it should not constitute a PE because the business has no control over the server and it is not the place of business of the enterprise. It does not matter that a server can be moved; it is important if it stays in one location for more than 12 months. The existence of computer equipment, even if at a fixed place, will not create a PE when the business conducted through it is limited to auxiliary services. When the business uses the computer equipment for essential/significant activities, it creates a PE; *see* OECD Committee on Fiscal Affairs, *supra* note 85; *see also* Sandra P. McGill & Lowell D. Yoder, *From Storefronts to Servers to Service Providers: Stretching the Permanent Establishment Definition to Accommodate New Business Models*, Taxes - The Tax Magazine, March 2003, 157.

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

[95] The OECD Model does not define "fixed place of business," the crucial point in determining whether a non-resident's activities in a host jurisdiction are sufficient to create a permanent establishment. Accordingly, the term has been applied according to legal doctrine, case law, and revisions to OECD Commentary since its inception. These interpretations allowed the "fixed place of business" terminology to adapt to changes occurring in the traditional business world, but Internet-based influences in the modern economy have resulted in hermeneutic confusion; *see* Cristián Gárate, *The Fixed Place of Business in the Context of Electronic Commerce* in Permanent Establishments in International Tax Law 45 (2003).

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of taxation.[96] There has been attempt particularly within OECD to subject e-commerce transactions to a different tax regime[97]. OECD's Task Force on the Digital Economy[98] has been specifically considering five options, namely, modifications to the exemption from PE status; the creation of a 'significant digital presence' PE;[99] varieties of a 'virtual' presence PE; withholding tax on digital transactions; and consumption tax options.[100] A detailed examination of each of these options is beyond the scope of this article.

The French 'Task Force on Taxation of the Digital Economy' argues that the activities of digital companies lack 'points of stability' required to create a PE.[101] The task force has proposed that the concept of PE be redefined to encompass 'permanent virtual establishment.'[102] Under the concept of a 'permanent virtual establishment', once a foreign enterprise's sales in a jurisdiction have reached a certain level, the foreign enterprise would be *deemed* to have a PE in the jurisdiction, and those profits from the enterprise attributable to that virtual PE could be taxed by the source jurisdiction.[103] The conceptual basis for taxation under such a system is that providing a healthy customer base is enough to entitle a source state with the right to tax profits arising in (or from) that state.[104] It is suggested that Article 5 of the OECD Model Convention incorporates the idea of a 'virtual' PE,[105] whereby a foreign enterprise may be deemed to have a PE by virtue of a given level of sales in the source jurisdic-

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[96] If permanent establishment principles are to remain effective in the new economy, the fundamental PE components developed for the old economy — place of business, location, and permanency must be reconciled with the new digital reality.

[97] Basu, *supra* note 14, 255.

[98] OECD's Task Force on the Digital Economy, a subsidiary body of the Committee on Fiscal Affairs (CFA), was established in September 2013 to carry out the work, with the aim of developing a report identifying issues raised by the digital economy and possible actions to address them by September 2014; *see* OECD, *supra* note 61.

[99] Peter Hongler & Pasquale Pistone, *Blueprints for a New PE Nexus to Tax Business Income in the Era of the Digital Economy* (IBFD Working Paper, 2015) available at https://www.researchgate.net/profile/Gopal_Kamal/publication/303549181_Redefining_the_PE_concept-whitepaper/links/5747f83e08ae707fe21e46da.pdf?origin=publication_list (Last visited on January 25, 2017) (The authors suggested a far more expanded definition of PE related to source principle but one which takes into account the intangible characteristic of an e-commerce business).

[100] OECD, *supra* note 61, 64-66.

[101] Pierre Collin & Nicolas Colin, *Task Force on Taxation of the Digital Economy*, (January 2013), available at http://www.hldataprotection.com/files/2013/06/Taxation_Digital_Economy.pdf (Last visited on January 25, 2017).

[102] *Id.*

[103] Anne Schäfer, International Company Taxation in the Era of Information and Communication Technologies 152 (2006).

[104] Sprague, *supra* note 94. Sprague, Gary D. and Hersey, Rachel (2003) "Permanent Establishments and Internet-Enabled Enterprises: The Physical Presence and Contract Concluding Dependent Agent Tests," February 27-28, 2003, 1 (available online at http://www.bmck.com/ecommerce/tax-art1.doc.

[105] OECD, *supra* note 26; *see* Danieal Blum, *Permanent Establishments and Action 1 on the Digital Economy of the OECD Base Erosion and Profit Shifting Initiative– The Nexus Criterion Redefined*, 6/7 Bulletin for International Taxation 69 (2015).

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tion.[106] Hinnekens suggests that such a concept would operate on the basis of the continuous and commercially significant business activity of a non-resident enterprise in the source country.[107] This idea would appear to be congruent with the fundamental theory behind source-based taxation in that it is reliant upon proof of a sufficient degree of participation in economic life by the enterprise in the source country.[108] In practice, whether a sufficiently high level of sales revenue creates a legal right for a country to claim the ability to tax an enterprise is questionable.[109] However, the 'discussion draft' states that varieties of a 'virtual' presence PE are included 'only for the sake of completeness.'[110] It is unclear whether 'for the sake of completeness' means that the OECD is not proposing to move forward with these suggestions at this time. This does seem to be the logical inference, but in any event, it certainly seems to reflect a lack of enthusiasm for these alternatives.

Another potential option discussed by the Task Force focuses on the establishment of an alternative nexus to address situations in which businesses are conducted wholly digitally. Such a proposal would identify an enterprise engaged in certain 'fully dematerialised digital activities' as a permanent establishment, if it maintained a 'significant digital presence' in the economy of another country.[111] Two alternative proposals were put forward, one of which is based on the use of personal data obtained from users in the country, and the other of which is based on additional elements of the business model.[112] The discussion draft indicated that a test may be applied to determine the nature of a 'fully dematerialised digital activity.'[113] OECD in the Final Report suggested where a company is engaged in fully dematerialised digital activities it would constitute a PE if it maintained a significant digital presence in another country's economy.[114]

Another option that has been suggested is the imposition of a final withholding tax on certain payments made by residents of a country for digital goods or services provided by a foreign e-commerce provider.[115] As Doernberg has argued, such a regime would supplement, rather than supplant,

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106 Basu, *supra* note 14, 254.

107 Luc Hinnekens, *Looking for an Appropriate Jurisdictional Framework for Source-State Taxation of International Electronic Commerce in the Twenty-First Century*, 26 Intertax 197 (1998); *See also* Richard Doernberg et al, Electronic Commerce and Multijurisdictional Taxation 349-354 (2001).

108 *Id*.

109 Sprague, *supra* note 94.

110 OECD, *supra* note 61.

111 *Id*.

112 *Id*.; *see also* OECD *supra* note 83.

113 *Id*.

114 OECD, *supra* note 83; *See also* Joachim Englisch, *BEPS Action 1: Digital Economy– EU Law Implications,* British Tax R. 277, 280 (2015).

115 OECD, *supra* note 61.

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the traditional PE nexus rules.[116] States would retain the right to tax all non-resident enterprises with a PE in their jurisdiction.[117] The broad international consensus for some years has been to try to minimise or eliminate withholding taxes[118] because taxes imposed on gross income do not take into account profitability and can act as a deterrent to international commerce by making expansion across borders unprofitable. Additionally, an important potential collateral impact is that withholding tax could be imposed on broad categories of 'conventional' commerce that previously were not subject to withholding tax – for example, payments for software products, music discs, and movies, which are all digital products. This illustrates the potential collateral impact of rules designed for a specific targeted industry. In addition, as noted in the report, various factors would need to be considered in relation to this proposal, such as trade obligations.[119] Additionally, the practicalities of collecting such a tax, especially in the case of individual customers, would be highly challenging.

Advocates of retaining a PE nexus-based system of international taxation argue that the existing OECD principle that income tax revenue should be attributed to the location where an enterprise is engaged in value-creating activities remains the appropriate basis for the imposition of an income tax.[120] The conceptual framework remains correct from a policy standpoint. Those advocating change have not offered sufficiently compelling reasons to justify a deviation from the conceptual basis of international taxation that has had overwhelming acceptance. The 'digital' economy, much like the 'traditional' economy, requires an enterprise to utilise capital, labour and other property in core income-producing activities to produce and market its products and services.[121] Even if the nature of those inputs and outputs may differ somewhat under a digital economy, the essential factors remain the same: physical presence and activity, as reflected by an entrepreneur's labour inputs, property investments, and risk assumption remains necessary components in an enterprise's creation of products and services.[122] Thus, there is no basis arising from digital economy business models to change a state's justification to share in a company's tax base. There is no basis for utilising different attribution algorithms for the digital and the 'traditional' economies. The nexus rules appropriate for the taxation of Internet-utilising businesses are the same as those, which over the years have proven acceptable and effective for more 'traditional' business models. The current rules do not allow a jurisdiction to tax a foreign enterprise's business profits *unless* the enterprise itself conducts core income-generating activities in the jurisdiction. If one agrees that these rules are appropriate for non-Internet

[116] Richard Doernberg, *Electronic Commerce and International Tax Sharing*, 16 Tax Notes Intl 1013 (1998).
[117] Sprague, *supra* note 94.
[118] OECD *supra* note 83.
[119] OECD *supra* note 61.
[120] OECD, *supra* note 91; *see also* Hongler, *supra* note 99.
[121] Sprague, *supra* note 94.
[122] *Id.*

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based enterprises, then it is only fair that these same rules be applied to Internet-based enterprises. To not do so would be unfair to those jurisdictions in which the income-generating activities were, in fact, being performed.[123] Moreover, there is no logical distinction between 'traditional' businesses and those utilising advanced communications technology (*i.e.,* the Internet) in their business models. E-commerce continues to infiltrate and be incorporated into the most 'traditional' of business enterprises (*e.g.,* the automotive and airline industries, brick & mortar retail store outlets, etc.). While e-commerce has created new business models, opportunities, products, and services, it has also changed the way 'traditional' business activities are being conducted by 'traditional' business enterprises.[124] The origin of wealth for these enterprises remains where it has always been– at the place where the cost and risk to develop, produce and distribute product is born.[125]

From a pragmatic viewpoint, the current system remains appropriate as well.[126] Given the expansive treaty network based on the current PE rules and e-commerce's permeation into all facets of business affairs, designing one set of nexus rules for e-commerce companies and another for non-e-commerce companies makes no logical sense and would be practically impossible to implement.[127] The PE provision was also designed with administrative practicality and convenience in mind. It is generally acknowledged that a country's jurisdiction to tax should not extend beyond its power to impose a tax. Therefore, if a taxpayer is not physically present in a country, a tax should not be imposed upon the income of the taxpayer by that country. The reasons for this conclusion are twofold. First, as a matter of principle, it is generally inappropriate for a country to assert jurisdiction over persons or matters beyond its actual power of enforcement. Second, as a practical matter, a country should not seek to impose taxes that it cannot collect. 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 subject to a tax, but as a matter of practical reality are never required to pay the tax, then the taxpaying public will perceive the system of tax as unfair and

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[123] *Id.*

[124] The means by which existing business have introduced efficiencies into their procurement of materials and components; collaborative R&D efforts; means of delivering products and services to customers; back-office functions such as accounting & finance, etc.

[125] *Id.*

[126] Although OECD in its final Report "Addressing the Tax Challenges of the Digital Economy" recommends modifying the list of exceptions to the definition of PE regarding preparatory and auxiliary activities as they relate to a digital environment, and introduces new anti-fragmentation rules to deny benefits from these exceptions through the fragmentation of certain business activities along with modifying the definition of a PE to address artificial arrangements through certain "conclusion of contracts"; *see* OECD, *supra* note 83.

[127] Sprague, *supra* note 94.

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discriminatory.[128] Therefore, the requirement of a fixed place of business serves the interests of fairness and administrability as well.[129]

IV. NAVIGATING CHANGE FOR DIRECT TAXATION

The Ottawa framework conditions noted that taxation should seek to be neutral and equitable between forms of e-commerce and between conventional and electronic forms of commerce.[130] Taxpayers in similar situations carrying out similar transactions should be subject to similar levels of taxation.[131] The OECD discussion draft also states, "ring-fencing the digital economy as a separate sector and applying tax rules on that basis would be neither appropriate nor feasible."[132] Academics have tried to defend the existing concepts of international taxation by arguing that the problems created by e-commerce are not serious enough to justify changes in the traditional conceptual basis of international taxation.[133] As Sprague and Hersey have advocated for change in international tax laws have not provided a sufficient basis upon which to deviate from the conceptual framework that has been in existence for more than 80 years.[134]

A. ENHANCED RESIDENCE-BASED TAXATION

The debate surrounding the desirability of residence-based taxation as opposed to source-based taxation preceded the advent of e-commerce. It has been argued that in order to address tax avoidance concerns, countries of residence should be granted primary authority to tax e-commerce business profits.[135] Perhaps the central international tax issue arising from e-commerce is the allocation of business profits between residence and source countries and diversion to tax havens.[136] If countries are permitted to exclusively tax a resident company's worldwide business profits, then multinational enterprises will arguably be discouraged from shifting their profit-making activities to lower

[128] *See* Thomas Adams, *Interstate and International Double Taxation* in Lectures on Taxation 101, 112 (Ross Magill, 1932).
[129] Sprague, *supra* note 94.
[130] OECD, *Report on Electronic commerce: Taxation Framework Conditions*, (October 8, 1998).
[131] OECD, *supra* note 61.
[132] *Id*.
[133] *See* Arthur Cockfield, *Purism and Contextualism With International Tax Law Analysis: How Traditional Analysis Fails Developing Countries*, (Queen's Univ. Legal Studies Research, Paper No. 07-03, 2007); see Arthur Cockfield, *Formulary Taxation versus the Arm's Length Principle: The Battle among Doubting Thomases, Purists and Pragmatists*, 52 Can. Tax J. 114 (2004).
[134] Sprague, *supra* note 94.
[135] Ine Lejeune, *Does Cyber-Commerce Necessitate a Revision of International Tax Concepts?*, 38 Eur. Tax Notes 50, 58 (1998).
[136] Doernberg, *supra* note 37.

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tax jurisdictions, since the residence country will continue to tax these profits. It is well realised that capital-exporting nations tend to support residence-based taxation under the principle of capital export neutrality, which is achieved if a taxpayer's choice between investing at home or in a foreign country is not affected by taxes.[137] The greatest proponent of a move towards a residence-based system for the taxation of international income is the US,[138] which also happens to be the world leader in the production and export of e-commerce goods and services. Proponents of a strict residence-based system for taxation of e-commerce profits believe that electronic transactions may escape taxation altogether unless the resident vendor is taxed on its net income. The reality is that the strict application of residency rules would lead to greater tax avoidance due to the increasingly malleable nature of corporate residency. Under a pure residence-based system of taxation, multinational enterprises would have considerable incentive to incorporate entities in tax havens and low-tax jurisdictions. Existing companies would be driven by the impetus to relocate their e-commerce and other profitable operations through isolated corporate entities. Start-up technology companies would be encouraged to establish the income-producing aspects of their operations within tax havens in order to avoid paying taxes. A company that is incorporated or deemed to be a resident of a country that is a tax haven may never pay any income tax whatsoever on its e-commerce profits under a pure residence-based approach.[139]

A move towards residence-based taxation of all forms of business income would entail radical shifts in the international distribution of tax revenues. The existing regime of jurisdictional allocation, as embodied by most bilateral tax treaties, assigns the taxpayer's country of residence the exclusive right to tax foreign-source business income in the absence of a PE in the foreign jurisdiction. Based on current economic trading patterns, the abandonment of source-based taxation of business profits would dramatically increase the flows of tax revenues from the treasuries of developing countries to the coffers of developed countries. Any further shift in the tenuous equilibrium of inter-nation revenue distribution in favour of the treasuries of wealthy nations would have profound international economic consequences. Because the adoption of a pure residence-based system of taxation for e-commerce or traditional commerce transactions would exacerbate distributive disparities among nations, it is unlikely that such a proposal would obtain the requisite international support.

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[137] Rachel Griffith et al, *International Capital Taxation* in Dimensions of Tax Design 914-996 (2010).

[138] Jane G. Gravelle, Reform of U.S. International Taxation: Alternatives (2011); *see also* Basu, *supra* note 14, 251.

[139] Arthur Cockfield, *Balancing National Interests in the Taxation of Electronic Commerce Business Profit*, 74 Tulane L. R. 172 (1992).

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B. EXPANSION OF SOURCE-COUNTRY TAX BASE

It is often presumed that tax revenues in the source country are declining and that, consequently, an enlargement of the tax attributes in the source country as well as taxation according to the source principle are necessary in order to guarantee equity among developed and developing nations. Expansion of taxation by the source country is based on the argument that a nation should have the primary claim to tax all business income derived within the borders of the country.[140] Developed countries, as well as developing countries, have expressed their inclination to favour source-based tax rules for business income.[141] The principle of tax neutrality requires that all business income, whether arising out of e-commerce transactions or through more traditional means, be taxed in a similar manner. Effective source-country taxation would involve modifications to traditional international tax norms, such as those dealing with transfer pricing, permanent establishment and the characterisation of income. Proposals to expand the jurisdiction of the source country to tax business income arising within its boundaries include first, the restricted force of attraction principle;[142] second, withholding taxes on e-commerce payments; and third, unrestricted domestic taxation of all business income generated within the country.

There is no doubt that international tax policy analysis suffers from a certain degree of arbitrariness because analysts and tax authorities generally cannot come to an agreement on the methods by which accepted general principles, such as the need for fairness among nations, should guide actual reform efforts.[143] The problem in part is that a particular nation's international tax interests may vary depending on its economic circumstances. As a result, capital-importing nations tend to support source-based taxation under the principle of capital import neutrality, which maintains that companies operating abroad should be placed in the same tax position as their local competitors. However, there may be a number of practical and administrative problems associated with taxing e-commerce profits on the basis of the source of the consumer. As with other approaches, the identification of the taxpayer would be a prerequisite to the imposition of an income tax. The ability of Internet users to

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[140] Basu, *supra* note 14, 252.

[141] Brian J. Arnold, *The Canadian International Tax System: Review and Reform*, 43 Can. Tax J. 1792, 1807 (1996) (Developing countries have long favoured an expansion of the source country jurisdiction to tax cross-border business income. Some wealthy nations, such as Canada, are also net capital importers. Compared with countries like the United States, Canada has a strong commitment to source taxation because of its history as a capital importer); *see also* Susan Lyons, *International Consensus Needed in Taxation of Electronic Commerce*, 14 Tax Notes Intl 1199, 1203 (1997).

[142] Michael Kobetsky, International Taxation of Permanent Establishments: Principles and Policy (2011).

[143] International Monetary Fund, *Staff Report on Current Challenges in Revenue Mobilization: Improving Tax Compliance* (January 29, 2015).

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prevent identification of their e-commerce transactions may present challenges for tax authorities. The vendor is obligated to remit income tax to the consumers' jurisdiction because it is the vendor's income that is being taxed. Without appropriate identification mechanisms, it would be difficult for governments to trace the productive processes of international business transactions through to the ultimate taxpayer. Where tax authorities are able to identify and audit perspective taxpayers, it is likely that some source-based withholding tax rules would be established to protect the interests of the treasury against foreign resident taxpayers with nominal assets in the market country. In such cases, the source country may establish a regime that could treat foreign companies less favourably than domestic enterprises. To respond to reasonable equity concerns, most countries should permit foreign businesses to file as net-basis taxpayers.

According to Doernberg, it is useful to adopt the 'base erosion' approach in the taxation of income streams in source countries.[144] The proposal requires taxation of any payment to a foreign enterprise if it is tax deductible in the hands of a taxpayer in the source country. The implementation of the tax would be in the form of a low withholding tax, with the option of being taxed on net income. This proposal implies that the concept of PE continues to exist.[145] In this context, it is further suggested that the 'base erosion' approach offers a possible solution for equitable tax sharing between residence and source countries when the concept is applied to all commerce and not just e-commerce. The tax is implemented through a low withholding tax on all tax-deductible payments to the foreign enterprise, and the withholding tax is final, without the option of a tax on net income being extended to the taxpayer or the tax administration.

Before considering a solution along these lines, trade data must be carefully studied to ascertain if, and to what extent, there will be an erosion of the tax base. However, it is recommended that a thorough study should be undertaken to examine the practicality of taxing all imports and to assess the erosion of the tax base as a result of credit for taxes levied by other countries on exports. It is, however, widely believed that the base of the 'erosion approach' is contrary to the international consensus that withholding taxes is appropriate only in certain limited cases.[146] Additionally, the simultaneous existence of the PE concept implies that traditional commerce will be taxed differently when compared to e-commerce.

C. FORMULARY APPORTIONMENT: AN ALTERNATIVE?

Because the current system has not produced a result that accurately reflects the economic source of the income or the location of the economic

[144] Doernberg, *supra* note 116.
[145] *Id*.
[146] Basu, *supra* note 14.

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activity,[147] it is imperative that we explore alternative forms of taxation. The suggested alternative is a formulary apportionment of income based on an economically justifiable formula.[148] Is formulary apportionment a way forward for e-commerce taxation? The main argument in favour of formulary taxation is that the system does a better job of addressing the economic reality of the behaviour of e-commerce businesses.[149] The main deficiency, in turn, is generally based on the argument that it is not a theoretically superior (or optimal) model because of implementation difficulties,[150] and the system artificially attempts to draw lines between related aspects of a company where no line truly exists.[151]

However, the arguments in favour of formulary taxation are quite powerful.[152] This system has been advocated most notably by its foremost proponent, Jinyan Li,[153] and has been found to be "both sound and theoretically attractive."[154] The OECD contends that global formulary apportionment would allocate the global profits of an MNE group on a consolidated basis among the affiliated enterprises in different countries and this allocation would be based upon a set mechanistic formula.[155] Three key components would govern such a global apportionment formula: identifying the unit to be taxed; determining global profits; and implementing the formula employed to allocate the global profits of the unit.[156] The formula would most likely be based on some combination of costs, assets, payroll, and sales.[157] The problem for us is that there are almost as many versions of formulary taxation systems as there are jurisdictions

[147] Kerrie Sadiq, *Taxation of Multinational Banks Using Formulary Apportionment to Reflect Economic Reality (Part 1)*, 22(5) J. of Intl Taxation 46 (2011); Kerrie Sadiq, *Taxation of Multinational Banks Using Formulary Apportionment to Reflect Economic Reality (Part 2)*, 23(2) J. of Intl Taxation 54 (2012).

[148] Apportionment is applied for instance to the individual states within the U.S.; *see* Kimberley Clausing, *The U.S. State Experience under Formulary Apportionment: Are There Lessons for International Tax Reform?*, 69(4) National Tax J. (2016) (Apportionment is applied for instance to the individual states within the U.S.).

[149] Basu, *supra* note 14.

[150] Sadiq, *supra* note 147.

[151] *Id.*; Basu, *supra* note 14.

[152] Ashley Greenbank, *Brexit Questions: Does Brexit Make the CCCTB More Likely?*, August 22, 2016, available at http://www.lexology.com/library/detail.aspx?g=af3ae825-cefe-4970-8b3e-9203aecfd097 (Last visited on January 25, 2017) (European Commission has recently released a Communication to the EU Parliament calling for a re-launch of its proposal from 2011 relating to the Common Consolidated Corporate Tax Base (CCCTB). The CCCTB essentially aggregates related EU companies into a single, consolidated tax return for all those entities. The EU group net taxable income is then apportioned back out to each entity and country in proportion to the relative assets and other economic factors within those locations. CCCTB is very similar to the long-established formulary apportionment regime used in the US. CCCTB would be a uniform apportionment system throughout the EU).

[153] Jinyan Li, *Global Profit Split: An Evolutionary Approach to International Income Allocation*, 50 Can. Tax J. 823 (2002)..

[154] Cockfield, *supra* note 133.

[155] OECD, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (July 22, 2010), Cl. 1.17.

[156] *Id.*

[157] *Id.*

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that have adopted such methods.[158] However, all of the systems have some common features: 'apportionable income,' the 'apportionment formula,' and 'definitions of the factors' utilised in the apportionment formula.[159]

The conceptual legitimacy of the formulary approach to income taxation is widely acknowledged. In fact, the shortcomings of the current transfer-pricing regime are becoming more prevalent and prominent as the process of globalisation encourages enhanced regional and global economic integration. Formulary taxation does seem more conceptually pure than the current arm's-length system, which is supported by international consensus among national tax authorities. In reality, at least below the surface, there is much disagreement concerning arm's-length principles on issues such as the allocation of profits among the different PE within a single legal entity.[160] Global formulary apportionment in relation to e-commerce would be expected to address the tax avoidance strategy of multinational companies attempting to locate in tax havens in order to avoid higher rates associated with residence-based corporation tax elsewhere. This could be accomplished as a global system, rather than a patchwork of national systems, thereby rendering consideration of which jurisdiction offers the lowest corporate tax rate irrelevant to companies. It is also argued that companies across the globe will be better able to make business decisions without the undesirable influence of national tax implications. This, in turn, would produce a greater level of productive efficiency, as fewer resources would be devoted to tax-related decision-making and business operations could then be based more purely on prudent commercial principles rather than tax avoidance.

From a broader perspective of international taxation of multinational companies, not just e-commerce companies, there would be a significant simplification of the entire international tax system, resulting in reduced compliance burdens for companies, as there would be no need to allocate income or expenses among countries, which is once again due to the global nature of formulary apportionment.[161] The reduced compliance burdens that naturally result from this simplification would further encourage productive efficiency savings. Further, this effect is the same from the point of view of revenue services in terms of costs of administrating the system. These two areas of increased efficiency and decreased costs represent indisputable benefit from this

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[158] Michael C. Durst, *The Tax Policy Outlook for Developing Countries: Reflections on International Formulary Apportionment* (ICTD Working Paper No. 32, 2015).

[159] From an econometric point of view, the criteria ought to include those factors that explain a significant share of the variability in profitability, *see* James R. Hines Jr., *Income Misattribution Under Formula Apportionment*, 54(1) EUROPEAN ECON. R. 108-120 (2010).

[160] Basu, *supra* note 14.

[161] Reuven Avi-Yonah & Kimberly Clausing, *A Proposal to Adopt Formulary Apportionment for Corporate Income Taxation: The Hamilton Project*, 15 (University of Michigan Law School Law and Economics Working Paper No. 85, 2007).

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method of taxation in accordance with recognised objectives and principles of international taxation.

Formulary taxation accepts the reality of firm integration and attempts to come up with a workable solution that matches each jurisdiction with tax revenues related to the value-adding economic activity that takes place within the jurisdiction.[162] Formulary taxation more accurately considers actual corporate integration and is, therefore, able to make a more conceptually satisfying estimation of the total amount of profit realised by large firms that are technically made up of several affiliated companies.[163] The resulting broad, global view enables the system to apportion tax revenues more accurately and thus more equitably, amongst individual countries. It also disregards the residential location of a parent company in multinational enterprises, which would render the artificial and arbitrary residence-based distinctions obsolete and would, therefore, better represent the true nature of the emerging global economy.[164]

The strongest argument against formulary apportionment is its lack of general acceptance internationally. The OECD relies on this argument to dismiss formulary apportionment, stating that reaching such an agreement would be time-consuming and extremely difficult: "Transition to a global formulary apportionment system [...] would present enormous political and administrative complexity and require a level of international cooperation that is unrealistic to expect in the field of international taxation."[165] It can be argued that even if some countries are willing to accept formulary apportionment, there would be disagreements because each country may want to emphasise or include different factors in the formula based on the activities or factors that are predominant in its jurisdiction. The OECD lists a number of areas which would present a particular difficulty for agreement in terms of the composition of the formula.[166] In order to avoid double taxation, there would need to be agreement on the measurement of the tax base of a multinational enterprise group; on the use of a common accounting system; on those factors to be included in the formula in order to apportion the tax base; and, finally, on how to measure those factors. The consequence of jurisdictions that do not agree to the exclusive use of formulary apportionment would be the need to calculate profits attributable to relevant jurisdictions using two different standards.[167] However, difficulty in

[162] Cockfield, *supra* note 133.

[163] Avi-Yonah & Clausing, *supra* note 161, 13.

[164] *Id*.

[165] OECD, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (July 22, 2010), Cl. 1.22, 1.24.

[166] OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (July 22, 2010), Cl. 1.22.

[167] OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (July 22, 2010), Cl. 1.24.

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reaching international consensus is an inadequate reason for dismissing formulary apportionment outright and should not be an obstacle to its inception.

The multiplicity of tax bases in the world also raises questions regarding the feasibility of a formulary approach. It is argued that there would need to be a sufficient number, if not all, of the major countries from which multinational enterprises operate in agreement about the adoption of a formulary system.[168] If an insufficient number of countries were in concurrence, any multinational firms targeted by the countries who had assented to the use of a formulary system would then need to adopt two parallel practices for accounting in order to comply with both systems simultaneously,[169] which would increase compliance burdens and possibly lead to double-taxation. Having considered the success of the current system in lessening the frequency of its manifestations, this would represent an incontrovertibly regressive outcome. The OECD further highlights a number of what it calls fundamental inadequacies in the formulary approach which relate to a lack of consideration for varying exchange rates and market conditions as a result of the use of a predetermined, arbitrary formulary; the potential for increased compliance costs associated with the amount of data necessary for collection and distribution in a manner that is compatible with each jurisdiction; and, finally, the effect of the use of different accounting standards and currencies around the world on the accurate valuation of the assets to be used as inputs for the formula.[170]

Unilateral adoption of formulary apportionment by a country does not require the formulary apportionment country and all others to have the same tax base, although the ideal case situation is that all countries adopting formulary apportionment would use the same formula. Given that multinational enterprises use uniform accounting for worldwide financial reporting purposes, it is quite plausible to use financial reporting as a starting point for calculating the global profits of the multinational enterprises. Further, it must be noted that differences in accounting standards are narrowing worldwide due to the adoption of International Accounting Standards.[171] In developing countries, there is a clear mandate to push for the adoption of such international accounting standards; the EU and Japan have already adopted them. Alternatively, it may be possible for each multinational enterprise to use its home country's accounting methods in calculating the global tax base. However, the system

168 Roland Paris, *The Globalization of Taxation? Electronic Commerce and the Transformation of the State*, 47 Intl Studies Quarterly 172 (2003).

169 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (July 22, 2010), Cl. 1.24.

170 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (July 22, 2010), Cl. 1.22, 1.25-1.28.

171 *See* Robert H. Herz & Kimberley R. Petrone, *International Convergence of Accounting Standards-Perspectives from the FASB on Challenges and Opportunities*, 25 NW. J. Int'l L. & Bus. 631 (2005).

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would intrude to an unacceptable extent on a nation's tax sovereignty[172] and it is not clear whether a system which is quite sensitive to the choice of criteria, would lead to a fairer distribution of taxing rights among countries.[173] As such, countries would need to reach an agreement on a set of common rules at the supranational level that would determine how much revenue each state would collect from cross-border transactions. By doing so, each state would have to cede fiscal sovereignty with respect to aspects of its international income tax laws. Even proponents suspect that effective formulary taxation will call for an even greater sacrifice of sovereignty because it will require the harmonisation of corporate tax bases and possibly even tax rates.[174] In short, fiscal sovereignty concerns would continue to play a critical role in a nation's decision to reform its international tax system.[175]

Bird points out, "changes in tax policy and tax structure reflect changes in administrative realities as much [as] or more than they do changes in policy objectives."[176] The reality is that the OECD and its member states seem wedded, at least for the foreseeable future, to the maintenance of the transactional arm's-length standard, despite its many deficiencies. A comparative review of the responses by national tax authorities suggests that these authorities have for the most part approached taxation of e-commerce issues in a tepid and conservative manner, relying on traditional principles. This slavish following of traditional principles has led to some misguided reform efforts, which have been discussed in this article. International tax rules will not be leapfrogging at least not in near future. But then again perhaps it may be far more preferable to adopt a reform approach that protects tax sovereignty and is technically feasible. Even then it will not solve the inherent problems of unnecessary complexity that have shaped the current international tax system, and a decade on we may still be debating and perhaps also lamenting a missed opportunity.

V. CONCLUSION

As mentioned previously, international taxation is a phenomenon widely observed but often imprecisely discussed. A possible policy approach to accommodate the taxation of e-commerce transactions is to leave the

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[172] This argument encompasses what can be termed as "political judgement", however it is essential to remind the reader that when it comes to tax reform factors ranging from economic, to practical and finally to political has to be considered simultaneously.

[173] European Parliament, *supra* note 43.

[174] Paul McDaniel, *Formulary Taxation in the North American Free Trade Zone*, 49(4) Tax L. R. 691-744 (1994).

[175] Arthur Cockfield, *Tax Integration under NAFTA: Resolving the Conflict Between Economic and Sovereignty Concerns*, 34(1) Stan. J. of Intl L. 39-73 (1998).

[176] Richard Bird, *Taxing Electronic Commerce: A Revolution in the Making*, September 2003, available at https://www.cdhowe.org/sites/default/files/attachments/research_papers/mixed//commentary_187.pdf (Last visited on January 25, 2017).

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existing international jurisdictional rules and concepts as they are currently in the OECD Model Convention.[177] The existing international tax regime has enjoyed a long history and has been the product of many years of development.[178] Against this background, countries would be reluctant to move from a system that is both familiar to them and that has taken many years to develop. It is also arguable that the present system, though far from perfect, has served the international community well by forging a workable compromise between the competing fiscal interests of countries that engage in international trade. Therefore, from a traditional and a historical perspective, there may be merit in leaving the current rules as they presently stand.[179] However, I argue that the issues are whether the current international tax regime is able to tax e-commerce income, and also whether it is the appropriate regime for taxing e-commerce income. The logic of the current economic allegiances and the premise behind the contribution of each country to the production of income are not applicable to e-commerce today.

The intangibility and seamlessness of e-commerce services and products challenge the suitability of the traditional tax system, especially when these services are provided across jurisdictions. It is difficult to apply the current system of giving the source country priority in taxing active income while the country of residence has priority in taxing passive income to e-commerce because the current system does not produce a result that accurately reflects the economic source of the income or the location of the economic activity. This ambiguity has necessarily launched a twofold debate, on the one hand about shifting from source-based taxation to residence-based taxation,[180] and on the other hand pleading for continuing vitality of source-based taxation, as discussed in the previous section.[181] However, neither system is capable of reaching its objectives. It is not enough that a solution is workable; it must also be supported by enough countries, and it is obvious that neither of these approaches has achieved global acceptance or is capable of ever realising global consensus.

It is the ability to perform services for customers anywhere in the world while also having the ability to establish residency in a low-tax jurisdiction that leads to tax minimisation. The path of international law is directed

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[177] OECD, *supra* note 84.

[178] Dale Pinto, '*Conservative' and 'Radical' Alternatives for Taxing E-Commerce (Part 1)*, 17(4) J. of Intl Taxation 38 (2006).

[179] *Id*.

[180] US suggestion to shift from source-based taxation to residence-based taxation seems to be motivated by concerns regarding revenue collection via the source-based route in the Internet age.

[181] India and Australia are arguing that source is less elusive than residence, because it is impossible to take Silicon Valley to Monte Carlo. It is cheaper to continue with an established standard (source) than to negotiate numerous treaties based on a new one (residence), and residence-based taxation is likely to empower tax havens. This will erode the fiscal sovereignty of all source countries, which produce goods and services that benefit due to digitisation.

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by three main drivers: tax sovereignty concerns, practical administrative concerns, and guiding international tax principles.[182] Although perfection is not the goal, many of the participants in the ongoing debates over international taxation of e-commerce have strongly argued in favour of a higher degree of international cooperation in this area. During the second half of the twentieth century, there were a variety of attempts to create international organisations with sufficient authority to propose, although seldom impose, solutions to problems with substantial international dimensions. There is a practical concession among all of the nation states that they cannot deal with problems associated with e-commerce taxation alone, as Brauner argues, "the grand illusion of a single, worldwide tax system that would eliminate all international inefficiencies and assist all the nations of the world in maximising their relative advantages is commonly accepted as utopian."[183] Again, it is extremely unlikely that policymakers will ever consider any radical propositions, and this has led to the advancement of propositions that would make only minor adjustments to the framework, which have also been characterised as fundamentally flawed.

The question is: Where do we go from here? I believe that no clear and definite solution exists, and there is not enough empirical evidence to support adoption of any of the proposed solutions. In any case, by 'solution' I do not mean a comprehensive prescription for change. Rather, it is about making choices among plausible alternatives. Hence, based on contemporary realities, I would strongly argue that due consideration should be given to formulary apportionment as a viable alternative and that we should further consider developing the mechanics of a workable formulary apportionment system while addressing its shortcomings. In the previous section, I have explored the benefits of formulary apportionment. I would argue that the main benefit of the approach is efficiency, as it would reduce wasteful compliance and enforcement costs and curb the erosion of the tax base. Undeniably, the practical difficulties associated with implementation are not insignificant. In particular, consensus must be reached to determine the tax base, the composition of the formula (accounting concerns about the measurement of the formula components), and the definitions of the factors, and consensus will not be reached without conflict. However, the discussion has never been about finding a 'perfect' solution. In the context of international taxation, perfection would be a non-starter, but there is merit to a logical argument in favour of developing an 'optimal regime'.

[182] Cockfield, *supra* note 133.

[183] Yariv Brauner, *An International Tax Regime in Crystallization* 56 Tax L. R. 259 (2003).

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