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By Benjamin Hoffart*

¶1 The contemporary international tax system developed to allocate taxing jurisdiction over buyers and sellers of tangible, physical goods. Accordingly, the current system is based on the actual geographic location of these buyers and sellers. The Organization for Economic Cooperation and Development (OECD), the preeminent international tax policymaker,[1] has incorporated and consistently reaffirmed these physical presence principles in its Model Tax Convention on Income and on Capital ("OECD Convention"), the predominant world-wide model for bi- and multi-lateral tax treaties. The bright line principle established under the current OECD Convention states that "an enterprise in one state shall not be subject to a direct tax on its business profits based on net income in the other state unless it carries on business in that other state through a permanent establishment ("PE") located in the other state."[2] The OECD Convention further establishes fundamental criteria for determining if a permanent establishment exists:

(1) there must be a fixed place of business (*situs test)*;
(2) the fixed place of business must be located [in a] certain territorial area (*locus test*);
(3) the use of the fixed place of business must last for a certain period of time (*tempus test*);
(4) the taxpayer must have a certain right of use [over] the fixed place of business (*ius test*); and
(5) 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*).[3]

Finally, if a company does not meet these standards, PE status may still be imputed if an agent of the company regularly conducts business in the non-resident jurisdiction.[4]

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[1] *See* e.g. Arthur J. 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) [hereinafter Cockfield, *Rise of the OECD*].

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

[3] Cristián Gárate, *The Fixed Place of Business in the Context of Electronic Commerce*, *in* PERMANENT ESTABLISHMENTS IN INTERNATIONAL TAX LAW 41, 45 (Hans-Jörgen Aigner & Mario Züger eds., 2003); *see also* Organization for Economic Co-operation and Development, Model Tax Convention on Income and on Capital, art. 5(1), 7(1), Jan. 28, 2003[hereinafter OECD Model Convention, 2003].

¶2 The importance of permanent establishment within the contemporary treaty-heavy international taxation system is that "[w]hen a treaty governs the tax relations between [a] foreigner's country of residence and the country which is his host, 'permanent establishment' supplants the taxing nexus of the domestic tax law of the host country."[5] A foreign person or business that does not have adequate contacts sufficient to trigger the OECD standards creating a permanent establishment is exempt from taxes on business income and will pay taxes on investment income at a reduced rate.[6] As a result, determining "when the foreigner arrives at the crucial point [creating a permanent establishment] becomes a question of enormous financial significance."[7]

¶3 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 the 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.[8]

¶4 The advent of the Internet, and especially the proliferation of e-commerce, has led many commentators to question the OECD's use of permanent establishment as the defining nexus by which a country may tax the business profits of a nonresident entity.[9] These arguments are based on the idea that while permanent establishment was an effective criterion in the pre-digital age when cross-border commerce required a physical presence to conduct business, this criterion is no longer viable in an age where technology allows buyers and sellers to conduct cross-border business without ever establishing a physical presence in a non-resident state. These criticisms are accompanied by a diverse array of reform suggestions including PE status determined by economic rather than physical nexus[10] and e-commerce withholding taxes.[11] Despite the frequent calls for change, the OECD and other tax theorists maintain that the current PE rules are robust and flexible enough to respond to the challenges presented by the digital economy.[12]

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[4] OECD Model Convention, 2003, *supra* note 3, at art. 5(5).

[5] John Huston & Lee Williams, PERMANENT ESTABLISHMENTS: A PLANNING PRIMER, 1 (1993).

[6] *Id*. at 2.

[7] *Id*.

[8] Gárate, *supra* note 3, at 45.

[9] *See* e.g. Charles E. McLure Jr., *Taxation of Electronic Commerce: Economic Objectives, Technological Constraints, and Tax Laws*, 52 TAX L. REV. 269 (1997); Walter Hellerstein, *State Taxation of Electronic Commerce*, 52 TAX L. REV. 425 (1997) [hereinafter Hellerstein, *State Taxation*]; Arthur J. Cockfield, *Designing Tax Policy for the Digital Biosphere: How the Internet is Changing Tax Laws*, 34 CONN. L. REV. 333 (2002)[hereinafter Cockfield, *Digital Biosphere*]; Catherine L. Mann, *Balancing Issues and Overlapping Jurisdictions in the Global Electronic Marketplace: The UCITA Example*, 8 WASH. U. J.L. & POL'Y 215 (2002); Reuven S. Avi-Yonah, *International Taxation of Electronic Commerce*, 52 TAX LAWYER 507 (1997) [hereinafter Avi-Yonah, *International Taxation of E-Commerce*]; Richard L. Doernberg, *Electronic Commerce and International Tax Sharing*, 16 TAX NOTES INT'L 1013 (1998); Sprague & Hersey, *supra* note 2.

[10] *See* McLure, *supra* note 9, at 295; Hellerstein, *State Taxation*, *supra* note 9, at 440-41.

[11] *See* Arthur J. Cockfield, *Balancing National Interests in the Taxation of Electronic Commerce Business Profits*, 74 TUL. L. REV. 133, 205-209 (1999); Doernberg, *supra* note 9, at 1017-18.

[12] OECD Model Convention, 2003, *supra* note 3, at Introduction ¶ 35; Reuven S. Avi-Yonah, *Tax Competition and E- Commerce*, Worldwide Tax Daily, Sept. 17, 2001, *available at* LEXIS, 2001 WTD

¶5 This comment will consider the issue of the permanent establishment in the Internet economy from a new perspective: the permanent establishment as a proxy for access to the market. The "location of value-creation" perspective of the permanent establishment rules adopted by many commentators has suggested that for taxing purposes income from e-commerce should be allocated by point of sale or consumption. Moving from this angle to a model using the assumption that the traditional, physical presence test was intended by tax policymakers as a means of approximating a non-resident company's access to a host country's market also largely supports allocation by point of sale or consumption. Thus, the "market proxy approach" supports many of the revisions to current PE practices advocated by commentators applying the "location of value creation" approach. While the practical outcome of each justification may be the same, the approach advocated in this comment provides different and potentially more complete justifications for these reforms.

¶6 Part I of this comment traces the history and theoretical basis for the modern conception of permanent establishment. Cognizant of this background, Part II continues by reviewing recent suggestions for reform or maintenance of the current PE rules and usage. Part III argues that suggestions for reform based in "access to markets proxy" rather than the currently predominant "location of value creation" frame yield more robust reform proposals, and uses this access to markets proxy to re-examine and refine current reform arguments. Part III also shows how the access to markets approach stimulates further discussion and consideration of how the ill-defined world of cyberspace relates to our traditional, tangible world.

I. THE HISTORY OF PERMANENT ESTABLISHMENT AS A MEANS OF ASSIGNING TAXING JURISDICTION

¶7 The concept of permanent establishment developed in the late 19th century in conjunction with the rapidly evolving business climate sometimes referred to as the "second industrial revolution."[13] This period was characterized by increases in business mobility not entirely dissimilar to the recent Internet-influenced changes to the commercial environment. Between 1870 and 1920, capital of "industrialized countries changed from being predominantly circulating capital (working capital) to capital invested in plants, machines, etc. (fixed capital)."[14] This transformation of capital was accompanied by a transportation revolution as improvements in railroads and steamships and the advent of the automobile dramatically decreased transportation time and cost.[15] While these changes drastically changed fiscal mobility, industrial mobility remained

180-11 [hereinafter Avi-Yonah, *Tax Competition*] (noting that it has been more difficult than initially expected for multi-national enterprises to avoid having permanent establishments by relying on e-commerce); Avi-Yonah, *International Taxation of E-Commerce*, *supra* note 9, at 516; Sprague & Hersey, *supra* note 2, at 311 (acknowledging that while e-commerce has changed the business world, the origin of wealth for businesses remains where it always has, at the place where the costs and risks to develop, produce, and distribute the products are borne).

[13] Arvid A. Skaar, PERMANENT ESTABLISHMENT, 65 (1991).

[14] *Id*.

[15] *See id*. at 66.

limited to the transportation industry.[16] "It appears, therefore, that PE as an international fiscal concept emerged at a time when production factors were relatively immobile[.]"[17]

¶8 "After World War I when governments were in dire need of revenue to rebuild their economies, they began to try to tax the earnings of the visiting businessman and the profits of the foreign company on goods sold through him."[18] In the 1920's, the League of Nations addressed the pernicious double taxation of non-resident companies' business profits.[19] Reports submitted to the League of Nations in 1923 and 1925 highlighted a special need for mechanisms preventing double taxation of these profits.[20] In 1927 and 1928, the League of Nations responded to the reports' recommendations with drafts of the Bilateral Convention for the Prevention of Double Taxation,[21] introducing the concept of permanent establishment as a means of allocating taxing jurisdiction among states with a potential claim to taxing rights.[22] "Within the traditional economic context of this theory a material or physical transaction took place if a natural or juridical person developed tangible economical activities in a certain territory for a minimum period of time."[23] This "fundamental structure for international taxation of income announced nearly seven decades ago in the 1928 League of Nations Model Treaty forms the common basis for more than twelve hundred bilateral tax treaties now in force throughout the world."[24]

¶9 The permanent establishment rules first promulgated by the League of Nations in 1928 and currently embodied in the OECD's Model Convention are well situated in source models of taxation.[25] "The claim of source countries to tax income produced within their borders is analogous to a nation's long-recognized claim of sovereignty over natural resources within its boundaries."[26] Source-based justifications for taxation also hold that countries have "a fair claim to the income produced within [their] borders[.] [F]oreigners, whose activities reach some minimum threshold, should contribute to the

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[16] *Id*. at 67.

[17] *Id*.

[18] Michael J. Graetz & Michael M. O'Hear, *The "Original Intent" of U.S. International Taxation*, 46 DUKE L.J. 1021, 1088 (1997).

[19] *See* Philip Postlewaite, Samuel Donaldson, & Allison Christians, UNITED STATES INTERNATIONAL TAXATION (forthcoming Nov. 2007) ("One of the most fundamental issues of international taxation is the potential for double taxation that exists due to the movement of people and transactions across borders. Double taxation is considered to be so distortive of efficient economic behavior that most countries, including the United States, have addressed it statutorily ... The issue of double taxation is also addressed in treaties entered into with other countries, usually on a bilateral basis.")

[20] *See, e.g.*, *Report on Double Taxation*, League of Nations Doc. E.F.S.73.F.19 (1923) (reporting findings of Professors Bruins, Einaudi, Seligman and Sir Josiah Stamp to Financial Committee of the League of Nations) [hereinafter *1923 LON Report*]; *see also Technical Experts on Double Taxation and Tax Evasion*, League of Nations Doc. F. 212 (1925) [hereinafter *1925 LON Report*].

[21] *Double Taxation and Tax Evasion Report*, League of Nations Doc. C.216.M.85 1927 II (1927) [hereinafter *1927 LON Report*]; *see also Report Presented by the General Meeting of Government Experts on Double Taxation and Tax Evasion*, League of Nations Doc. C.562 M.178 1928 II (1928) [hereinafter *1928 LON Report*] (amending the Bilateral Convention for the Prevention of Double Taxation first presented in the 1927 LON Report).

[22] 1927 LON Report, *supra* note 21, at 10.

[23] Gárate, *supra* note 3, at 43.

[24] Graetz & O'Hear, *supra* note 18, at 1023.

[25] *See* Michael J. Graetz, *The David R. Tillinghast Lecture: Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies*, 54 TAX L. REV. 261, 298 (2001).

[26] *Id*. at 298; *see also* Blair Downey, *E-Commerce: The Taxman's Nemesis*, 2 ASPER. REV. INT'L BUS. & TRADE L. 53, 61 (2002)("Traditional source-based systems are deeply connected to PE").

costs of services provided by the host government."[27] This "social contract" view also evokes the cost and benefit theories of taxation which say that taxpayers should pay the state for the cost of state-provided services or in accordance with specific benefits received by the taxpayer.[28]

¶10 In light of the theoretical bases for the permanent establishment rules, and the emergence of PE in the early twentieth century "when significant international commerce in foreign markets required the creation of a branch or similar physical presence,"[29] many tax commentators have determined that "the conceptual basis for allocating taxable income [under the PE rules] was the location of value-creating activity"[30] or source of taxable profits.[31] This basis for the permanent establishment rules was almost immediately tested by the advent of radio and television marketing.[32] Even though radio and television were not easily subjected to direct taxes, since stations' profits resulted from advertising sales rather than direct charges on listeners and viewers, the proliferation of analog media did not significantly challenge the PE rules due to the implicit assumption that consumption consisted primarily of tangible products sold by those advertising merchants.[33]

¶11 Nevertheless, the increasing mismatch between law and technology continued to challenge the appropriateness of physical nexus requirements like those embodied in the permanent establishment rules.[34] In 1967, a question of taxing jurisdiction over multi-state business profits reached the United States Supreme Court. In *National Bellas Hess*,[35] a case involving a mail order company conducting business in a State where it had no physical presence, the Court reaffirmed physical presence requirements indicative of the broader theoretical justifications for the PE rules.[36] Twenty-five years later, in 1992, the Court re-examined its *Bella Hess* holding in *Quill Corp. v. North Dakota*,[37] another case involving an attempt by a State to tax the mail order profits of a company with no physical connection to the State. In *Quill*, the lower court declined to follow *Bellas Hess* because innovations of the prior quarter century rendered its holding "obsolete."[38] While the majority reaffirmed its *Bellas Hess* holding, Justice White noted

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[27] Graetz, *supra* note 25, at 298.

[28] Sprague & Hersey, *supra* note 2, at 304-305; *see also* Thomas S. Adams, *The Taxation of Business*, 11 NAT'L TAX ASS'N PROC. 185, 186 (1917) (arguing that because providing and maintaining a market costs money, those costs should be distributed amongst those benefiting from that market).

[29] Arthur J. Cockfield, *Transforming the Internet into a Taxable Forum: A Case Study in E-Commerce Taxation*, 85 Minn. L. Rev. 1171, 1179 (2001) [hereinafter Cockfield, *Transforming*].

[30] Sprague & Hersey, *supra* note 2, at 302.

[31] *See* Cockfield, *Transforming*, *supra* note 29, at 1180 (highlighting how PE principles represented a balanced rule from an international equity perspective since source countries could obtain revenue from profits created by commercial opportunities presented by their markets).

[32] *See* McLure, *supra* note 9, at 293.

[33] McLure, *supra* note 9, at 293-294.

[34] *See* Arthur J. Cockfield, *Jurisdiction to Tax: A Law and Technology Perspective*, 38 GA. L. REV. 85, 92 (2003)[hereinafter Cockfield, *Jurisdiction to Tax*]; Walter Hellerstein, *Jurisdiction to Tax Income and Consumption in the New Economy: A Theoretical and Comparative Perspective*, 38 GA. L. REV. 1, 41 (2003)[hereinafter Hellerstein, *Jurisdiction to Tax Income*].

[35] Nat'l Bellas Hess, Inc. v. Dep't of Revenue of Ill., 386 U.S. 753 (1967).

[36] *Id*. at 758 ("But the Court has never held that a State may impose the duty of use tax collection and payment upon a seller whose only connection with customers in the State is by common carrier or the United States mail.").

[37] Quill, Corp. v. North Dakota, 504 U.S. 298 (1992).

[38] North Dakota v. Quill Corp., 470 N.W.2d 203, 208 (N.D. 1991).

in his dissent that "in today's economy, physical presence frequently has very little to do with a transaction a State might seek to tax."[39]

¶12 While Justice White expressed the minority opinion of the Court in *Quill*, his argument that physical presence had little meaning for taxing jurisdiction seems to be echoed by a majority of contemporary tax scholars. Professor Hellerstein notes, "if there is one proposition with which virtually all observers agree, it is that the way in which income is generated in the 'new economy' is materially different from the way it was generated during the formative era of international income tax rules."[40] The change with the greatest impact on traditional taxation structures has been the development of the Internet, "a decentralized, global, and rapidly evolving network that often transmits intangible goods and services[, and is] highly resistant to traditional forms of government regulation."[41] In 1996, The United States Treasury office commented on the changing commercial environment:

> Electronic commerce, on the other hand, may be conducted without regard to national boundaries and may dissolve the link between an income-producing activity and a specific location. From a certain perspective, electronic commerce doesn't seem to occur in any physical location but instead takes place in the nebulous world of "cyberspace." Persons engaged in electronic commerce could be located anywhere in the world and their customers will be ignorant of, or indifferent to, their location.[42]

¶13 Given the "nebulous" nature of cyberspace, many commentators[43] have noted how e-commerce fundamentally challenges physical presence-based permanent establishment rules. 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.[44] Perhaps the greatest difficulty of applying traditional permanent establishment principles in the e-commerce sense is finding a component[45] of the Internet the effectively meets the OECD Model Convention's requirements for PE status.[46]

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[39] Quill, 504 U.S. at 328 (White, J., dissenting).

[40] Hellerstein, *Jurisdiction to Tax Income*, *supra* note 34, at 41.

[41] Cockfield, *Transforming*, *supra* note 29, at 1173.

[42] Deptartment of the Treasury, OFFICE OF TAX POLICY, SELECTED TAX POLICY IMPLICATIONS OF GLOBAL ELECTRONIC COMMERCE, 7.2.3.1 (1996), http://www.treas.gov/offices/tax-policy/library/internet.pdf [hereinafter 1996 Treasury Department Report]; *see also* Gárate, *supra* note 3, at 48-49 ("[The] Internet creates an almost instantaneous interactivity that is virtual (non physical), global (borderless), anonymous (difficult to track), non intermediated (impersonal), closely integrated and specialized across borders; it is an alternative to business conducted through traditional channels.").

[43] *See generally* sources cited *supra* note 9.

[44] Gárate, *supra* note 3, at 51.

[45] The 1996 Treasury Department Report highlights how PE principles apply to one specific Internet component, the server. In the report, the Department notes that computer servers can be easily located anywhere in the world and users of these servers are indifferent to the server's location. Servers are often not involved in the creation of income so as to be considered in determining whether a trade or business exists, and servers are mobile, so businesses can potentially locate their servers outside high-tax jurisdictions (i.e., tax avoidance) if they are given PE status. 1996 Treasury Department Report, *supra* note 42.

[46] Downey, *supra* note 26 at 58; *see also* OECD Model Convention, *supra* note 3 and accompanying text; Gárate, *supra* note 3, at 49 ("[T]he *situs test* needs to be revised to include the new technological *situs*

¶14 In 2000, the OECD responded to this major impediment to the use of traditional PE rules in the Model Convention, and made changes to the Convention's Commentary[47] on Article 5.[48] This revised Commentary clarifies key issues about how indistinct or difficult to understand Internet components should be considered under current PE principles.[49] While the OECD has responded to the questions posed by the digital economy through changes to the Model Convention's Commentary, they have stopped short of modifying the current PE system and have advocated that the traditional PE concepts will adequately respond to the evolving modern economy.

II. CURRENT ARGUMENTS FOR AND AGAINST THE VIABILITY OF THE CURRENT USE AND CONCEPTION OF PERMANENT ESTABLISHMENT

A. Arguments For Changing the Current Permanent Establishment Rules

¶15 This section briefly outlines the prevalent arguments for economic nexus-based allocation of taxing jurisdiction at the point of consumption while also considering some of the better-developed ancillary e-commerce tax policy recommendations stemming from these arguments. As e-commerce has sparked considerable debate over the continued viability of the PE rules, numerous reform suggestions have appeared in the tax policy and law literature. Generally speaking, suggestions for improving allocation of taxing jurisdiction in an era of flourishing electronic commerce advocate a move away from PE standards using physical presence tests towards PE standards using tests of economic presence[50] at the location of consumption.[51]

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in the forms of a server and web sites. The *locus test* needs to be reconsidered to comprise new locations ... in the form of ... Intranets, Extranets, and the Internet. The *tempus test* needs to be analyzed to support economic operations that are performed instantaneously between several parties. Likewise, human intervention comprised in the original concept of permanent establishment needs to be revised in the light of fully electronic equipment that performs instructions with a code or program denominated [s]oftware.").

[47] Cockfield, *Transforming*, *supra* note 29, at 1189 ("The OECD Commentaries are important because they are used by tax authorities and courts, including U.S. courts, to interpret tax treaty provisions.").

[48] *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 ARTICLE 5 (2000), http://www.oecd.org/dataoecd/46/32/1923380.pdf [hereinafter OECD E-Commerce Clarification Report] (last visited Nov. 21, 2006); *see also* Michael Dezsi, *U.S. Taxation of International E-Commerce: The Organization for Economic Cooperation and Development's New Commentary to its Model Tax Convention Redefining Permanent Establishment*, 79 U. DET. MERCY L. REV. 123 (2001).

[49] The new Commentary provides the following guidance: (1) web sites are composed of software and data, not tangible property, and therefore cannot be considered a place of business sufficient for characterization as a PE; (2) 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 if the server is owned or leased by the business operating the server; (3) presence of business personnel at the location of the server is not necessary to create a PE; (4) if the server is operated by a web provider, it should not constitute a permanent establishment because the business has no control over the server and it is not a place of business of the enterprise; (5) it doesn't matter that a server can be moved, it is important if it says in one location for more than 12 months; (6) computer equipment if a fixed place does not create a PE when the business conducted through it is limited to auxiliary services (auxiliary services being defined on a case-by-case basis with regard for all the business functions performed through the computer equipment); and (7) when the business uses the computer equipment for essential/significant activities they create a PE. OECD E-Commerce Clarification Report, *supra* note 48, at ¶¶ 42.2-42.10.

[50] Charles McLure succinctly states, "Basing nexus on physical presence probably does not make sense in the digital age ... 'economic nexus' would be a more appropriate concept." McLure, *supra* note 9, at

¶16 As detailed in the prior section, Internet-based businesses might allow non-resident entities to reap considerable gains from sales in another jurisdiction without having sufficient physical presence in the jurisdiction to give it PE status.[52] Accordingly, commentators have argued that the fundamental concept — profit should be attributed to the location where value is created — used by the OECD is obsolete.[53] The appropriate test should not be based solely on wealth-creating activities, but should also consider place of consumption.[54]

¶17 Arthur Cockfield, perhaps the most prolific author of e-commerce tax literature, argues that

> the United States and other OECD member states have, despite assertions that traditional tax principles must be preserved, moved toward an economic presence test for cross-border e-commerce income tax purposes, a significant departure from traditional international tax principles that focused on the need for a physical presence within a taxing state.[55]

Cockfield points out that the OECD member states have already significantly diluted the traditional permanent establishment principle for e-commerce activities by agreeing (in the revised Commentary to the OECD Model Convention) that certain physical aspects of the network can, in some circumstances lead to a taxable presence within a foreign country.[56]

¶18 This change, Cockfield argues, along with tentatively proposed OECD rules to govern the amount of profits that should be allocated to a server for tax purposes by determining what substantive economic activities are being conducted by the server, "may lead to a fundamental shift in the approach used by taxpayers and tax authorities in their efforts to allocate profits among activities in different countries."[57] The primary change Cockfield forecasts is that tax authorities will no longer ask what sort of taxable presence exists within each country, but instead will ask what type of economic activity is occurring in each country.[58] This effectively allows profits to be diverted away from countries that have a meaningful connection to profit-making activities, and the increasing complexity surrounding taxpayer compliance strategies (i.e., tax avoidance and tax competition) might actually undermine the international income tax system.[59] In short "[b]y clinging to traditional principles, United States tax authorities and OECD

295; *see also* Mann, *supra* note 9, at 231-32 ("Physical presence is much less important in value creation for information-rich and network-based productions.").

[51] *See* Cockfield, *Digital Biosphere*, *supra* note 9, at 395.

[52] *See* Doernberg, *supra* note 9.

[53] *See* sources cited *supra* note 9.

[54] *See* Cockfield, *Digital Biosphere*, *supra* note 9.

[55] *Id*. at 390-391.

[56] *Id*. at 391

[57] *Id*.

[58] *Id*. at 391-392.

[59] *Id*. at 395; *see also* Arthur J. Cockfield, *The Law and Economics of Digital Taxation: Challenges to Traditional Tax Laws and Principles*, 56 BULL. FOR INT'L FISCAL DOCUMENTATION 606, 606 (2002) [hereinafter Cockfield, *Law and Economics*].

member State tax authorities have inhibited the ability of their tax systems to protect real world norms."[60]

¶19 A more sensible solution would focus on the location of consumption, rather than the location of production.[61] Cockfield notes,

> The use of location of consumption to allocate tax revenues to importing countries can be justified under a number of theories, including the fact that e-commerce importing countries created the market opportunities that enabled the profits to be made through the cross-border transaction (for example, by subsidizing the physical network infrastructure within their country that permitted the transaction to go forward).[62]

Allocating revenues to the location of consumption also combats income shifting and tax competition fostered by the OECD's revised Commentary allowing servers to rise to the level of permanent establishments:

> The act of consumption requires a real human being who must necessarily be situated somewhere in geographic space, whereas the act of production of intangible assets can be diverted to a location that does not have any meaningful connection to any real value-adding economic activity.[63]

¶20 Interestingly, Cockfield suggests that the unique aspects of the Internet be harnessed as a solution to the challenges presented by e-commerce.[64] Tax authorities should identify the critical values they wish to see preserved, such as the desire to maintain their ability to collect taxes to pay for public goods. Then, regulators should see if Internet technological solutions can help preserve those values. Cockfield points to the efforts of The Streamlined Sales Tax Project (SSTP), which ran a pilot project in Kansas, Michigan, North Carolina and Wisconsin, designed to withhold taxes from remote sellers as a potential solution to the many logistical difficulties associated with e-tax collection at the point of consumption.[65]

¶21 A similar point of consumption withholding tax scheme has been developed and advocated by Professor Doernberg.[66] Under his proposal, commonly called the "Base Erosion Approach," cross-border payments from a payor that is entitled to deduct the payment for its local tax purposes would be subject to a withholding tax regime.[67] In Doernberg's eyes, this approach would supplement, not completely replace, the current PE nexus principles. Countries could still tax all nonresident businesses with a permanent establishment within their borders, but, in addition, a country where consumption occurred would also have the right to levy a withholding tax on payments with a source in that country to a non-resident (out of country) vendor. In lieu of

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[60] *See* Cockfield, *Digital Biosphere*, *supra* note 9, at 395.
[61] *Id*.
[62] *Id*. at 396.
[63] *Id*.
[64] *See id*. at 353.
[65] *Id*. at 387-390.
[66] *See* Doernberg, *supra* note 9, at 1022 (introducing the Base Erosion Approach).
[67] *Id*.

suffering the withholding tax, the non-resident payee could file a tax return in the host country (i.e., place of consumption) if that income were attributable to permanent establishment in that country. Doernberg's proposal has received backing from a number of commentators, perhaps most notably in a study commissioned by the government of India ("HPC Report").[68]

¶22 Much of the base erosion approach's appeal lies in its simplicity and ease of enforcement.[69] Only the cross-border payments that are deductible by the payer would be subject to withholding. "Assuming that local deductions are contingent on withholding, this approach would offer a degree of self-enforcement because the local withholding agent would have a built-in incentive to withhold."[70] This approach also simplifies tax law by eliminating complex characterization and sourcing rules.[71]

¶23 Another point of consumption, economic nexus solution is presented by Professor Avi-Yonah.[72] His suggestion is a system where, once a foreign business's sales within a jurisdiction reach a certain level, the foreign business could be taxed by the source jurisdiction. This compensates the source jurisdiction for the costs borne to produce a healthy consumer base and supporting infrastructure that allows the business to function in the source jurisdiction. As Arthur Cockfield points out, the primary challenge under such a system would be the establishment of a predetermined level of business, giving rise to a host country's ability to tax a non-resident vendor.[73]

¶24 Another proposal, in the vein of Cockfield's suggestion that the new properties of the Internet be harnessed to counteract the challenges presented by the Internet, is a suggestion that countries enforce an e-commerce "bit tax" on non-resident companies making use of their market.[74] Effectively, this proposal advocates taxes on non-resident business profits at the point of consumption, but the bit tax would not directly tax consumption, but instead, would tax the Internet activity leading to consumption.

¶25 One final, and perhaps "looser," point of consumption/economic nexus suggestion for revamping the traditional permanent establishment rules involves formulary appointment.[75] This system argues that, as businesses create greater percentages of their value through intangible elements and Internet-enabled remote selling activity, appropriate percentages of income, as established by a mathematical formula, should be appointed as PE income in the state where consumption occurs. This system, like those previously mentioned in this section, is conceptually based on the premise that point of consumption provides a more accurate allocation of taxing jurisdiction in light of modern commercial practices. While the proposals discussed above work through what might be

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[68] Report of the High-Powered Committee on (Indian) Electronic Commerce and Taxation, 77-78, at http://www.laws4india.com/indiantaxlaws/notification/ecomchapter2.pdf (Sept. 12, 2001) (last visited Nov. 25, 2007) [hereinafter "HPC Report"] (supporting the Doernberg Base Erosion Approach with the caveats that (1) it should replace rather than supplement the current PE rules, and (2) it should apply to all commerce, not just e-commerce).

[69] *See* Doernberg, *supra* note 9, at 1017.

[70] Sprague & Hersey, *supra* note 2, at 309.

[71] *Id*.; *see also* HPC Report, *supra* note 68, Executive Summary at 15.

[72] *See* Avi-Yonah, *International Taxation of E-Commerce*, *supra* note 9.

[73] *See* Cockfield, *Digital Biosphere*, *supra* note 9 at 395-396.

[74] *See* Michael Mazerov, *Making the Internet Tax Freedom Act Permanent in the Form Currently Proposed Would Lead to a Substantial Revenue Loss for States and Localities*, TAX NOTES TODAY, Oct. 20, 2003, pp. 203-39.

[75] *See* McLure, *supra* note 9, at 418-419.

considered more direct taxes levied at the point of consumption, the formulary appointment method achieves a similar goal by utilizing a formula that applies greater weight to the country where consumption occurs.

B. Arguments for Maintaining the Current PE System

¶26 While the vast majority of recent academic discourse has argued for revamping the current PE rules, the OECD has steadfastly adhered to the principles first developed in the 1920s by the League of Nations and later adopted into the Model Convention. They, along with some assistance from many academics (including some authors suggesting PE retooling), have justified their continuing use of the current permanent establishment principles with four main arguments: (1) the PE rules are conceptually correct, (2) there is little evidence supporting the tax avoidance and loss of revenue scenarios predicted by change advocates, (3) the PE rules are robust and flexible enough to handle the challenges of e-commerce, and (4) transfer pricing and other remedies are available to correct any inefficiencies caused by the existing rules.[76]

¶27 Arguments touting the conceptual firmness of the PE system say that the current system allows a state to tax a foreign business that has a sufficient nexus with the state to justify the state to get a portion of the foreign business's tax base. E-commerce efficiencies shouldn't undermine this assumption.[77] The digital economy still requires businesses to utilize capital, labor, and other property to produce and market its products. Physical presence and activity — labor, property investment, assumption of risk — remain necessary for a business to market and sell its products and services. Specifically,

> That a jurisdiction has customers which are available to make purchases from a foreign enterprise should not be given much weight as a policy matter in designing the tax nexus rules. This is because market accessibility does not indicate that a particular foreign enterprise has created value in that state. Selling into a market does not equate to an enterprise's "participation in the economic life of a country." Instead, it reflects the enterprise's "participation with the economic life of a country."[78]

While e-commerce has changed the business world, the origin of wealth for businesses remains where it always has, at the place where the costs and risks to develop, produce, and distribute the products are borne.[79]

¶28 Arguments supporting the existing PE rules also point out a lack of empirical evidence suggesting their inability to respond to e-commerce challenges and also point out that those proposals supporting a direct tax nexus rely on the assumption that under the current PE rules, most e-commerce transactions would not be subject to taxation in the country of consumption. It would not be reasonable to implement change until clear evidence of this scenario emerges. With respect to remote sellers of consumer products,

[76] *See* Sprague & Hersey, *supra* note 2, at 311-322.
[77] OECD Model Convention 2003, *supra* note 3, at art. 7(1).
[78] Sprague & Hersey, *supra* note 2 at 312.
[79] *Id.* at 312.

empirics are showing that business without physical presence are generally not able to replicate the economic success of businesses that are physically established.[80]

¶29 Those arguments showing a dearth of empirical evidence also suggest that the current PE system has already been able to adequately respond to the evolving modern marketplace. The OECD has asserted that modest changes in international tax practice can be achieved through continuous interpretation of the existing rules as simple changes to the Commentary on Article 5 of the Model Convention have historically been used to account for new business realities.[81]

¶30 Moreover, the permanent establishment rules are just part of a much larger international taxation system, and thus, there are other taxation principles where correcting for the challenges of the digital economy might make more sense. For instance, attribution of profit to a PE based on arm's length principles remains appropriate in an Internet-enabled economy: the growing use of e-commerce may create a situation where there is a lack of comparable transactions suitable for determining an arm's length standard, yet there are few, if any, examples where current transfer pricing rules cannot be used to resolve the issue.[82]

III. PERMANENT ESTABLISHMENT AS AN ACCESS TO MARKETS PROXY

¶31 Each of the arguments highlighted in the previous section is based on the presumption that the current permanent establishment principles use "location of value production" as their conceptual basis. While the history of the permanent establishment principle certainly supports that the permanent establishment principles were developed with location of value production as their conceptual root, scholars and tax policymakers have been perhaps too ready to accept location of value production as the only conceptual basis to the exclusion of other plausible justifications of the traditional permanent establishment principles. This section will show how an alternative basis for the permanent establishment principles, an "access to markets proxy", is supported by the historical literature surrounding the League of Nations' formation of the early PE rules. This section then continues to show how this alternative, albeit small, shift in conceptual basis can be used to supplement the arguments for and against PE rule revision discussed in the previous section.

¶32 As mentioned in a prior section, two fundamental theoretical underpinnings of the international tax system are the cost and benefit theories of taxation. Sometimes pooled together under a larger "equivalence theory,"[83] these principles hold that "the taxpayer should pay taxes equivalent to the benefits he has, or the expenses he causes, through the use of the infrastructure of a country, in particular the use of public goods and natural

[80] *See* Avi-Yonah, *Tax Competition*, *supra* note 12 (noting that it has been more difficult than initially expected for multi-national enterprises to avo*id* having permanent establishments by relying on e-commerce); Avi-Yonah, *International Taxation of E-Commerce*, *supra* note 9, at 516.

[81] *See* OECD Model Convention, 2003, *supra* note 3, at arts. 5, 7(1), Introduction ¶ 35 ("changes or additions to the Commentaries are normally applicable to the interpretation and application of convention concluded before their adoption, because they reflect the consensus of the OECD Member countries as to the proper interpretation of existing provisions and their application to specific situations.").

[82] Sprague & Hersey, *supra* note 2, at 311.

[83] *See* Skaar, *supra* note 13, at 24.

resources."[84] Thomas Sewell Adams, an architect of both early United States international taxation policy and the early League of Nations reports and resolutions first establishing the permanent establishment principles,[85] echoes the sentiment of the equivalence theory:

> A large part of the cost of government is traceable to the necessity of maintaining a suitable business environment . . . . Business is responsible for much of the work which occupies the courts, the police, the fire department, the army and the navy. New business creates new tasks, entails further public expense . . . . The relationship between private business and the cost of government is a loose one . . . . The connection, however, is real . . . . Business ought to be taxed because it costs money to maintain a market and those costs should in some way be distributed over all the beneficiaries of that market.[86]

¶33 The equivalence theories were prized by American economists in the early part of the twentieth century, and were a salient influence on the League of Nations reports and model treaties where the concept of permanent establishment was first defined. Many of these early League of Nations documents, discussing apportionment of taxing jurisdiction, do not use the term creation of value, but instead use "origin of wealth" terminology, meaning "all the stages which are involved up to the point of the wealth coming to fruition, that is, all the stages up to the point when the physical production has reached a complete economic destination and can be acquired as wealth."[87]

¶34 While the interpretation of the intent underlying the modern PE rules as being "creation of value" certainly seems like a valid reading, the terminology used in the early stages of PE rule development is sufficiently broad to allow the possibility that market access was a consideration at the time the rules were ordained. Further, given the influence of American economists and tax theorists like T.S. Adams, a professed supporter of equivalence justifications for taxation, on the League of Nations reports, "location of value production" seems to be just one of many potential conceptual bases congruent with equivalence theories supporting the traditional PE rules. Moreover, the "origin of wealth" phrasing and explanation given above, along with an obvious focus on market access by influential members of the League of Nations Technical Experts panel, would seem to go so far as supporting an argument that market access proxy was at least partial motivation for the resulting PE rules.

¶35 The digital economy has changed all aspects of the business world — perhaps most notably, it has expanded markets for traditional brick and mortar businesses that have successfully made the change to "click and mortar" or even entirely digital businesses.[88] Just like "creation of value" once required a tangible presence, access to markets once required a physical presence (a store, for example). While creation of value can now be

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[84] *Id*.

[85] For a historical account of Adams's impact on the shaping of twentieth century tax policy, *see* Graetz & O'Hear, *supra* note 18, at 1028-1041.

[86] Adams, *supra* note 28, at 187.

[87] 1923 LON Report, *supra* note 20, at 23 (presenting report by Professors Bruins, Einaudi, Seligman and Sir Josiah Stamp to Financial Committee of the League of Nations).

[88] *See* Aldo Forgione, *Clicks and Mortar: Taxing Multinational Business Profits in the Digital Age*, 26 SEATTLE UNIV. L. R. 719, 722-23 (2003).

achieved by automated software functions bearing no relationship to geographic boundaries, the same can be said for businesses' market access efforts.[89] This subtle distinction between "location of value-creation" and a "market access" vantage also shifts consideration away from the existing arguments about e-commerce taxing jurisdiction and stimulates greater scrutiny of the activities used by e-tailers to market their products.

¶36 Adding this market access proxy approach to the current debate featuring arguments for either revision or preservation of the traditional permanent establishment principles, in many cases, adds increased complexity and justification to proposals advocating reform. For instance, approaching the traditional permanent establishment rules as having a conceptual foundation in market access proxy seems to directly support the reform efforts proposed by professor Avi-Yonah.[90] Under the Avi-Yonah proposal, threshold levels of profits or sales of a non-resident business would trigger taxation by the host state. This proposal has intuitive appeal from the location of value production perspective that value is only created in a jurisdiction when business reaches or exceeds certain pre-defined levels. Stated a bit differently, the Avi-Yonah approach seems to use these pre-determined levels of business activity as a sort of proxy for determining when value is being created in a host country. Thus, it is a small, if even subtle, jump to a market access proxy. Such an approach, would, in the case of the Avi-Yonah proposal, reach essentially the same conclusion, though for a slightly different reason. Rather than certain levels of sales triggering host state taxation because they implied a locus of value creation, the levels of sales would trigger taxation because they implied a sufficient access to the host state market to warrant taxation in that state.

¶37 In the same way, a market access proxy approach seems to supplement arguments in favor of e-commerce bit taxes.[91] Bits of information transmitted over the internet carry information — product information, account data, shipping addresses, etc. — essential to electronic commerce. Situating bit tax proposals in the location of value creation principle would say that these bits serve as a sort of proxy for identifying value creation. Once a certain number of bits are associated with an out-of-state vendor, value creation is assumed in the host state, and taxing jurisdiction is allocated accordingly. Again, the market access proxy is a small and subtle shift. Rather than bits being used as a means of determining point of value creation, they serve as a means of determining market access for non-resident business in a host state. Whereas in the pre-digital age, accessing a market would require a business to establish in a host state in some form or perhaps by sending agents into the host state, the same outcomes can now be achieved by sending bits of information via web into the host state.

¶38 For these same reasons, the market access proxy approach seems to be a good fit with the Base Erosion Approach advocated by Professor Doernberg.[92] The key principle in Doernberg's proposal is that a direct tax nexus should exist whenever a foreign enterprise receives a payment from an in-country payor. Since bits transmitted over the network can now accomplish the same goals that a tangible physical establishment could in the pre-digital age, including exchange of payment, taxation based on the access that

[89] *See id*.; Cockfield, *Digital Biosphere*, *supra* note 9, at 338.

[90] *See* Avi-Yonah, *Tax Competition*, *supra* note 12; Avi-Yonah, *International Taxation of E-Commerce*, *supra* note 9.

[91] *See* sources cited *supra* note 74 and accompanying text.

[92] *See* Doernberg, *supra* notes 9, 66, and accompanying text.

these bits provide the non-resident business to the host country market seems to fall under the same broad justifications supporting a base erosion approach.

¶39 While the market access proxy justification appears to reasonably align tightly with many of the PE reform proposals, perhaps the most interesting comparison of how the market access approach differs from the value creation principles typically used to evaluate the permanent establishment principles is found in an application of the market access approach to the broad Cockfield point of consumption proposal.[93] Cockfield notes a particular problem with the OECD's revisions to the Model Convention Commentary that allow servers to rise to the level of a permanent establishment, saying that tax authorities will no longer ask what sort of taxable presence exists within each country, but instead will ask what type of economic activity is occurring in each country.[94] Approaching the issue from the market access proxy suggests that tax authorities should be questioning economic activity in exactly the fashion that Cockfield fears. This is because the market access proxy approach supports many of the arguments forwarded by the OECD in favor of maintaining the current PE system with minor adjustments.

¶40 Until recently, non-resident companies establishing an effective business presence in a host country most likely required some sort of physical presence, be it a retail location, a warehouse, or human agents, in order to access the host country's market. The Internet has, as detailed throughout this paper, drastically reduced (and continues to further reduce) the physical presence needs of non-resident companies trying to access a host state market. What formerly could only be achieved through physical presence, can now be achieved by ones and zeroes transmitted electronically via a loosely defined network. Rather than asking if there is a physical presence in the country worthy of taxation, as Cockfield seems to advocate, the market access proxy approach cares little about actual presence but cares a lot about the activities whether physical or not that allow a business to access a host country's market. The key questions, under the market proxy approach, should not be, as Cockfield suggests, the amount of consumption in a host country market, but if the efforts taken by a non-resident company gave that company access to that market. This is the line currently toed by the revised OECD Commentary to the Model Convention, and as it seems, a completely reasonable application of the permanent establishment principles as originally intended by the economists and tax policymakers establishing the PE rules nearly 80 years ago.

¶41 The biggest justification to consider permanent establishment principles from an access to market point of view, however, may lie in the continued evolution of the Internet economy. Commentators have already well documented the "disappearing of the taxpayer in Cyberspace,"[95] detailing how under the current PE rules, producers are increasingly able to use the nebulous nature of the web to avoid or minimize tax liabilities. Many of these same commentators have argued that the basis for taxing jurisdiction should be shifted to place of consumption.[96] However, just as cyberspace has altered how businesses deliver products to consumers, making producers more "elusive" and less tangible, it has also fundamentally changed the traditional "properties" of consumers and has blurred where products are actually "consumed." Accordingly,

[93] *See* sources cited *supra* notes 51-65 and accompanying text.
[94] Cockfield, *Digital Biosphere*, *supra* note 9, at 391-392.
[95] Gárate, *supra* note 3, at 48.
[96] *See* discussion Part II, subsection A *supra*.

alterations to the current system of international taxation relying on point of consumption in a particular jurisdiction may be a short term solution to the challenges presented by businesses' increased use of the Internet. An access to market approach may provide a more dynamic system of allocating taxing jurisdiction that is able to better respond to continuing evolution of the Internet economy.

IV. CONCLUSION

¶42 Given the discussion of the prior section, it is probably helpful to pause and ask what adopting a market access proxy understanding of the permanent establishment rules accomplishes. As noted in the prior section, changing from the traditional point of value creation characterization as the primary conceptual basis for the traditional PE rules and considering the added possibility that market access was a salient underlying theoretical justification of the rules does very little to challenge or change the current arguments for and against modifying the existing system of international taxation. What is really gained by adding market access proxy to the discussion is that it presents an avenue to ensure that tax policy remains cognizant of real world norms and values. When long-established legal principles of all sorts are being confronted with the new realities of the digital world, the subtle distinction between "location of value-creation" to a "market access" vantage also shifts consideration away from the existing arguments about e-commerce taxing jurisdiction and stimulates greater scrutiny of the activities used by e-tailers to market their products.

¶43 The question of who should have jurisdiction to tax the profits of individuals and businesses conducting multi-national business via the Internet is just one example of where law developed in response to a traditional, tangible world intersects with the modern realities of cyberspace. While the questions posed by this paper may not, at a glace, appear to drastically impact our daily lives, the principles derived from the current debate over taxation of electronic commerce will undoubtedly impact how law and policy are shaped in response to future technological advances. The question of how to tax in the digital age has already stimulated questions about the relationship between real world and digital norms. Continuing debate about the proper theoretical basis for the international tax system in an e-commerce world will help perfect our understanding of how technology impacts society in non-tax disciplines and may provide a greater understanding of cyberspace as a whole.