The chapter is organized as follows. It discusses the application of cross-border tax rules to: (a) business profits; (b) services income; (c) royalties; (d) individual and corporate residence; (e) transfer pricing issues; and (f) CFCs. Each section begins with a general discussion of the problems presented by the application of traditional tax rules to a cross-border digital commerce hypothetical. This is followed by a general discussion of the appropriate tax treatment of the hypothetical under United States and, at times, Canadian tax law. The remaining analysis for each category of cross-border income discusses related Organisation for Economic Co-operation and Development (OECD) reforms as well as, where relevant, national government reactions to these reforms.

§4.02 APPLYING TAX RULES TO CROSS-BORDER BUSINESS PROFITS

[A] Digital Commerce Hypothetical

Suppose R Corp. is a state R resident offering a wide variety of network security goods and/or services (e.g., software to protect computers against hackers). R Corp. is contemplating entering the market for country S customers. R Corp. plans to have no offices, warehouses, factories, or other facilities in country S. No employees of R Corp. will work in country S. However, residents of country S will be able to acquire goods and/or services from R Corp. by logging on to R Corp.'s website on the Internet. In order to establish an Internet presence, R Corp. arranges with an ISP (RISP Corp.) to establish a connection to the Internet.

R Corp. intends to provide the following network security goods and services to S individual and business customers:

(1) S customers can access R Corp.'s website (e.g., netsecurity.com) to order and download network security software directly into their computers or mobile devices;
(2) S customers can access R Corp.'s website and order a CD with the software, which will be shipped from country R to the customers;
(3) Country S business clients can similarly subscribe to Software as a Service (SaaS) from R Corp.'s cloud-based services; and
(4) R Corp. provides remote technical services, through a call centre located in a foreign country, to its individual and business clients located in S country through the telephone as well as via teleconferencing (using services such as Microsoft Skype or Apple FaceTime).

Many of the customers in country S connect to the Internet through ZISP Corp., an ISP that is a resident of country Z. Typically, there is no need for any ZISP Corp. employees to be present in country S as problems with software can generally be addressed from a remote location. In the event of a problem requiring service personnel, ZISP Corp. may send one of its employees or hire an independent country S technician.

In the discussion that follows, the primary focus is on the income generated by R Corp. However, the tax implications of ZISP Corp.'s activities in country S are also considered.[1]

[B] Problems Presented

[1] Where Is Income Generated

R Corp. is generating income from country S customers – income made possible perhaps by the political, economic and social environment of country S, but R Corp. may have very little or no physical presence in country S. If country S is to assert the authority to tax R Corp. on the income generated in country S, what is the basis for exercising such taxing jurisdiction? Possible bases for exercising jurisdiction might include: (a) the location of the customer base; (b) where the contract between R Corp. and country S customers is concluded; (c) the transmission of bits from the R Corp. server to a customer's browser in response to a customer's request; (d) the use of the phone lines and telecommunications infrastructure; (e) the presence of R Corp.'s ISP (RISP Corp.); or (f) the activities of agents at the telecommunications company or RISP Corp.

As discussed in the previous chapter (and assuming that country R and country S are treaty partners), in order for country S to assert taxing authority, it would normally be necessary for R Corp. to have a physical presence in country S (e.g., an office, retail outlet) and for the income to be attributable to that physical presence (although, as subsequently explored, the OECD BEPS initiative modified the OECD model tax treaty to expand the definition of a permanent establishment (PE) to, in some cases, reduce the need for a physical presence). In the absence of a tax treaty requiring a physical presence, country S might assert taxing authority on the basis of the activities of agents operating in that country on behalf of R Corp. Under these principles, the location of the customer base would normally be irrelevant for establishing authority to impose an income tax. If the only presence of R Corp. in country S were the presence of customers, under generally shared international income taxing principles country S would not have authority to tax R Corp. on its income generated by those customer purchases.[2]

Similarly, no physical presence is established merely by the fact that the contracts are concluded in country S. Furthermore, it may be difficult to determine where a contract is concluded in an online digital transaction, and the place of contract in any event may be subject to easy manipulation. The transmission of bits (e.g., sending an electronic image of an HTML page from the server in country R to the customer's client

1. The digital commerce hypothetical also raises tax issues with respect to other taxpayers, such as the telecommunications companies, banks, and software companies (providing for secure digital cash transactions). The tax issues involving these taxpayers are touched on where relevant throughout this chapter.
2. The imposition of a consumption tax (e.g., a VAT) might be determined based on where customers are located. *See* Chapter 5.

computer in country S) is not normally the type of physical presence sufficient to trigger taxing jurisdiction in country S; bits are no more than electrical impulses. If the bits themselves do not provide sufficient physical presence, perhaps the phone lines and telecommunications infrastructure provide the nexus that would allow country S to tax income from R Corp.'s activities. If S were to base taxing authority on the use of the telecommunications infrastructure, it would be virtually impossible for R Corp. to transact any business in country S without triggering country S taxation. Even if R Corp. operated through the mail rather than through the telephone, use of the roads and the postal infrastructure would presumably subject R Corp. to tax if use of the telecommunications infrastructure would.

Suppose that R Corp. made arrangements in country R with RISP Corp. to connect R Corp. to the Internet and to have RISP Corp. host the R Corp. website on the RISP Corp. server in country R. Suppose further that RISP Corp. also provides Internet access for customers in country S.[3] Should RISP Corp.'s physical presence in country S constitute sufficient physical presence for R Corp. to be subject to tax in country S in the absence of any other physical connections? It would not make sense to saddle R Corp. with potential tax liability in country S solely because one of the enterprises it does business with also has a physical presence in country S. Certainly, R Corp. would not be subject to tax liability in country S if, for example, it purchased an Apple computer, solely because Apple does business and has a physical presence in country S.

However, the analysis might be different if R Corp. purposefully availed itself of RISP Corp.'s presence in country S. For example, if RISP Corp. maintains a server in country S that provides advertising for R Corp., country S might have a stronger claim. Even then, advertising, without more, may not provide sufficient taxing authority under general international tax principles.[4] But if RISP Corp. maintains a server in country S and R Corp. maintains its website on that server, R Corp. may have a sufficient presence in country S to justify an exercise of country S's taxing authority if country S would have taxed R Corp. had it maintained its own server in country S.[5]

Even if none of the arrangements in the discussion above provides a sufficient physical nexus with country S based on traditional international tax norms, perhaps the activities of agents in country S might bring R Corp. within country S's taxing authority. It is true that R Corp. neither has employees in country S, nor has R Corp. hired agents who regularly conclude contracts binding R Corp. (although under BEPS reforms, a source country's ability to tax dependent agents has been expanded as explored in §4.02[D][3]). But would R Corp.'s relationships with the telecommunications company or ISPs render R Corp. subject to the taxing authority because of the activities of employees of those companies in establishing and maintaining Internet service?

3. RISP Corp. might have routers, servers and other equipment, as well as office space, in country S.
4. *See*, e.g., OECD Model, 2017, Art. 5(4).
5. Under the OECD Model, the test is whether the taxpayer 'has at its constant disposal' the premises in question. OECD Model, 2017, Art. 5, para. 4. If RISP was providing a service rather than leasing space on the hard drive, then R Corp. would not have a permanent establishment. *See* the discussion in §4.02[D][3].

There is another interesting agency issue arising from digital commerce. Historically, agents have been individuals or firms, which are collections of individuals, who act on behalf of their principals. As discussed in the last chapter, tax treaties typically deem certain dependent agent activities to constitute PEs, subjecting the cross-border income to source country taxation. It is now possible for R Corp. to operate a software agent (perhaps assisted by artificial intelligence) that can make decisions and conclude contracts with a digital signature in the name of its principal. Like a human agent or a collection of human agents in a firm, a software agent can be given a set of parameters within which it can make decisions without contacting its principal. To the extent that the software agent operates in country R on R Corp.'s server, no agency issues are raised concerning country S's taxing authority.

But suppose that R Corp.'s software agent functions on a customer's computer in country S (i.e., the agent software is downloaded by the customer or is streamed from a cloud of servers). The agent might be able to help the customer search for merchandise, answer any questions about the use of the merchandise, negotiate any appropriate discounts, conclude a purchase order, process the payment details and arrange for shipping (and even complete shipping in the case of digital goods and services). If these activities done on a regular basis by a human agent in the United States are sufficient to permit the United States to exercise taxing authority over R Corp., perhaps the same result is required in the case of a software agent.

So far the discussion has focused on whether R Corp. might be subject to tax in country S by virtue of its physical contact or through the activities in country S of an agent. Aside from R Corp.'s tax liability in country S as a content provider, questions arise concerning the tax liability in country S of the ISPs – ZISP Corp. and RISP Corp. Conceptually, it may be easier to determine that ZISP Corp., as opposed to R Corp., should be subject to country S's taxing authority. For R Corp., Internet access is a means for delivering what R Corp. produces. For ZISP Corp., local Internet access is what ZISP Corp. produces. ZISP Corp. is conducting its business in those countries where local Internet access is made available. In the absence of a tax treaty, under most national facts and circumstances tests (e.g., 'effectively connected to a trade or business' or 'carrying on business'), S country should be able to tax the income generated by ZISP Corp. through dealings with S country consumers.

However, more difficult problems are posed if ZISP Corp. provides service to state S customers in a situation where no land-based equipment is used (e.g., using low altitude satellites). In this situation, there may be no physical presence in state S to justify state S taxation of ZISP Corp. RISP Corp. should not be subject to tax in country S if its only connection with country S is that it allows persons outside of country S, such as R Corp., to post home pages and other data on the Internet which then can be accessed worldwide, including in country S.

[2] What Costs Are Attributable to Includible Income

To determine accurately the tax base that may be subject to a country's tax jurisdiction, it is necessary to determine both the income produced within the jurisdiction and the

deductible expenses incurred in producing that income. Just as digital commerce raises difficult questions concerning where income is produced, digital commerce raises a similar problem with respect to where expenses are incurred. For example, suppose that R Corp. earns business income in country S. That income may be a result of joint production that took place when R Corp. employees in countries M, N, O, P, and Q used the Internet to design goods that were sold, to compile a database, to plan a marketing strategy, etc. The costs of computer hardware and software, the cost of labour, and costs of overhead must be allocated to the income produced. The problem of allocating costs is not a new problem arising out of the growth of digital commerce. However, the Internet and intranets[6] make it easier than ever for joint production within a firm across transnational boundaries, making cost allocation a central issue, and promoting transfer pricing headaches (*see* section §4.06).

[3] *Enforcement Concerns*

Assuming for the moment that country S is able to assert taxing authority over some or all of the income generated in country S, does country S have a means of enforcing its authority? Normally, when a non-resident has a physical presence in another country, the taxing authorities of that country: (a) are aware of that presence (e.g., there is a store or factory); and (b) can enforce any failure to pay the taxes owed by encumbering or seizing assets within the taxing authority's jurisdiction. These enforcement issues were explored in earlier reports by the OECD as well as national tax authorities (*see* Appendix A 'Select Government and OECD Digital Commerce Tax Policy Reports').[7]

In the example above, R Corp. may not have a meaningful presence in country S. Indeed, country S may not be aware that R Corp. is doing business in country S. There is no practical way for taxing authorities of country S to be aware of every company worldwide that maintains a website accessible by residents of country S. Moreover, the taxing authorities of country S have no way of ascertaining how much business R Corp. is doing in country S. This problem is enhanced by the ability of country S consumers to use anonymous digital cash methods to pay for their purchases from R Corp. (*see* Chapter 2 for a discussion of online payment systems).

If R Corp. is subject to the taxing authority of country S but does not pay the taxes due, the country S taxing authorities may have no practical way of seizing R Corp.'s assets to satisfy the tax obligation. If goods are purchased from R Corp. over the Internet and those goods are delivered to customers in country S by conventional

6. An intranet is a private network within an organization (e.g., a business) that is cordoned off from the public network (i.e., the Internet) through software programs known as 'firewalls': insiders can venture out onto the Internet, but unauthorized outsiders cannot come in.
7. *See* OECD, *Tax Administration Aspects of Electronic Commerce: Responding to the Challenges and Opportunities* (OECD February 2001). *See also Discussion Report of the Australian Tax Office Electronic Commerce Project, Tax and the Internet* (Second Report) (ATO December 1999) (hereinafter referred to as the 'ATO Second Report'). For discussion of enforcement and compliance issues for US-based multinationals, *see* Arthur J. Cockfield, *Tax Compliance Issues for US Companies with International Electronic Commerce Transactions*, 20 Tax Notes Int'l 223 (2000).

transport, country S authorities may be able to seize goods that are shipped. This would not be possible for intangibles or services that are provided over the Internet itself. Indeed, it may well be that the mere announcement that R Corp. is subject to tax in country S would be sufficient for many companies in the position of R Corp. to comply even if coercive enforcement procedures are not available. Many taxpayers either out of a sense of right and wrong or out of a fear of bad publicity try to comply with reasonable applicable law. However, not all taxpayers will comply with country S tax laws if they can get away with non-compliance (i.e., there is no coercive enforcement possibility). The potential mix of compliant and non-compliant taxpayers creates problems with basic tax principles of efficiency and fairness. Withholding taxes on cross-border digital sales are meant to address this enforcement challenge (*see* Chapter 7).

There are additional enforcement problems arising out of new payment methods. In commercial transactions today, cash businesses pose special enforcement problems because there may be no external record of a company's income (e.g., no cancelled cheque or credit card statement). However, commercial payments often are made by cheque or by credit card, creating a paper record of the transaction. For large transactions (e.g., buying a car), the use of cash is unusual in developed economies. In part, the physical logistics of transporting large amounts of cash limit its use. However, cryptocurrencies like Bitcoin offer the opportunity for near-anonymous transactions in large denominations. A consumer can download electronic tokens from an online bank, use those tokens to consummate a transaction and leave no paper (or electronic) trail whatsoever (if she takes steps to completely anonymize her identity such as the use of a proxy server). Consequently, even if country S asserts taxing authority over the income earned by R Corp., and even if the country S taxing authorities can enforce that authority in some manner, country S may have no reliable means of determining the extent that R Corp.'s income is generated from country S customers. Attempts to control the use of cryptocurrencies through bank regulation may prove unsuccessful because customers in country S will easily be able to use banks or other financial companies beyond the jurisdiction of country S (*see also* the discussion in Chapter 2).

Enforcement of a tax obligation imposed on ZISP Corp. by country S may not be as difficult as enforcement of R Corp.'s tax obligations because ZISP Corp. has some assets in country S (e.g., servers, routers and other equipment) that can be seized in the event of non-payment. Also, country S may be able to prevent ZISP Corp. from doing business in country S by regulating the ability of ZISP Corp. to contract with local telecommunications companies.

In the discussion that follows, the application of current tax rules to new methods of producing income are analysed. First, there is a non-comprehensive consideration of national tax laws in the United States and, at times, Canada (along with a brief mention of other relevant national income tax laws from time to time). Then, treaty issues are considered in the context of the OECD Model treaty, along with government reactions to OECD reforms.

planning and, to the extent they are implemented, will require a re-evaluation by tax advisors of existing and planned cross-border structures. On the other hand, the reforms, particularly in the digital tax arena, do not significantly change the existing global tax landscape for tax planners.

§4.07 CONTROLLED FOREIGN CORPORATIONS

To prevent or limit the reduction, deferral, or avoidance of taxes through the use of controlled foreign corporations (CFCs) set up in low tax jurisdictions, more and more countries are enacting specific anti-tax-haven legislation[334] whereby the undistributed income of a controlled foreign company is not deferred, but is taxed to its domestic shareholders on a current basis.[335] The legislation all follows the same basic pattern. Deferral of domestic taxation on the income of a controlled foreign corporation until it distributes dividends to its shareholders is eliminated. The existence of the foreign corporation is ignored for specified purposes. The resident shareholder of the controlled foreign corporation is taxed directly on a pro rata share of the corporation's undistributed income.[336]

Anti-tax-haven legislation operates to distinguish a foreign corporation whose undistributed income should be taxed currently to its domestic shareholders from a foreign corporation whose income should be taxable to its domestic shareholders only when distributed to them.[337] Usually three factors are used to make this distinction: (1) the domestic shareholders must control or have a significant ownership interest in the foreign corporation; (2) the geographical location of the controlled foreign corporation – where it is established or does business – is suspect; and (3) the nature of the activities engaged in by the foreign corporation and the character of the income derived by it are used to distinguish between CFCs engaged in bona fide business operations and those used primarily to defer or avoid domestic tax.

Countries with anti-tax-haven legislation define a controlled foreign corporation (CFC) in a similar manner. A controlled foreign corporation, for example, can be

334. While many countries use the term 'controlled foreign corporation (CFC)' in their tax-avoidance legislation, a few do not, though the provisions operate in relatively the same manner. To avoid confusion, this study at times uses the broader term 'anti-tax-haven legislation' to include all countries with such measures, whether or not they specifically reference controlled foreign corporations. For discussion, *see* OECD, *Controlled Foreign Company Legislation: Studies in Taxation of Foreign Source Income* (OECD 1996). *See also* OECD, *Harmful Tax Competition* (OECD 1998).
335. For a thorough review of the US regime for controlled foreign corporations, *see* Department of the Treasury, *The Deferral of Income Earned Through US Controlled Foreign Corporations* (December 2000) ('US Treasury CFC Report').
336. *See* Brian J. Arnold, *The Taxation of Foreign Controlled Corporations: An International Comparison* 131 (Canadian Tax Foundation 1986).
337. For a comparative assessment of elements of different national CFC regimes, *see* Arthur J. Cockfield, *Examining Policy Options for the Taxation of Outbound Direct Investment: A Report for the Advisory Panel on Canada's System of International Taxation* (Advisory Panel on Canada's System of International Taxation September 2008) (discussing the CFC regimes of Canada, the United States, Germany, Italy, Australia, Japan, Hong Kong, United Kingdom, France, the Netherlands and Sweden), 22–35.

defined as a foreign corporation more than 50% of whose shares, voting power, or value is owned by domestic shareholders. Beyond this general principle, however, each country's definition appears to differ in minor ways. For example, to be considered 'shareholders' for purposes of the above definition, some countries require a certain percentage of share ownership or voting power. US shareholders are defined as US persons owning stock with at least 10% of the voting power. As a result, US persons owning less than 10% of the voting stock are not counted for purposes of determining controlled foreign corporation status, nor are they taxed on their shares of the controlled foreign corporation's subpart F income ('tax haven income') prior to receipt of it as a dividend.[338]

The geographic location requirement is aimed at identifying those countries which impose little or no tax on income generated in their territory – 'tax havens'. To be useful to non-resident individuals and corporations, tax havens usually have the following characteristics which bolster their appeal as a location for commercial enterprise, while at the same time allowing a reduction or avoidance of tax in the individual or corporation's country of residence: low taxes (or none at all) on certain types of income and capital; high levels of banking and commercial secrecy; absence of exchange controls on foreign deposits of foreign currencies; a disproportionately large financial sector; modern communications facilities, including sea and air transport; self-promotion as an offshore financial centre; and few or no tax treaties providing for the EOI.[339]

The OECD's initiative against harmful tax competition highlighted four tax haven criteria: (1) no or nominal tax on geographically mobile financial and other service activities; (2) no effective EOI with respect to the regime; (3) the jurisdiction's regimes lack transparency (i.e., lack of disclosure, inadequate regulatory supervision or details of tax system are not apparent); and (4) the jurisdiction facilitates the establishment of foreign-owned entities without the need for local substantive presence or prohibits the entities from having any commercial impact on the local economy. Over time, the OECD's initiative came to focus on the first three factors (*see* Chapter 9).

Because legislation for the taxation of CFCs is primarily aimed at those entities established in tax havens, many countries have written their legislation to apply only to those CFCs located in defined tax havens. Under this 'designated jurisdiction' approach, the taxing authorities in a country issue a list of tax haven or non-tax haven countries and the anti-deferral measures either do, or do not apply, respectively. The tax haven lists may be issued as part of the legislation itself or as an administrative pronouncement. Countries deploy different technical rules to determine whether a tax haven exists (e.g., blacklists, white lists of acceptable countries, or focus on corporate tax rates).

Even after it has been determined that a CFC exists in a tax haven/low-tax jurisdiction it is often still necessary, under various countries' legislation, to determine if the income earned falls within the definition of income which is attributed to

338. IRC §§ 951 and 957.
339. Richard A. Gordon, *Tax Havens and Their Use by United States' Taxpayers – An Overview* (US Treasury 1981).

domestic shareholders on a current basis. Where the provisions apply only to special kinds of attributable income, usually only certain types of passive income and/or foreign base company sales or service income are included.

Income derived by a controlled foreign corporation from selling property or rendering services is considered to be active business income (and not attributed to its domestic shareholders), unless the income is 'base company income'. The term 'base company income' generally refers to income of a controlled foreign corporation, other than passive income, which is attributed to the corporation's domestic shareholders. Most definitions include two basic requirements: (1) the income must be derived from transactions between the controlled foreign corporation and a related party; and (2) the income must arise from sales made or services rendered outside the country where the controlled foreign corporation is located (unless an exemption is allowed). Thus, where a subsidiary is incorporated in a tax haven, sells only products acquired from its parent or related corporations, sells such products outside the country in which it is incorporated, and does not have a substantial or genuine presence in that country, the subsidiary may appropriately be viewed as a vehicle to avoid domestic tax, and the income may be currently taxable to the domestic shareholders. Similarly, where a controlled foreign corporation established in a tax haven is used to perform services in the country in which its controlling shareholder is resident, whether such services are performed for related or unrelated persons, the arrangement may be viewed as an artificial reduction of domestic tax, and subject to the anti-tax haven legislation.

Also, in situations where a related party provides substantial assistance to the controlled foreign corporation in earning its sales or service income, it may be appropriate for the income to be attributed to the parent corporation if the income could not have been earned by the controlled foreign corporation on its own. However, if the assistance provided by the related person is insignificant or incidental to the subsidiary's business, the subsidiary's income typically is not treated as base company income.

[A] Problems Presented

The growth of digital commerce should not pose any major problems with regard to which corporations are classified as CFCs, or which jurisdictions qualify as tax havens. However, electronic commercial transactions may create confusion in determining where transactions took place and what type of income was produced. For example, income from the performance of services is generally sourced to the place where the services are performed. Digital commerce often blurs the geographic issue. Chat rooms, instant messaging and videoconferencing can often substitute for many face-to-face meetings. Thus, it becomes difficult to determine where the service was actually performed, and particularly whether it was outside the country where the controlled foreign corporation is located. The same problem arises in the sales context where customers can download software and other products over the Internet rather than actually having a physical location where buyer and seller come together. A corresponding problem raised by digital commerce is determining what is purchased -

tangible/intangible goods or services – and, if goods are involved, whether the goods are licensed (i.e., intangible), leased (i.e., tangible), or sold outright. That characterization may be crucial in determining whether a controlled foreign corporation regime applies.

Global digital commerce has likely contributed to a rise in controlled foreign corporation arrangements, especially in certain areas such as gambling and pornography. For tax and regulatory reasons, Internet start-up companies may be incorporated in tax havens. In addition, incorporating a server in a tax haven so that customers can download the parent company's product (e.g., software), may be much easier than incorporating a more traditional business establishment in the tax haven country. This development has placed pressure on the CFC rules. Moreover, as certain countries have transitioned from residence-based tax systems to exemption (or territorial) systems that exempt from taxation all foreign source active business income earned in CFCs, there have been ongoing efforts to tighten-up CFC rules.[340]

[B] National Law

Suppose that CFC Corp., resident in a tax haven (TH) sells software created by R Corp., its parent corporation, resident in country R. Customers in country S purchase the software by accessing CFC Corp.'s website and downloading the software to their own computers. First, it should be noted that some countries do not distinguish between types of income. Instead, all income is considered attributable to the domestic shareholders if it is produced by a controlled foreign corporation. For these countries, the income resulting from CFC Corp.'s activities may be taxable by country R, unless an exemption is applicable.

For countries, like the United States, which asserts tax jurisdiction only when income is considered 'tainted income' (i.e., passive income or base company income), CFC Corp.'s purchase of software from a related party, R Corp., and its sale to customers in country S would generally constitute tainted income under traditional principles. But suppose that employees of CFC Corp., perhaps residing in country R, develop the software which is then sold to country S customers. In this situation, because CFC Corp. is not itself purchasing the software from a related party but rather is developing the software, under some controlled foreign corporation regimes (such as Canada and the United States), the income may not be treated as tainted income.[341]

Suppose that instead of selling software to customers in country S, CFC Corp. licenses the software to customers in exchange for a royalty. The initial issue, of course, is whether the transfer of the software should be characterized as a sale of goods or the licensing of an intangible. Many countries would adopt the latter view since no

340. For discussion, *see* Cockfield (n. 337 above), 60–69.

341. *See*, e.g., IRC § 954(d). Of course the compensation paid to the state R programmers must be arm's length in accordance with IRC § 482. For further discussion, *see* Ned Maguire & Stuart H. Anolik, *Subpart F and Source of Income Issues in Digital commerce*, Tax Notes Int'al (23 October 2000) 1935; David Tillinghast, *Taxation of Electronic commerce: Federal Income Tax Issues in the Establishment of a Software Operation in a Tax Haven*, 4 Fla. Tax Rev. 339 (1999).

physical product is changing hands.[342] Under this view, the income received from the transaction would be royalty income. If the royalty income is considered to be passive, some controlled foreign corporation regimes would permit country R to tax the income. The royalty income would be considered passive income if CFC Corp. merely purchases the software from R Corp. and then licenses the software to customers in country S.

However, a different result might be reached if the software is created, or substantially modified (after receipt by R Corp., but prior to the licence thereof) by CFC Corp. Now the royalties may constitute active business income that cannot be taxed by country R when earned.[343] This is a situation that tests the purpose of controlled foreign corporation legislation. It may be feasible for R Corp. to arrange its affairs so that CFC Corp. develops or substantially modifies the software it licenses. The ease with which this can be accomplished may cause some countries to rethink whether income from an active licensing business perhaps should constitute income that is taxed by the country of the parent corporation.[344] It may cause some countries like Canada to rethink whether the existing test for active versus passive income is adequate. Under the existing test, if a CFC and its related entities have more than five full-time employees engaged in the licensing business throughout the year, the royalties earned by the CFC are considered to be income from an active business. Because digital commerce has the potential to make many employee positions redundant, many businesses may find it difficult and nonsensical, from a business perspective, to engage the required number of employees. Therefore, start-up situations and technology businesses may not meet the five-employee test and may find themselves caught by the Canadian anti-tax-haven rules.[345]

Suppose that instead of selling or licensing intangible goods, CFC Corp. operates a server that advertises and electronically sells tangible goods. The goods, produced by R Corp. in country R, are shipped from R Corp. directly to the customers, paying a fee to CFC Corp. commensurate with its function. This fact pattern does not pose any unusual problems under most controlled foreign corporation regimes. Where CFC Corp. is performing services on behalf of a related party for customers in country S, generally the income produced by CFC Corp. would be considered base company income.[346] It does not matter whether the services are rendered through a web page or by employees located in the tax haven.

342. *See* the discussion above in §4.04 on characterization of income.
343. Under the US CFC legislation, CFC's royalties could be considered base company income unless they are derived in the active conduct of a trade or business and are received from unrelated persons. Royalties are derived in the active conduct of a trade or business when the CFC has 'developed, created, or produced, or has acquired and added substantial value to the software', or if the CFC is 'regularly engaged in the development, creation or production of, or in the acquisition of and addition of substantial value to' the software. Reg. § 1.954-2(d).
344. *See*, e.g., US Treasury CFC Report (n. 335 above), Ch. 6.
345. *Electronic Commerce and Canada's Tax Administration, A Report to the Minister of National Revenue from the Minister's Advisory Committee* ('Canadian Advisory Committee Report') 4.2.5 (1998).
346. *See*, e.g., IRC § 954(d).

Suppose instead of providing services for a related party in connection with a sale, CFC Corp. maintains an investment information database. It charges fees to country S customers for access to this database. Employees providing the information found on the database are located in country R. In this case, CFC Corp. is rendering services for R Corp. in the tax haven.[347] The first determination that must be made is whether the income received is for the right to access the information database (i.e., for services rendered), or for the information contained on the database (i.e., for a licence). Assume the only income received by CFC Corp. from the customer is from access fees for services rendered. Because the payments received are for services rendered by CFC Corp. on its own behalf, it is unlikely that most controlled foreign corporation legislation would permit country R to tax them.

Some countries may not be happy with this result because, as in the licensing situation discussed above, R Corp. can easily arrange its affairs to isolate service income in a tax haven without making any physical commitment (e.g., the presence of employees) to that jurisdiction. Similar possibilities for isolating service income outside of country R exist under more traditional methods of commerce, but are made more likely by the portability of digital commerce.[348]

The ability of taxpayers to sell digitized information and services electronically may require a re-examination of controlled foreign corporation provisions to see if they are sufficient in their current form to achieve their intended purposes. If CFCs can engage in extensive digital commerce in information and services through websites or computer networks located in a tax haven, it may become increasingly difficult to enforce existing controlled foreign corporation legislation, in part because of the difficulty of detection.[349]

In the United States, new legislation was introduced in 2017 – known as the Tax Cuts and Jobs Act – to reform part of its CFC regime (*see also* Chapter 7).[350] The legislation includes a new tax on 'global intangible low-taxed income' or GILTI. It applies a corporate tax rate of at least 13.125% (until 2026 then 16.4% thereafter) on the excess of a shareholder's net CFC income over an ordinary return. Under this approach, an excess return can be identified by methods such as looking to intangibles and risk-shifting outside of the United States to determine if the activities within the CFC contributed to value.

While the GILTI serves as a 'stick' that tries to punish the shifting of intangible income to low tax jurisdictions, the same Act provided for a carrot called the 'foreign derived intangible income' (FDII) deduction. Under the FDII deduction, US C corporations that export goods and services that generate intangible income will be eligible for a tax deduction that, effectively, subjects such income to a rate of 13.125%. Like the

347. The United States considers services to be performed on behalf of a related person where: (1) the CFC is paid or reimbursed by a related person for performing the services; (2) the CFC performs services that a related person is obligated to perform; or (3) the CFC performs services in connection with the sale of property by a related person when the performance of the service is a condition of the sale. IRC § 954(e).
348. US Treasury CFC Report (n. 335 above), Ch. 6.
349. US Treasury E-commerce Report (n. 32 above), section 8.
350. OECD, Tax Challenges Arising from Digitilisation (n. 82 above), para. 289.

the item the state is taxing or exempting (e.g., 'candy') be defined in precisely the same way in all Member States.[80]

[ii] Tax Rate Simplification

Tax rate simplification is entirely an *intrastate* matter. As was the case with base simplification, SSUTA makes no attempt at interstate harmonization in the sense of requiring the states to adopt identical bases or rates. Despite the self-evident simplification that a rule of 'one rate per state' would bring to state and local sales and use tax administration, SSUTA did not adopt such a rule because of intrastate political concerns. Without the ability to establish their own rates, localities would have been deprived of significant fiscal (and, hence, political) independence. In light of these concerns, SSUTA's rate simplification restricts each state to a single rate (with a limited exception for zero-rating food and drugs) and each locality within a state to a single rate.[81] SSUTA provides for additional rate-related simplifications by generally eliminating caps or thresholds on rates,[82] and by requiring the states to provide databases that correlate rates to zip codes or street addresses.[83] States are required to relieve sellers and tax-collecting intermediaries of liability if they charge and collect tax on the basis of erroneous information provided in such databases.[84] Purchasers are similarly relieved of liability.[85]

[iii] 'Place of Taxation' or 'Sourcing' Rules

The need for SSUTA to prescribe rules to achieve base and rate simplification such as that described above is quite understandable. As a matter of principle, there is no reason why independent taxing jurisdictions, if left to their own devices, would settle upon common definitions of taxable or exempt goods and services, or would limit the rates to be applied to such goods and services. Hence, one would expect that any tax framework designed to establish a simplified sales and use tax regime for independent taxing authorities would need to create a set of common definitions for delineating the tax base as well as restraints on the multiplicity of rates.

It is not so clear, however, at least as a matter of principle, why SSUTA would need to prescribe mutually agreed upon rules for determining the place of taxation,

80. In contrast, the EU VAT Directive only allows such diversity when either the Directive itself specifically grants discretion to tax/not tax particular goods or services or the Member State has been granted a derogation from particular requirements of the Directive.
81. SSUTA § 308.
82. *Ibid.*, § 323. For example, before amending its sales and use tax code to conform to SSUTA, North Carolina capped the tax on farm equipment, telecommunications services, and manufacturing equipment at USD 80. Similarly, before Vermont adopted SSUTA-conforming amendments, it taxed articles of clothing only if the purchase price exceeded a USD 110 threshold.
83. *Ibid.*, § 305.
84. *Ibid.*, § 306.
85. *Ibid.*, § 331(A).

which SSUTA refers to as 'sourcing rules'.[86] After all, a good consumption tax should result in taxation in the jurisdiction in which consumption takes place. Taxing the sale or use of goods that cross state lines at their destination implements this principle because goods are typically consumed at their destination. Moreover, taxation by the state of destination promotes neutrality by treating all goods consumed in the state in the same way, regardless of the location from which they were shipped. Although the American retail sales tax is hardly a model of a good consumption tax, by and large it embraces the destination principle in its application to the sale of goods: 'Imports' shipped from outside the state to purchasers within the state are generally subject to sales or use tax in the state of destination, and 'exports' shipped from within the state to purchasers outside the state are generally exempt from sales or use tax in the state of origin.[87]

The problem, of course, is that the destination principle, though accepted in theory and generally respected in practice – at least with respect to the sale of goods – is fraught with exceptions and variations that differ from state to state.[88] Moreover, with respect to services and digital products, there is even greater diversity in state practice.[89] Finally, it is important to recognize that the sourcing issue arises not only in the interstate context but also in the intrastate context in determining the appropriate local rate to apply when transactions, though occurring wholly within a state, have a connection with more than one locality. Whatever may be the level of consensus in theory or practice as to the proper sourcing rule for interstate cross-border transactions, there is considerably less for intrastate cross-border transactions (e.g., the proper sourcing rule for a tax on a pizza prepared at a pizza parlour in one county but delivered to a customer in another). In short, there is an acute need for uniform sourcing rules if sales and use taxes are to be simplified, and the SSUTA sourcing provisions address that need.

Apart from a handful of exceptions and special sets of sourcing rules for telecommunications and direct mail, SSUTA provides a hierarchical set of sourcing rules for all sales.[90] In principle, the rules 'apply regardless of the characterization of a product as tangible property, a digital good, or a service'.[91] As a practical matter, however, some of the sourcing rules are more relevant to one type of transaction than to another (e.g., the rule sourcing a transaction to the location 'from which the digital good … was first available for transmission by the seller'[92]). Moreover, there is a discrete set of rules, even though falling under the rubric of 'general sourcing rules', for leasing and rental of various forms of tangible personal property.[93]

86. *Ibid.*, §§ 309–315.
87. *See* 2 Hellerstein, Hellerstein & Swain (n. 14 above), ¶ 18.02[1].
88. *Ibid.*, ¶¶ 18.02–18.05.
89. *Ibid.*, ¶ 18.05.
90. SSUTA §§ 309–310.
91. *Ibid.*, § 309(A).
92. *Ibid.*, § 310(A)(5).
93. *Ibid.*, §§ 310(B)–310(D).

[iv] Administrative Simplifications

Administrative simplification is an umbrella category that covers a wide variety of SSUTA's provisions other than those described above and those addressed to governance and consumer privacy, described below. These 'administrative simplification' provisions embrace what may be regarded as SSUTA's most innovative feature: the creation of a system whereby state-subsidized and certified third-party intermediaries act as a seller's 'agent to perform all the seller's sales and use tax functions'.[94] They also include provisions that range from the establishment of an online registration system with a single point of registration[95] to the prescription of common or uniform rules for such matters as exemption administration,[96] tax returns,[97] and remittances[98] to specific problem areas, such as sales tax holidays,[99] rounding,[100] and recovery of bad debts.[101]

[v] Consumer Privacy

Although consumer privacy concerns clearly extend far beyond the state tax arena, and privacy concerns are typically tangential to discussions of state sales and use tax reform, consumer privacy has become an increasingly important issue in sales and use tax reform efforts. The interest in consumer privacy in this context is due in large part to the increased attention devoted to taxation of digital commerce and the privacy implications of establishing an effective regime for collecting taxes on B2C sales in an electronic environment. There is an additional reason for SSUTA's concern with privacy – namely, the introduction of the concept of a Certified Service Provider (CSP), which acts as a seller's 'agent to perform all the seller's sales and use tax functions'.[102] The privacy implications of turning over one's tax compliance functions to an intermediary are self-evident, and SSUTA prescribes protective rules designed to assure that: (1) personally identifiable information is limited to what is essential for tax administration; (2) any information so gathered remains confidential; (3) such information is discarded when no longer needed; and (4) notice is provided to consumers regarding privacy policies.[103]

94. *Ibid.*, § 203; *see also ibid.*, §§ 501, 601.
95. *Ibid.*, §§ 303, 401, 404.
96. *Ibid.*, § 317.
97. *Ibid.*, § 318.
98. *Ibid.*, § 319.
99. *Ibid.*, § 322.
100. *Ibid.*, § 324.
101. *Ibid.*, § 320.
102. *Ibid.*, § 203; *see also ibid.*, §§ 501, 601.
103. *Ibid.*, § 321.

[vi] Governance

Six of SSUTA's twelve articles relate to governance issues.[104] These include SSUTA's effective date; subsequent state entry into and withdrawal from SSUTA; administration of SSUTA; SSUTA procedures; amendments and interpretation of SSUTA; issue resolution; relationship of SSUTA to Member States and persons; and review of SSUTA's costs and benefits.

[C] Application of Sales Tax to Multijurisdictional Transactions

[1] Place of Taxable Transactions

[a] Taxation of Goods

The taxable event under most state retail sales taxes is the transfer of title or possession of tangible personal property for a consideration. Virtually all states treat this transfer as occurring at the point of delivery, which is a practical proxy for a destination-basis tax, although not a perfect one for cross-border shopping.[105] For example, the New York sales tax regulations provide that 'the sales tax is a "destination tax"'. The point of delivery or point at which possession is transferred by the vendor to the purchaser, or the purchaser's designee, controls both the tax incidence and the tax rate'.[106] To enforce the destination-basis character of the sales tax, most states exempt from tax all sales for delivery outside the state.[107]

[b] Taxation of Services

As we have already observed, the state retail sales taxes do not apply generally to services.[108] When the states do tax services, however, the rules for the place of taxation for such services are not as consistent or as well established as they are with regard to the place of taxation of sales of tangible personal property. Following the same destination-basis principle that they employ in connection with the place of taxation for

104. *Ibid.*, Arts VII-XII.
105. The problem of tax evasion through cross-border shopping – when a resident of State A travels to State B to purchase goods – is minimized by the widespread adoption of sales taxes by most of the states. One exception, however, exists on the Washington/Oregon border, where shoppers from Washington, a state with a relatively high sales tax (6.5%), do a disproportionate amount of their shopping in Oregon, one of the five states with no sales tax. As a consequence, Washington loses hundreds of millions of dollars of sales tax revenues. Washington State Department of Revenue, *Cross Border Study: An Analysis of Sales and Revenue Losses From Washington Residents Shopping Across the Border to Avoid Washington Sales Taxes* (2014), https://dor.wa.gov/sites/default/files/legacy/Docs/reports/2014/Cross_Border_Study_2014.pdf. The more serious problem for the states is the problem of revenue losses from distance selling, which we address below. *See* §6.01[C][2].
106. N.Y. Code Comp. Codes R. & Regs. tit. 20, § 525.2(a)(3) (Westlaw 2019).
107. Due & Mikesell (n. 4 above), 271; 2 Hellerstein, Hellerstein & Swain (n. 14 above), ¶ 18.02[1].
108. *See* §6.01[A][2].

sales of tangible personal property, some states take the position that services should be taxed in the state in which they are delivered or enjoyed, and they exempt services 'if the beneficial use of the service occurs entirely outside the state'.[109] Thus, the New York State tax administration, drawing on the analogy to the retail sale of tangible personal property, issued an advisory opinion, which reasoned that because the sales tax is a consumption-based 'destination' tax, the sale of information services delivered by electronic means should be attributed to the purchasers' offices.[110] This principle would be implemented by allocating a proportion of the consideration for such services equal to the number of the purchasers' offices in New York having access to electronic reports over the number of all of the purchasers' offices having access to such reports. Moreover, a number of states, by statute, regulation, or administrative pronouncement, follow the rule – analogous to the rule prevailing with regard to sales of tangible personal property – that information, computer, and other electronically deliverable services are taxable where the purchaser is located, with exemptions for services delivered to out-of-state purchasers.[111]

Other states, however, take the position that a sale of services takes place in – and is taxable by – the state in which the services are performed, even though the services are in effect 'delivered' and consumed outside the state.[112] While a performance-based rule may be inconsistent with a consumption tax applied on a destination basis,[113] this position may recommend itself from an administrative perspective because the taxing authorities of the state in which services are performed will always have jurisdiction over the service provider and will thus be in a position to enforce collection of the sales tax.

109. *In re State and Municipal Sales and Use Tax Liability of K.O. Lee Co.*, 489 N.W.2d 606, 610 (S.D. 1992) (quoting the statute).
110. Advisory Opinion, N.Y. Commissioner of Taxation & Fin., TSB-A-90(43)S, 20 August 1990, available at www.checkpoint.thomsonreuters.com.
111. *See*, e.g., D.C. Mun. Regs. tit. 16, §§ 475.8, 475.9 (Westlaw 2019) (taxing information services for use or consumption within the District and exempting information services 'sold and delivered by the vendor to locations outside the District'); Tex. Tax Code Ann. §§ 151.010, 151.051, 151.101 (Westlaw 2019) (imposing tax on each 'taxable item', defined to include taxable services, sold or used in this state); *ibid.*, § 151.330(e) (exempting '[s]ervices performed for use outside this state').
112. *See*, e.g., *Airwork Service Division v. Director, Division of Taxation*, 2 N.J. Tax 329 (1981), *aff'd*, 4 N.J. Tax 532 (Super Ct., App. Div. 1982), aff'd, 478 A.2d 729 (N.J. 1984), *cert. denied*, 471 US 1127 (1985) (sustaining tax on repair services performed in state on airplane engines delivered to customer outside the state); *Matter of Airlift International, Inc. v. State Tax Commission*, 382 N.Y.S.2d 572 (App. Div., 3d Dep't 1976) (sustaining tax on repairs of airplanes used in interstate and international commerce). *See* 2 Hellerstein, Hellerstein & Swain (n. 14 above), ¶ 18.05. The careful reader will note that the *Airlift International* case is a New York decision and thus, as a matter of principle at least, inconsistent with the advisory opinion of the New York tax administration described in the preceding paragraph, because its place of taxation rule looks to where the service was performed rather than to where it was delivered. In fact, that inconsistency reveals an important point: individual states often have different (and arguably inconsistent) place of taxation rules with respect to services depending on the type of service involved. Similar inconsistencies, of course, arise under VATs and GSTs with regard to particular types of services.
113. In many instances, of course, there is no inconsistency because the services are performed in the same state in which they are consumed.

There is yet a third variation on the rule of the place of taxation for services. States sometimes take the position that a sale of services may be apportioned among the states in which they are used depending on the extent of use. In Texas, for example, if an information service is used to support a customer's business that is conducted at locations within and without the state, the service is taxable only to the extent that it is used within Texas, and the taxpayer 'may use any reasonable method for allocation which is supported by business records'.[114] The District of Columbia regulation likewise provides for proration of the District tax on information services.[115]

It is worth noting that states that have adopted the Streamlined Sales and Use Tax Agreement (SSUTA), and therefore incorporated SSUTA's place of taxation rules, would follow the hierarchical set of 'sourcing' rules applicable to all sales, rules that generally adopt the destination principle[116]

[2] *Federal Constitutional Restraints on State Sales Taxation of Multijurisdictional Transactions*

[a] *The States' Incompetence to Tax Interstate Sales and the Development of Complementary Use Taxes*

Under the US Supreme Court's interpretation of the Commerce Clause of the Federal Constitution,[117] the states lack the constitutional power to impose a sales tax on goods or services purchased in other states or in interstate commerce because 'to impose a tax on such a such transaction would be to project its powers beyond its boundaries and to

114. 34 Tex. Admin. Code § 3.342(g)(2) (Westlaw 2019).

> A multistate customer purchasing information services for the benefit of both in-state and out-of-state locations is responsible for issuing to the information service provider an exemption certificate asserting a multistate benefit, and for reporting and paying the tax on that portion of the charge for information which will benefit the Texas location. An information provider that accepts such a certificate in good faith is relieved of responsibility for collecting and remitting tax on transactions to which the certificate relates.

Ibid., § 3.342(g)(3). *See*, e.g., Private Letter Ruling 2017010121L, Tex. Comp. of Pub. Acc'ts, 18 July 2018, available at www.checkpoint.thomsonreuters.com (taxpayer's services of hosting a website on the cloud and other cloud-related services are all taxable data processing services presumed to be located in Texas because the taxpayer is located in Texas, but the taxpayer can overcome the presumption by accepting an exemption certificate asserting the multistate benefit exemption, i.e., services performed for use both within and outside Texas or that its services are performed for use entirely outside Texas).
115. *See* D.C. Mun. Regs. tit. 9, § 475.9 (Westlaw 2019).
116. *See* §6.01[B][4][b][iii].
117. The Commerce Clause by its terms is simply an affirmative grant of power to Congress to 'regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes'. US Const. art. I, § 8, cl. 3. Nevertheless, the US Supreme Court has long construed the clause as imposing implicit restraints on state authority, even when Congress has not acted. Under this so-called negative Commerce Clause doctrine, the Court has consistently struck down taxes that, in the Court's judgment, discriminate against or otherwise burden interstate commerce. *See* generally 1 Hellerstein, Hellerstein & Swain (n. 14 above), Chapter 4.

(1) the cumulative gross receipts from sales of tangible personal property to purchasers in Illinois by the marketplace facilitator and by marketplace sellers are USD 100,000 or more; or
(2) the marketplace facilitator and marketplace sellers cumulatively enter into 200 or more separate transactions for the sale of tangible personal property to purchasers in Illinois.[359]

The marketplace facilitator 'is required to comply with the same requirements and procedures, as all other retailers maintaining a place of business in this State who are registered or who are required to be registered to collect and remit the tax'.[360]

A 'marketplace facilitator' is 'a person who, pursuant to an agreement with a marketplace seller, facilitates sales of tangible personal property by that marketplace seller'. A person facilitates a sale of tangible personal property by, 'directly or indirectly through one or more affiliates, doing both of the following':

(i) listing or otherwise making available for sale the tangible personal property of the marketplace seller through a marketplace owned or operated by the marketplace facilitator; and
(ii) processing sales or payments for marketplace sellers.[361]

[k] Indiana

Effective 1 July 2019, Indiana considers a 'market facilitator' to be 'the retail merchant of each retail transaction … that is facilitated for sellers on its marketplace when it does any of the following on behalf of the seller':

(1) Collects the sales price or purchase price of the seller's products.
(2) Provides access to payment processing services, either directly or indirectly.
(3) Charges, collects, or otherwise receives fees or other consideration for transactions made on its electronic marketplace.[362]

As a deemed 'retail merchant', when the marketplace facilitator has no physical presence in the state, it must comply with all applicable tax collection requirements '*as if*' it had a physical presence in the state, when its gross revenue from the combination of '(A) the sale of tangible personal property that is delivered into Indiana; (B) a product transferred electronically into Indiana; or (C) a service delivered in Indiana' exceeds USD 100,000 or more than 200 transactions.[363] In determining whether it has

359. 35 Ill. Comp. Stat. § 105/2d(b) (Westlaw 2019).
360. *Ibid.*, § 105/2d(c).
361. *Ibid.*, § 105/2d(d). For an analysis of Illinois's marketplace platform legislation, see Paul Bogdanski, et al., *Illinois's Online Retailer Legislation Offers Simplicity at a Price*, 93 Tax Notes State 587 (August 2019).
362. Ind. Code § 6-2.5-4-18(a) (Westlaw 2019).
363. *Ibid.*, § 6-2.5-2-1(c) (emphasis supplied).

exceeded the prescribed thresholds, the marketplace facilitator 'must include both transactions made on its own behalf and transactions facilitated for sellers'.[364]

A 'marketplace facilitator' is a person that '(1) owns, operates, or otherwise controls a marketplace; and (2) facilitates a retail transaction'.[365] The term does not include 'a payment processor' that is appointed by a merchant to handle payment transactions from various channels and 'whose sole activity with respect to marketplace sales is to handle payment transactions' between two parties.[366]

[l] Iowa

Effective 1 January 2019, marketplace facilitators that make or facilitate USD 100,000 or more in Iowa sales in the immediately preceding or current calendar year are required to collect and remit tax on all taxable sales that they either make on their own behalf or facilitate.[367] A 'marketplace facilitator' is broadly defined to include a person who engages in a variety of facilitation activities, and would include, for example, a person who 'lists' the products of a 'marketplace seller'[368] in its marketplace and 'charges listing fees', regardless of whether the person is involved in payment processing or order fulfilment.[369] However, the statute does provide liability relief in instances when the marketplace facilitator can 'demonstrate[] to the satisfaction of the department that the marketplace facilitator has made a reasonable effort to obtain accurate information from the marketplace seller about a retail sale and that the failure to collect and remit the correct tax was due to incorrect information provided to the marketplace facilitator …'[370]

[m] Kentucky

Effective 1 July 2019, Kentucky requires every 'marketplace provider' whose own or facilitated retail sales of tangible personal property or digital property transferred electronically to a purchaser in Kentucky exceed, in combination, USD 100,000 or 200 transactions during the preceding or current calendar year must register for and collect taxes imposed on such transactions.[371] The marketplace provider must collect tax on the sales price of every retail sale it makes or facilitates regardless of whether the marketplace retailer would have been required to collect the tax had the sale not been facilitated by the marketplace provider.[372]

364. *Ibid.*, § 6-2.5-2-1(d).
365. *Ibid.*, § 6-2.5-1-21.9(a).
366. *Ibid.*, § 6-2.5-1-21.9(b).
367. Iowa Code § 423.14A(3)(d) (Westlaw 2019).
368. A 'marketplace seller' is a person who makes sales through a marketplace. *Ibid.*, § 423.14A(1)(c).
369. *Ibid.*, § 423.14A(1)(b)(1).
370. *Ibid.*, § 423.14A(3)(d)(3).
371. Ky. Rev. Stat. § 139.450(2) (Westlaw 2019).
372. *Ibid.*

A 'marketplace' is

> any physical or electronic means through which one (1) or more retailers may advertise and sell tangible personal property, digital property, or services, or lease tangible personal property or digital property, such as a catalog, Internet Web site, or television or radio broadcast, regardless of whether the tangible personal property, digital property, or retailer is physically present in this state.[373]

A 'marketplace provider' is any person that facilitates a retail by 'directly or indirectly' engaging in any of the following activities:

a. Lists, makes available, or advertises tangible personal property, digital property, or services for sale by a marketplace retailer in a marketplace owned, operated, or controlled by the person;
b. Facilitates the sale of a marketplace retailer's product through a marketplace by transmitting or otherwise communicating an offer or acceptance of a retail sale of tangible personal property, digital property, or services between a marketplace retailer and a purchaser in a forum including a shop, store, booth, catalog, Internet site, or similar forum;
c. Owns, rents, licenses, makes available, or operates any electronic or physical infrastructure or any property, process, method, copyright, trademark, or patent that connects marketplace retailers to purchasers for the purpose of making retail sales of tangible personal property, digital property, or services;
d. Provides a marketplace for making retail sales of tangible personal property, digital property, or services, or otherwise facilitates retail sales of tangible personal property, digital property, or services, regardless of ownership or control of the tangible personal property, digital property, or services that are the subject of the retail sale;
e. Provides software development or research and development activities related to any activity described in this subparagraph, if the software development or research and development activities are directly related to the physical or electronic marketplace provided by a marketplace provider;
f. Provides or offers fulfillment or storage services for a marketplace retailer;
g. Sets prices for a marketplace retailer's sale of tangible personal property, digital property, or services;
h. Provides or offers customer service to a marketplace retailer or a marketplace retailer's customers, or accepts or assists with taking orders, returns, or exchanges of tangible personal property, digital property, or services sold by a marketplace retailer; or
i. Brands or otherwise identifies sales as those of the marketplace provider.[374]

In addition, as a 'market provider', the person must, directly or indirectly, engage in one of the following activities with respect to the marketplace retailer's products:

373. *Ibid.*, § 139.010(21).
374. *Ibid.*, § 139.010(22)(a)(1).

a. Collects the sales price or purchase price of a retail sale of tangible personal property, digital property, or services;
b. Provides payment processing services for a retail sale of tangible personal property, digital property, or services;
c. Charges, collects, or otherwise receives selling fees, listing fees, referral fees, closing fees, fees for inserting or making available tangible personal property, digital property, or services on a marketplace, or receives other consideration from the facilitation of a retail sale of tangible personal property, digital property, or services, regardless of ownership or control of the tangible personal property, digital property, or services that are the subject of the retail sale;
d. Through terms and conditions, agreements, or arrangements with a third party, collects payment in connection with a retail sale of tangible personal property, digital property, or services from a purchaser and transmits that payment to the marketplace retailer, regardless of whether the person collecting and transmitting the payment receives compensation or other consideration in exchange for the service; or
e. Provides a virtual currency that purchasers are allowed or required to use to purchase tangible personal property, digital property, or services.[375]

[ii] Maine

Effective 1 October 2019, Maine requires every 'marketplace facilitator' whose own or facilitated retail sales of tangible personal property or taxable services delivered into Maine exceed, in the aggregate, USD 100,000 or 200 transactions during the preceding or current calendar to register for and collect taxes imposed on such transactions.[376]

> A 'marketplace facilitator' is 'any person that facilitates a retail sale by providing a marketplace that lists, advertises, stores, or processes orders for tangible personal property or taxable services for sale by marketplace sellers' and, directly or indirectly, does any of the following:
> A. Transmits or otherwise communicates an offer by the marketplace seller or an acceptance between the customer and marketplace seller;
> B. Collects payment from the customer and transmits that payment to the marketplace seller; or
> C. Engages in any of the following activities with respect to the marketplace seller's products or taxable services:
> (1) Fulfillment or storage services;
> (2) Customer service; or
> (3) Accepting or assisting with returns or exchanges.[377]

375. *Ibid.*, § 139.010(22)(a)(2).
376. Me. Rev. Stat. Ann. tit. 36, § 1754-B(1-B)(L) (Westlaw 2019).
377. *Ibid.*, § 1762(6-F).

A 'marketplace' is 'a physical or electronic location, including, but not limited to, a store, a booth, an Internet website, a catalog or a dedicated sales software application, where tangible personal property or taxable services are offered for sale'.[378]

[o] *Maryland*

Effective 1 October 2019, Maryland requires a 'marketplace facilitator' to 'collect the applicable sales and use tax due on a retail sale or sale for use by a marketplace seller to a buyer in this State'.[379] The marketplace facilitator shall must report and collect tax on its facilitated sales separately from the sales and use tax collected by the marketplace on sales made directly by the marketplace facilitator to in-state purchasers.[380] Although the marketplace legislation does not specifically prescribe a threshold applicable to marketplace facilitators, following the US Supreme Court's decision in *Wayfair*, the Maryland taxing authority promulgated regulations requiring remote sellers to comply with the state's sales and use tax law if their gross revenue from the sale of tangible personal property or taxable services exceeded USD 100,000 or more than 200 transactions,[381] and these thresholds presumably will also apply to marketplace facilitators.

A 'marketplace facilitator' is a person that

(i) facilitates a retail sale by a marketplace seller by listing or advertising for sale in a marketplace tangible personal property; and
(ii) regardless of whether the person receives compensation or other consideration in exchange for the person's services, directly or indirectly through agreements with third parties, collects payment from a buyer and transmits the payment to the marketplace seller.[382]

The term does not include

(i) a platform or forum that exclusively provides Internet advertising services, including listing products for sale, if the platform or forum does not also engage, directly or indirectly, in collecting payment from a buyer and transmitting that payment to the vendor;
(ii) a payment processor business appointed by a vendor to handle payment transactions from clients, including credit cards and debit cards, whose only activity with respect to marketplace sales is to handle transactions between two parties;
(iii) a peer-to-peer car sharing program, … or

378. *Ibid.*, § 1762(6-E).
379. Md. Code Ann. – Tax Gen. § 11-403.1(a)(1) (Westlaw 2019).
380. *Ibid.*, § 11-403.1(d).
381. Code of Maryland Regulations § 03.06.01.33 (Westlaw 2019).
382. Md. Code Ann. – Tax Gen. § 11-101(a)(c-2)(1) (Westlaw 2019).

(iv) a delivery service company that delivers tangible personal property on behalf of a marketplace seller that is engaged in the business of a retail vendor and holds a license [under Maryland law].[383]

[p] *Massachusetts*

Effective from 1 October 2019, Massachusetts requires a 'marketplace facilitator' whose combined direct and facilitated sales of tangible personal property or taxable services within the state exceed USD 100,000 during the current or prior taxable year to collect and remit tax on all taxable sales both direct and facilitated.[384]

A 'marketplace facilitator' is a person that contracts with marketplace sellers to facilitate the sale of the seller's tangible personal property or services through its marketplace by, directly or indirectly, engaging in any of the following activities:

(i) transmitting or otherwise communicating the offer or acceptance between the buyer and the seller;
(ii) owning or operating the infrastructure, electronic or physical, or technology that brings buyers and sellers together;
(iii) providing a virtual currency that buyers are allowed or required to use to purchase tangible personal property or services from the seller; or
(iv) software development or research and development activities related to any of the activities described in subsection (b), if such activities are directly related to a physical or electronic marketplace operated by the person or a related person.[385]

In addition, to qualify as a 'marketplace facilitator', the person must engage in one of the following activities with respect to the marketplace seller's tangible personal property or services:

(i) payment processing services;
(ii) fulfillment or storage services;
(iii) listing tangible personal property or services for sale;
(iv) setting prices;
(v) branding sales as those of the marketplace facilitator;
(vi) order taking;
(vii) advertising or promotion;
(viii) or providing customer service or accepting or assisting with returns or exchanges.[386]

383. *Ibid.*, § 11-101(a)(c-2)(2).
384. Mass. Gen. Laws ch. 64H, §§ 1, 34 (Westlaw 2019).
385. *Ibid.*, § 1.
386. *Ibid.*

The base erosion approach maintains the use of gross basis withholding taxes and in some situations may expand their use. However, in order to minimize the likelihood of imposing a gross base withholding tax when there is no net income, the suggested withholding tax rate would be set very low. To illustrate how the base erosion approach might work, consider the following hypothetical. Suppose that R Corp. maintains servers in state R that contain a database. R Corp. has no presence in state S, except that unrelated customers in state S use the R Corp. database for a fee. For example, assume that S Corp., a state S corporation, earns 1,000 in state S. In order to earn that income, it incurs a 300 expense for accessing the R Corp. database. Assume also that a state S individual resident, S, earns 1,000 in wage income. S accesses the R Corp. database for personal purposes (e.g., to download personal reading material), paying 300.

From the perspective of state S, the 1,000 of income earned by S Corp. is taxable, but that 1,000 of gross income is reduced by the 300 paid to R Corp., resulting in 700 of net income. If the 300 paid to R Corp. constitutes business profits, then state S will not have taxing authority over the 300 as R Corp. has no PE in state S. On the contrary, if the 300 payment is deemed to be a royalty and if the R-S treaty permits source state taxation of royalties, then state S can withhold on the payment to R Corp.

Because countries in the position of state S fear an erosion of their tax base, it is possible that this will result in expansive (and arguably questionable) views of what constitutes a royalty. For example, the Indian tax authorities took a broad view of the term 'royalty' in the advance ruling request discussed in Chapter 4 in section §4.04, which is a living example of the R Corp.-S Corp. fact pattern. The Indian tax authorities were concerned that US Card (i.e., R Corp.) was doing extensive business in India (i.e., state S), generating large fees from IC (i.e., S Corp.), but claiming to be free of Indian taxation. Note that the concern over base erosion arises in connection with S Corp.'s deduction of the 300. When individual S pays 300 to R Corp. for personal consumption, no deduction is permitted (i.e., S is taxable on 1,000 of wage income), and so there is no base erosion in state S.

Rather than focus on whether a particular payment is a royalty or constitutes business profits, the base erosion approach renders labelling unimportant. Instead, the focus would be on whether the payment erodes the tax base of state S. The tax base of state S is eroded if the payment is deductible. If it does erode the tax base, then state S would be entitled to require withholding; if the tax base is not eroded (i.e., if the payment is non-deductible), no withholding would be permitted. So in the example above, state S could require withholding on the payment by S Corp. to R Corp. but would not require withholding on the payment from individual S to R Corp., which is a consumer transaction. Whether a payment is labelled a royalty makes no difference under this approach; the issue is base erosion. Note that this approach would permit state S to tax R Corp.'s business profits even if they are not attributable to a state S PE, so long as the payor could deduct the payment.

The key to the base erosion approach, should it be able to generate a consensus, would be the tax rate to apply to base eroding payments. The higher the tax rate on gross income, the more likely that the tax may be imposed even in the absence of net income (or that will result in a very high effective rate of tax on net income). For

example, a 20% withholding tax on 300 of gross income is a 100% tax if the expenses of earning the 300 of income are 240. If the expenses exceed 240, then the source state collects a tax in excess of 100% of the net income, and if expenses equal or exceed 300, state S collects a tax even though no net income has been generated.

What tax rate is 'appropriate'? In large part, this is a political question. From an economic perspective, any gross base tax is problematic because it may produce a tax that exceeds net income. Obviously, the lower the tax the more likely that the tax will not exceed net income. The political issue focuses on how the residence and source state will divide tax revenue. As long as any change in that division does not increase the tax burden on a taxpayer and does not result in additional inefficient tax planning or tax-induced behaviour, then which government ends up with the tax revenue is an uninteresting question from a global economic perspective, albeit a very interesting question from the economic perspective of each country involved.

Because the base erosion approach would permit source state taxation of many payments that are not currently subject to source state taxation, it would be sensible to set the rate low. This is particularly important because the proposed reallocation of tax revenue between residence and source countries is not intended to increase taxation – merely to reallocate tax proceeds. If residence countries are to fully relieve taxpayers of the burden of any new source state taxation (e.g., through a tax credit), the withholding rate should be set very low. A low tax rate applied to many base eroding payments can work a reasonable reallocation of tax proceeds. But ultimately, the determination of the appropriate rate would be an empirical decision informed by the impact that different rates would have on tax revenues. The OECD is well equipped to undertake such an empirical study. Armed with that information, countries could then try to reach a consensus on what would be an appropriate rate.

For purchasers, the base erosion approach may not prove burdensome. Source state residents making deductible payments to non-residents will have to withhold and submit the amount withheld to the taxing authority.[29] Because gross base withholding is a feature of current international tax rules, the system introduces few new complexities. Because withholding would be imposed only on base eroding payments, consumers would not be required to withhold on payments to non-residents. Given the broad definition some countries have of the term 'royalty' under current law, in some cases consumers would be responsible for collecting a withholding tax where an applicable treaty permits source state taxation of royalties. For example, if a consumer downloads a computer program or makes use of an online auction site, some countries may consider the consumer payment a royalty for the use of software. It is unrealistic to expect consumers to withhold on royalty payments in these cases. Under the base erosion proposal, no withholding would be required.

With respect to recent developments, the OECD Inclusive Framework on BEPS report notes:

29. Presumably, if R Corp. has a permanent establishment in state S and incurs a deductible expense for the purpose of the permanent establishment, withholding will be required for payments to non-residents if a deduction is claimed.

> Recent global developments show an increasing use of such exceptions in domestic law and double tax treaties for specific categories of digital products and services, generally asserting taxing rights when the non-resident enterprise has no physical presence. Further, digitalisation has blurred the distinctions between business profits, royalties and technical services in some cases (e.g., cloud computing), increasing the potential significance of these exceptions to the traditional PE threshold, and exacerbating the risk of characterization issues.[30]

More specifically, the report notes three trends in this area.[31]

First, the report notes the trend toward broadening of the withholding tax for royalties. As detailed in the report, some countries have expanded their domestic definition of royalties subject to withholding on a gross basis by incorporating into that category items of income traditionally classified as business profits in double tax treaties. Such expansion includes, for instance, payments for the use or right to use software (prevalent in Greece and the Philippines), and payments for 'visual images or sounds' transmitted through information and communication technology (Malaysia). The definitions generally bring certain Software as a Service (SaaS) type of transactions within the scope of the withholding tax. Some corresponding changes have also been introduced in recently negotiated double tax treaties (e.g., Cyprus-Luxembourg treaty, Azerbaijan-Malta treaty and the UN is discussing possible amendments to the Article 12 commentary regarding software-related payments). Separately, instead of just broadening the definition of royalties, the United Kingdom recently proposed legislation that would broaden the source definition in certain limited circumstances to enable the taxation of foreign-to-foreign related party payments connected to local sales. The proposal is targeted at intra-group arrangements that achieve low effective tax rates through holding intellectual property in low or no tax jurisdictions and if implemented, is expected to impact predominantly on more digitalised businesses. Ukraine has also developed a withholding tax for B2C transactions although it is reportedly 'hardly enforced'.[32]

Second, the report discusses the adoption of withholding taxes on fees for technical services. An increasing number of countries create an exception to the PE threshold for certain service fees in their domestic law and/or double tax treaties, allowing a withholding tax on a gross basis in the source country when the payer is resident in that country. The OECD Model does not contain this exception although it was recently added to the UN Model as part of its 2017 update in response to the fact that substantial services are now supplied without any physical presence in the source state. The scope of this exception is typically limited to fees for technical services, generally defined as payments in consideration for the services of managerial, technical (i.e., requiring expertise in a technology), or of a consultancy nature. While this

30. OECD, *Tax Challenges Arising from Digitalisation* (note 21 above) at paras 355–356. *See also* Chang Hee Lee and Ji-Hyun Yoon, General Report Subject 2: Withholding Tax in the Era of BEPS, CIVS and the Digital Economy, Cahiers de Droit Fiscal International 215, 260 (2018) (noting that specific withholding taxes targeting business income generated by digital commerce have yet to become part 'of most, if indeed at this stage, any' tax system).
31. *Ibid.*
32. Lee and Yoon (n. 30 above) at 250.

definition is not specifically targeted at digital products and services, it generally includes a broad range of cloud computing services. As mentioned, some countries such as Canada already impose withholding taxes on cross-border services under their domestic law although this approach normally requires the physical possession of a human being within the source country in contrast to the more recent withholding taxes (*see* Chapter 4).

Finally, the report notes the introduction of new withholding taxes on other specific categories of income, such as income from online advertising.

The report additionally notes that these withholding taxes may be constrained by treaty obligations. Where applicable, the withholding taxes will be easier to administer for B2B transactions, with relatively limited administrative and compliance costs for both taxpayers and the tax authorities. Collection issues become more difficult for B2C transactions, as private consumers have little incentive to declare and pay the tax due, and little experience performing tax withholding.

§7.04 TAXATION BASED ON RESIDENCE

Much of the attention lavished on the international tax consequences of the rise of digital commerce has focused on the challenge to source-based taxation. That challenge arises from the ability to carry on commerce in a country electronically without a physical presence. The same technology that makes it possible to carry on commercial activities electronically from a remote location also makes it possible to manage an enterprise from a remote (or more than one remote) location. Indeed, the challenge of technological change to traditional methods of determining residence-based taxation may well be as profound or more profound as the challenge to historical approaches to source-based taxation.

It is the ability of management to run an enterprise without a permanent physical presence in any single jurisdiction that will test traditional notions of corporate residence. The use of videoconferencing and the overall improvements in communications technology allow managers to reside in different jurisdictions and still coordinate management decision-making. The result is that determining the residence of a juridical entity such as a company becomes an even more artificial exercise than it has been historically.[33] We describe below different approaches to company residence that may be worthy of consideration in light of ongoing technological changes in communications.

33. The Report of the Minister's Advisory Committee on Electronic Commerce has recommended that the Canadian tax administration issue an interpretation bulletin addressing the significance of modern telecommunications technology on the concept of residence. *See* Canada, *A Report to the Minister of National Revenue from the Minister's Advisory Committee on Electronic Commerce, Electronic Commerce and Canada's Tax Administration* (May 1998), at §4.08, §4.02[B][1]. The Canadian Revenue Agency did prepare draft interpretation bulletins in this area, but ultimately decided to abandon the effort and did not publish these administrative guidance documents.

[A] Status Quo

It has always been possible for managers in different countries to manage a company in a coordinated fashion by using the telephone and by conducting meetings where managers would assemble. Electronic networking makes remote management easier, but some may argue that it does not enable a new form of management. Viewed in this manner, improvements in communications do not necessitate a change in historically proven residence tests such as the 'place of effective management' (*see* the discussion in Chapter 4).

[B] Enhanced Residence-Based Taxation

As early as 1819 the Netherlands exempted from the business tax (patentrecht) foreign ships of countries that made reciprocal allowances.[34] The first shipping treaty in 1843 between France and Belgium also exempted shipping from source-based taxation.[35] World War I led to similar legislation, with the United States abandoning source-based taxation of shipping enterprises from foreign countries with reciprocal provisions.[36] The exclusive residence-based taxation of shipping profits found favour in the early League of Nations efforts that ultimately resulted in Article 8 of the current OECD Model treaty. Air navigation was added to shipping in 1928.[37]

Article 8, which denies taxing authority to a source state with respect to shipping or air transport profits, was born out of a recognition that the peripatetic nature of shipping and air transport would mean that enterprises conducting such business might be subject to tax in multiple jurisdictions with the attendant likelihood of double taxation. Accordingly, under the OECD Model, taxing authority is limited to the Contracting State in which the place of effective management of the enterprise is situated.

Some may look to Article 8 as an analogue for the concept that profits generated by digital commerce should be taxable only in the residence state. Once a company establishes an Internet presence (e.g., a website), customers throughout the world that are connected to the Internet can access that site. Like shipping or air transport, digital commerce has the potential of causing multiple taxation because of the number of countries that may be involved. Article 8 principles could apply to income generated by both ISPs and content providers. Alternatively, the principles of Article 8 might be extended solely to ISPs, which, like shipping and air transport companies, may provide Internet communications globally.

Article 8 deals specifically with shipping and air transport and may be based on specific jurisdictional conventions (i.e., that a ship/aircraft constitutes territory). The

34. Edwin R.A. Seligman, *Double Taxation and International Fiscal Cooperation* 52 (Macmillan 1928).
35. *Ibid.*
36. *Ibid.*
37. The Joint Committee on Internal Revenue Taxation, 4 Legislative History of United States Tax Conventions 4170 (1962).

application of analogous principles to digital commerce would probably warrant a separate treaty provision. Such a provision would carve out business income arising from digital commerce from the scope of Articles 7 and 5 dealing with conventional ways of doing business and generating profits.

Of course, such a rule, applied in an ordinary international context, would be a radical shift of taxing authority as we now know it. Taxing authority would move from source countries to residence countries. Placing all taxing authority in the residence country would eliminate conflicting claims.[38] Aside from problems relating to the distribution of tax revenue, this exclusive residence-based possibility places great emphasis – which may not be warranted – on the definition of residence. The same forces that question the PE concept, and other source-based taxation concepts, also call the adequacy of the residence concept into question – particularly the residence of a company. If the definition of residence is artificial and easily manipulated, granting exclusive taxing authority to residence countries is not a good solution. Moreover, for an exclusive residence-based system to function smoothly, there would have to be international consensus concerning the definition of residence. This may not be easy to accomplish. Finally, anti-abuse rules would be required to prevent the deferral of residence country taxation through the use of tax-haven entities.

[C] Company Residence Based on Other Criteria

A company that is incorporated in one country may have directors and managers that reside in a different country (or countries), and they may meet and take action in one or more locations. The company is owned by its shareholders who may reside in many different countries. The company carries on business through its employees who may work in different countries. Corporate books must be kept. Dividends may be paid to the shareholders. Where these factors involve more than one country, determining residence can be complicated.[39] In determining residence, some countries, like the United States, use 'a place of incorporation' test. Other countries use a test based on the place of effective management (or central management and control). Different countries use different formulations of this test. Essentially, however, the test focuses on where decisions concerning the operation of the business take place.

The ease with which the place of effective management and the place of incorporation tests for company residence can be manipulated without necessarily substantively altering the way a company conducts its business raises the possibility of using or emphasizing different criteria. If it were deemed desirable to change the definition of residence in light of technological advances, one possibility would be to base a company's residence on the residence of its directors or managers, or perhaps

38. This statement assumes that countries share a definition of 'residence'.
39. Jean-Marc Rivier, *General Report – The Fiscal Residence of Companies*, 72a Cahiers de Droit Fiscal Int'l 47 (1988).

the residence of a specified number or percentage of its shareholders or employees.[40] For example, the OECD Commentaries contain suggested treaty language that would permit national tax authorities to scrutinize factors such as where the day-to-day operations of a business take place to determine residency status (*see* Chapter 4).

While, of course, these individuals can also move to a tax haven or low-tax jurisdiction, any such move will have real consequences in terms of personal considerations. It would require a much greater commitment for a director to physically move than simply to arrange directors' meetings in a low tax jurisdiction. By basing a company's residence on the residence of directors, shareholders, managers, or others who participate in the entity's operations, some of the artificiality of the entity residence definition is eliminated. The 'place of effective management' test tries to do that, but still focuses on where decisions are made rather than where the decision-makers actually reside.

[D] Full Integration: Taxing Shareholders on Income Earned Through Corporations

Of course, if the concept of company residence is called into question by advances in communications technology, a direct, albeit radical, approach would be to eliminate taxation at the entity level. Instead, income earned by an entity would in some manner be taxable directly to the shareholders in whatever jurisdictions they reside.[41] For tax purposes, the difference between a partnership and a corporation would become insignificant. This approach substitutes the residence of natural persons for the residence of artificial persons (e.g., corporations).

§7.05 CHARACTERIZATION OF INCOME

[A] Categories of Income

As international tax principles have developed, different tax rules have been fashioned to apply to different categories of income. For example, the OECD Model treaty contains different taxing provisions for business profits, income from real property,

40. A publicly traded corporation might be deemed to be resident where it is traded. However, global trading may mean that a company's shares are listed and traded on more than one exchange.
41. Further consideration of different methods of corporate tax integration may be found in the following: Reuven S. Avi-Yonah, *The Treatment of Corporate Preference Items Under an Integrated Tax System: A Comparative Analysis*, 44 Tax L. 195 (1990); Richard M. Bird, *Corporate-Personal Tax Integration, in Tax Coordination in the European Community* (Sijbren Cnossen ed., 1987); John K. McNulty, *Corporate Income Tax Reform in the United States: Proposals for Integration of the Corporate and Individual Income Taxes, and International Aspects*, 12 Int'l Tax & Bus. L. 161 (1994); US Department of the Treasury, *Report on the Integration of the Individual and Corporate Tax Systems – Taxing Business Income Once* (1992); Kees van Raad, *Observations on Integration of Corporation and Individual Income Taxes Within the European Community*, 9 Conn. J. Int'l L. 763 (1994); and George K. Yin, *Corporate Tax Integration and the Search for the Pragmatic Deal*, 47 Tax L. Rev. 431 (1992).

income from shipping and air transport, dividends, interest, royalties, capital gains, income from dependent personal services, income from independent personal services, directors' fees, pensions, etc. Creating separate categories of income with potentially different tax consequences places a premium on income categorization. In an economic sense, income is income. Vendors rarely concern themselves with the categorization of income before transferring their wares or services for compensation. Distinctions between different types of income can be artificial, particularly at the margins between closely related categories (e.g., the 'sale' of a digital good, the provision of 'services', and the 'licensing' of an intangible). As potentially artificial distinctions are created, it is inevitable that creative entrepreneurs and tax planners will seek to structure their (and their clients') business arrangements to take advantage of the differences. For example, the growth of derivative financial instruments is due in part to the ability of those structuring the arrangements to transform one form of income (e.g., dividends) into another type of income (e.g., interest) that may be taxed in a more favourable way.

Transactions involving digital commerce raise categorization issues and there are several approaches to addressing these issues:

- One approach is to apply existing rules to digital commerce and to characterize income from digital commerce according to traditional categories, such as business profits, royalties, or service fees. This was the approach recommended by the OECD TAG in the late 1990s, which the OECD Commentaries ultimately adopted (*see* Chapter 4).
- Another approach is to create a new category of income for digital commerce. Defining this new category of income would require international consensus.
- A third approach is to create additional distinctions to accommodate income generated by digital commerce. For example, it has been suggested that service income should be divided into two subcategories with different source rules applying to each category.[42] Services involving human action might be sourced under traditional principles (e.g., under US law, where the services are performed). Services that are purely mechanical (e.g., a database located on a server that accessed by a client) would not be sourced under the place-of-performance principle. Instead, these 'Type 2' services would be sourced according to the rules governing the exploitation of tangible or intangible personal property.
- Another suggestion is to categorize income from digital commerce into 'digital income' (income from digital transactions) and non-digital income (income from digital commerce transactions involving physical delivery of goods or services).[43]

42. Peter Glichlich, et al., *Electronic Services: Suggesting a Man-Machine Distinction*, 87 J. Tax. 69 (1997).
43. Jinyan Li, *Rethinking Canada's Source Rules in the Age of Electronic Commerce: Part 2*, 47 Can. Tax J. 1411 (1999).