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To Tax Or Not To Tax, That Is The Question: A Critique of the United States' Policy on Taxation of Servers

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The international tax authorities are struggling to create an effective scheme to generate revenue from electronic commerce ("e-commerce"). Currently, the United States, a global leader in e-commerce, has no clear policy on the taxation of these transactions, which deters international companies from locating their servers within the United States based on the fear of high tax rates and uncertain results. The United States should adopt a domestic and international policy that focuses on a consumption-based approach to taxing e-commerce. However, the informal world tax organization, the Organization for Economic Co-operation and Development ("OECD") and several member countries recommend using source-based concept of permanent establishment to tax the transactions based on the location of the server. By focusing on the location of the server, permanent establishment allows companies to manipulate the patchwork international tax scheme and locate servers in tax havens. This paper proposes that the United States take the lead in shifting the international consensus towards a consumption-based approach of permanent establishment that sets a minimum floor of gross income and transactions within a jurisdiction. This solution would not only eliminate the uncertainty of the United States' position on taxation of e-commerce, but also would generate increases in tax revenue and frustrate opportunities to manipulate the system.

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I. INTRODUCTION

Electronic commerce ("e-commerce") has quickly become a part of everyday life. Whether a person is scouring daily deals sent through their e-mail by Groupon or noticing Facebook's well placed advertising as they keep in touch with friends, companies are looking for every opportunity to make money on-line. E-commerce even has its own day now, Cyber Monday (the rival to the typical in store day known as Black Friday), which in 2010 was the highest spending day of the year.[1]

The rise of e-commerce has not gone unnoticed by tax authorities that are currently under pressure to generate extra revenue due to the recent struggles of the worldwide economy. However, "the application of today's taxing regimes to the contemporary world of . . . electronic commerce is uncertain, inconsistent, and complex."[2] For example, a recent study suggests that in the United States the states collectively lose between $11.4 billion to $12.7 billion of sales tax revenue annually to e-commerce due to holes in their tax codes.[3]

The international community has especially been challenged as the Internet allows companies to do business across borders with unprecedented ease never before seen. Traditionally, "[t]he power to levy taxes [was] inherent in the power to govern, and . . . [was] practically without limit, extending to all persons, property, and business over which the sovereign power extend[ed]."[4] However, as applied to e-commerce, the question is how far does the sovereign power extend in the nebulous world of cyberspace?[5]

Several countries began tackling this question, including the United States, Australia, and Canada by issuing reports that identified key tax issues raised by the rise of e-commerce.[6] The first non-country specific guidance came from the Organization for Economic Co-

1. *Cyber Monday*, WIKIPEDIA, http://en.wikipedia.org/wiki/Cyber_Monday (last visited Feb. 24, 2012).

2. Walter Hellerstein, *Telecommunications and Electronic Commerce: Overview and Appraisal*, 12 ST. TAX NOTES 519, 525 (1997).

3. Phil Schlesinger, *The Impact of the Loss of State Sales and Use Tax Revenue on Businesses and Consumers*, CCH, 3 (Dec. 2009), *available at* www.cch.com/press/news/CCHWhitePaper_Loss_of_Revenue_f.pdf.

4. 84 C.J.S. *Taxation* 7 (2011).

5. *See* U.S. DEPT. OF THE TREASURY, SELECTED TAX POLICY OF IMPLICATIONS OF GLOBAL ELECTRONIC COMMERCE § 7.2.3.1 (1996).

6. *See, e.g.*, *id.*; AUSTL. TAX'N OFFICE, TAX AND THE INTERNET (1997); CAN. TAX ADMIN., ELECTRONIC COMMERCE AND CANADA'S TAX ADMINISTRATION (1998).

operation and Development ("OECD"), which has been anointed by some scholars as the "informal world tax organization."[7] However, "[d]espite a number of forums convened, commissions appointed and white papers issued, there remains little international accord, national legislation, or case law on the taxation of e-commerce."[8]

Despite the lack of accord, the countries and organizations working on solutions have focused their attention on key areas of e-commerce, which they believe can be taxed under the pre-existing concepts of international taxation. One of these key areas is the location of servers and whether this creates a permanent establishment which countries can tax. Permanent establishment is the major exception to the general rule that the country in which the business is headquartered has exclusive authority to tax all profits generated by the business.[9] If a company maintains a permanent establishment in the country where it generates profits, then that country can tax all the profits that are attributable to the permanent establishment.[10] Typical examples of permanent establishments are an office, branch, factory, workshop, warehouse, or place of management.[11]

Should servers be added to this list? In the world of e-commerce, servers are the key tangible piece of equipment that ties into the production of profit.[12] What a specific server does is determined by the software it runs, such as providing communications links, security, advertising, delivering of products, and fulfilling payment.[13] Best estimates show that several large companies have at least 50,000 servers, with Google running almost one million.[14] Many of these servers are housed within data centers spread all over the globe.[15]

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

8. Oleksandr Pastukhov, *Going Where No Taxman Has Gone Before: Preliminary Conclusions and Recommendations Drawn from a Decade of Debate on the International Taxation of E-Commerce*, 36 RUTGERS COMPUTER & TECH. L.J. 1, 3 (2009) [hereinafter Pastukhov I].

9. U.S. International Portfolios: Portfolio 908-2d U.S. Taxation of Foreign Corporations: Treaties, ISSN 1947-3923 (September 3rd, 2012), *available at* BLOOMBERG BNA TAX & ACCT. CTR. [hereinafter U.S. International Portfolios].

10. *Id*.

11. JOEL D. KUNTZ & ROBERT J. PERONI, US INTERNATIONAL TAXATION ¶ C4.05 (2011).

12. *Server (Computing)*, WIKIPEDIA, http://en.wikipedia.org/wiki/Server_(computing) (last visited Feb. 26, 2012).

13. OECD, Model Tax Convention on Income and on Capital, Commentary on Art. 5 ¶¶ 42.7–9, July 22, 2010 [hereinafter Model Tax Convention].

14. Rich Miller, *Who Has the Most Servers?*, DATA CENTER KNOWLEDGE (May 14, 2009), http://www.datacenterknowledge.com/archives/2009/05/14/whos-got-the-most-web-servers.

15. Data Center Map, http://www.datacentermap.com/ (last visited Feb. 26, 2012); *see also, Data Center*, WIKIPEDIA, http://en.wikipedia.org/wiki/Data_center (last visited Feb. 26, 2012).

Servers might just be the modern day version of an office, factory, workshop, etc. However, there are several differences, including perhaps the strongest distinction that they "can be located anywhere in the world and their users are indifferent to their location."[16] Servers can be turned on or off, rebooted, or reconfigured from anywhere in the world.[17] Thus, if a server does create a permanent establishment, companies might migrate the location of their servers from countries with a high corporate tax rate like the United States to countries with much lower rates.[18] There are other considerations of where to locate a server such as labor costs, utility prices, reliable power sources, network speeds, and economies of scale, but taxation is certainly a major factor.[19]

The OECD, after weighing the pros and cons of making a server a permanent establishment, decided that under certain circumstances a server would indeed create a permanent establishment.[20] The OECD's approach mainly focused on the role of the server and whether the activities performed are core to the profit-generating aspects of the business.[21] Most countries that are parties to the OECD have adopted its approach through ratification in treaties.[22]

However, the United States, which had $3.4 trillion of shipments, sales, and revenue from e-commerce in 2009, has not outright adopted the OECD approach in its treaty network.[23] Instead, the United States has issued conflicting guidance and has remained silent on how to resolve the problem.[24] The United States has not even resolved how its domestic laws would apply to foreign companies from non-treaty countries that have servers within its borders.[25]

To illustrate the problems, imagine Foreign Co., a foreign e-commerce business that sells 99-cent items, that wants to locate servers in the United States because natural disasters are constantly

16. U.S. DEP'T OF THE TREASURY, *supra* note 5, § 7.2.3.1.

17. *Server (Computing)*, *supra* note 12.

18. U.S. DEP'T OF THE TREASURY, *supra* note 5, § 7.2.3.1.

19. *See* Sang Kim, *Tips to Effectively Expand in International Markets*, BUSINESS XPANSION J., http://www.bxjmag.com/bxj/article.asp?magarticle_id=1759 (last visited Feb. 26, 2012).

20. Model Tax Convention, *supra* note 13, ¶¶ 42.1–9.

21. *Id.*

22. Oleksandr Pastukhov, *International Taxation of Income Derive from Electronic Commerce: Current Problems and Possible Solutions*, 12 B.U. J. SCI. & TECH. L. 310, 315 (2006) [hereinafter Pastukhov II].

23. *E-commerce 2009*, U.S. CENSUS BUREAU, 2 (May 26, 2011), http://www.census.gov/econ/estats /2009/2009reportfinal.pdf.

24. *See* U.S. DEPT. OF THE TREASURY, *supra* note 5, § 7.2.3.1 (stating the server's location is irrelevant); ADVISORY COMMISSION ON ELECTRONIC COMMERCE, REPORT TO CONGRESS 42 (2000) (affirming support for the OECD).

25. Tax Advisors Plan. Sys. (Title 43) 43:8.01(C) (2012), *available at* RIATAPS s 43:8.01(C) [hereinafter Tax Advisors].

taking its local servers off-line, and the president of Foreign Co. believes the United States will offer the most protection from natural disasters.[26] Foreign Co. is headquartered in a moderate tax jurisdiction and is always looking for opportunities to minimize its tax burden. Foreign Co.'s servers are located in several countries, but a server at its headquarters finalizes the contract with customer, fulfills payment, and delivers the product. Foreign Co.'s customers are mainly in Japan and the United Kingdom. As part of the due diligence in making the decision, the president asks his tax advisors for guidance.

Will they recommend locating the servers in the United States? What laws and regulations will they use to support their advice? What potential is there for the Internal Revenue Service to rule against their tax plan? Are there other opportunities to minimize taxes?

This article shows that the answer to the questions above is not easy, because of the United States' policy or lack there of regarding taxation of servers located within the United States that belong to foreign companies. The article will critique the current taxation policies available and propose a solution to the current uncertainty regarding the United States' position. Section II will discuss the background and governing law of the taxation of servers under the guidance of the OECD and the United States. Section III will critique the United States' most likely approach to taxing servers of foreign companies based on whether the enterprise comes from a treaty or non-treaty country. Finally, Section IV will propose that the United States should move to a consumption-based tax approach to define permanent establishment and trade or business for servers.

II. BACKGROUND: TAXATION OF SERVERS

A. OVERVIEW OF CURRENT INTERNATIONAL TAX SCHEME

Since the beginning of the 20th century, the international community has consistently grappled with the question of how to tax business profits that crossed several borders.[27] Through the use of over 1,000 bilateral double tax treaties based on the model treaty developed first by the League of Nations in the 1920-30s and later by the OECD after World War II, countries have established rules for

26. John Rath, *Data Center Site Selection*, RATH CONSULTING, http://rath-family.com/rc/DC_Site_Selection.pdf (last visited Feb. 26, 2012) (noting that natural disasters are a primary factor in deciding where to locate servers).

27. Pastukhov II, *supra* note 22, at 315.

allocating the right to tax the business profits.[28] The treaties supersede each country's domestic tax laws, but not all countries have chosen to join the treaty network, their domestic law still reigns supreme.[29]

Despite being a member of the OECD, the United States has a separate "U.S. Model Treaty" ("U.S. Model"), though the U.S. Model is similar in many respects to the OECD Model treaty.[30] For both sets of models, if there are undefined terms or questions regarding terminology, the treaties provide that the term is given the meaning of the country that has the right to tax.[31] Additionally, both the OECD and United States Treasury provide commentary on their interpretation of the meaning and intent of the treaties.[32]

The general rule adopted in the OECD Model Treaty and all United States treaties is that the country where the business resides ("resident country") cedes the primary authority to tax profits generated by the business to the source country.[33] This rule applies even when profits are generated in different countries ("source country").[34] Specifically, if a company maintains a "permanent establishment" in the source country, then the source country can tax all the profits that are "attributable" to the permanent establishment.[35] To ensure no double taxation on the same profits, the resident country, very roughly, is required to exempt the income attributable to the source country or credit the tax paid on such income.[36]

The concept of permanent establishment originated from the Technical Experts group working for the League of Nations in 1927-1928, and its lead advocate was the United States representative.[37] The United States, due to its position of being a major net exporter of goods, was concerned with protecting the interests of United States' businesses operating abroad.[38] After the devastation of World War I, governments were in dire need of revenue to rebuild economies, so they began to try to tax earnings of visiting businessmen and the revenue of the foreign enterprise on goods sold through the businessmen.[39] In reply, the United States successfully championed the

28. Pastukhov II, *supra* note 22, at 315–16.
29. *See supra* note 28, at 316.
30. U.S. International Portfolios, *supra* note 9.
31. *Id.*
32. *Id.*
33. Reuven Avi-Yonah, *International Taxation of Electronic Commerce*, 52 TAX L. REV. 507, 517 (1997); U.S. International Portfolios, *supra* note 9.
34. Avi-Yonah, *supra* note 33; U.S. International Portfolios, *supra* note 9.
35. *Id.*
36. *Id.*
37. Michael J. Graetz & Michael M. O'Hear, *The "Original Intent" of U.S. International Taxation*, 46 DUKE L.J. 1021, 1087–88 (1996-1997).
38. *Id.*
39. *Id.*

permanent establishment threshold that prevented taxation unless the business was conducted through a branch, factory, agency, warehouse, office, or depot.[40]

The purpose of the rule prevented a business from being taxed in every country in which it operated unless it exceeded a reasonably high threshold.[41] Thus, the permanent establishment threshold exemplified an agreeable compromise when it was first conceived because it dates back to a period in which physical presence was necessary to run significant business operations.[42]

Nowadays, the exact definition of a permanent establishment varies from treaty to treaty depending on the countries' agreement.[43] For example, the United States as a developed country prefers a high threshold in order for it to retain primary jurisdiction over the significant foreign profits of the Unites States businesses, but a developing country would want a lower threshold for exactly the opposite reasons.[44] Despite the differences, generally a foreign business will be considered as having a permanent establishment in the United States only if it maintains a "fixed place of business" or the activities of another person are imputed to the foreign business.[45]

For businesses in countries without a treaty with the United States, they will be taxed in the United States if they meet the Internal Revenue Code's definition of a "trade or business."[46] The term "trade or business" is common throughout the code, but regulations have never been issued to clarify its exact definition.[47] The only statutory guidance provided by the Internal Revenue Code to foreign corporations is only applicable to businesses that perform personal services or trade in securities or commodities.[48] For the remainder of the foreign businesses in other industries, the determination of whether they operate a trade or business within the United States is a fact-based inquiry left to judicial and administrative rulings.[49] Due to the unique factual pattern of each request, the Internal Revenue

40. Graetz & O'Hear, supra note 37.

41. *See id.* at 1088.

42. Frances M. Horner & Jeffrey Owens, *Tax and the Web: New Technology, Old Problems*, 50 BULL. INT'L FISC. DOC. 516, 516–18 (1996).

43. U.S. International Portfolios, *supra* note 9.

44. *Id.*

45. *Id.*

46. *Id.*

47. 6 CHRISTOPHER M. SOVE & JASON A. FISKE, MERTENS LAW OF FEDERAL INCOME TAXATION §25:6 (2012); *See* I.R.C. §§ 62, 162, 165-66, 172, 1231 (West 2012).

48. U.S. International Portfolios, *supra* note 9. *See* I.R.C. §864(b) (West 2012).

49. *Id.*

Service ordinarily does not offer rulings on whether a foreign corporation operates a trade or business.[50]

A case from outside of the e-commerce industry, but shares many of the same issues in determining whether a foreign corporation is a trade or business, is *Piedras Negras Broadcasting Co. v. Commissioner*.[51] In *Piedras*, a foreign corporation broadcasts radio programs from Mexico into the United States, drawing 95% of its advertising revenue and 90% of its listeners from the United States.[52] The company used independent agents to sell advertising time to United States' businesses and had a limited physical presence in the United States, including the use of a post office box and a hotel room in Texas for sorting mail and collecting income.[53] The court saw the functions within the United States as merely "incidental."[54] The court instead focused on the radio transmissions, emphasizing that the station personnel, studio, power station, and other broadcasting equipment was in Mexico.[55] Despite the court acknowledging that the radio waves had some physical effect in the United States, it concluded that "[t]he transmission of the impulses through the ether over the United States and the reception at receiving sets therein" was only an "intermediate" and "secondary" step.[56] The primary generator of income was the transmission equipment and supporting labor in Mexico.[57] Ergo, the court concluded that the corporation was not engaged in a United States trade or business.

The United States' definition of a trade or business has been compared to the permanent establishment concept, because there are some similarities in the way the rules act as thresholds in determining whether the foreign corporation will be taxed within the jurisdiction.[58] However, as will be discussed below, they are not exactly similar and can lead to different conclusions.[59] In particular, generally, a lower threshold of activity is needed to conclude that a taxpayer has a United States trade or business than to conclude that the taxpayer has a permanent establishment.

For example, if Foreign Co. decides to locate a server in the United States and it performs preparatory functions, then there is a chance there will be two different results under international and domestic

50. *See supra* note 48.
51. 43 B.T.A. 297 (1941), *aff'd* 127 F.2d 260 (5th Cir. 1942).
52. *Id.* at 302–03.
53. *See supra* note 51, at 307.
54. *Id.* at 307–08.
55. *Id.* at 313.
56. *Id.*
57. *Id.*
58. U.S. International Portfolios, *supra* note 9.
59. Tax Advisors, *supra* note 25.

law. Under the OECD Model Treaty and U.S. Model, this server will likely not cause a permanent establishment. Under domestic law, however, the server might constitute a trade or business. In Part III, the article will proceed under the hypothetical transaction in light of the OECD as well as United States' guidance.

B. THE OECD'S APPROACH TO SERVERS

Beginning on December 22, 2000, the OECD started providing its views on the effect of a web server on a company's taxability under the OECD Model Treaty.[60] The process is still evolving as the OECD continues to refine its position on servers.[61] In addition to interpreting the OECD Model Treaty, these rules were meant to serve as practical guidance to countries that based their treaties on the OECD Model Treaty or even where there is no tax treaty.[62]

Under OECD guidance, a web server may create a permanent establishment, because it is tangible equipment located within the country seeking to tax the server.[63] The initial inquiry is whether a server is actually "fixed" within the country. The server must remain within the country for a sufficient amount of time in order to become a permanent establishment.[64] Presence of employees (engineers, management, etc.) of the company is not even required, because in some instances a server by itself can create a permanent establishment.[65]

Next, the country must determine whether the company has the server at its disposal.[66] A server will generally not be at the disposal of a company when its website is hosted by a third party.[67] This remains true even when a company tells the third party the servers it wants a

60. OECD COMMITTEE ON FISCAL AFFAIRS, CLARIFICATION ON THE APPLICATION OF PERMANENT ESTABLISHMENT DEFINITION IN E-COMMERCE: CHANGES TO THE COMMENTARY ON THE MODEL TAX CONVENTION ON ARTICLE 5 (2000), *available at* http://www.itc-leiden.nl/LinkClick.aspx?fileticket=BmBsPTOOjik%3D&tabid=270&language=nl-NL.

61. *See* OECD, INTERPRETATION AND APPLICATION OF ARTICLE 5 (PERMANENT ESTABLISHMENT) OF THE OECD MODEL TAX CONVENTION (2012), *available at* http://www.oecd.org/tax/taxtreaties/48836726.pdf.

62. Tax Advisors, *supra* note 25.

63. Model Tax Convention, *supra* note 13.

64. *Id.* ¶ 42.4; *see* DAVID A. HARDESTY, TAXABILITY OF BUSINESS PROFITS IN A FOREIGN TREATY COUNTRY, Elec. Commerce Tax'n & Plning ¶11.05[2][a][ii] at *5 (2011) (suggesting that if a company moved a server every couple months to a new country it would not be a permanent establishment).

65. Model Tax Convention, *supra* note 13, ¶ 42.6.

66. *Id.* ¶¶ 42.3, 42.5.

67. *Id.* ¶ 42.3.

website to run on and pays based on disk space used.[68] The business is not considered as having a physical presence in the country unless it actually leases or owns the server equipment.[69] However, each case will be reviewed individually to determine if the server is enough at the disposal of the business to be a permanent establishment.[70]

Once the country has established that the enterprise has a server at its disposal at a fixed location, the question becomes whether the business of the company is wholly or partially carried on through the location.[71] The server carries on business when it operates core functions that are the main profit-generating activity of the enterprise.[72] To illustrate a core activity, some Internet service providers ("ISPs") operate servers in order to host websites or applications for other companies.[73] For these ISPs, the operation of servers is fundamental to their ability to provide services to their customers.[74]

Another common example is that of an "e-tailer" that sells products through the Internet.[75] Examples of e-tailers are Amazon and Overstock.com. If typical functions related to sales are carried out in the server (i.e., finalizing the contract with customer, fulfilling payment, and delivery of products), then the server is conducting a core operation of the enterprise.[76] Using Foreign Co., which is an e-tailer, as an example, the only server that meets this requirement is located at its headquarters.

On the other hand, if the activity is considered preparatory or auxiliary then it does not create a permanent establishment.[77] Examples of activities that typically are considered as preparatory or auxiliary include: "providing a communications link—much like a telephone line—between suppliers and customers; advertising of goods and services; relaying information through a mirror server for security and efficiency purposes; gathering market data for the enterprise; and supplying information."[78] "E-tailers" are not routinely in the business of operating servers, so each activity performed by the server will need to be analyzed to determine whether it goes beyond

68. *See supra* note 65 at ¶ 42.3.
69. *See supra* note 65 at ¶ 42.3.
70. *Id.* ¶ 42.5.
71. *Id.* ¶¶ 42.8.
72. *Id.*
73. *Id.* ¶ 42.9.
74. *Id.* at ¶ 42.9.
75. *Id.*
76. *Id.*
77. *Id.* ¶ 42.7.
78. *Id.*

preparatory or auxiliary.[79] If the location hosts a server that merely operates a website that is used exclusively for advertising, presenting an inventory of products, or supplying information to potential customers, then the location is not a permanent establishment.[80]

Despite providing a few examples of what is considered core as opposed to preparatory or auxiliary, there is no bright line test. For example, the Commentary notes that even when the server performs the activities listed as preparatory or auxiliary, there is a chance that those functions by themselves or grouped together will form a core function of the enterprise.[81] Additionally, the OECD expects countries to promulgate their own rules regarding servers and permanent establishment.[82] For example, the United Kingdom's position is that any server of an "e-tailer" cannot by itself result in permanent establishment.[83]

C. THE UNITED STATES' APPROACH TO SERVERS

In 1996, the United States took the international lead in questioning what impact e-commerce and specifically, servers would have to permanent establishment.[84] The United States took the approach that servers would likely not create a permanent establishment, because the location is "irrelevant since it can be accessed anywhere in the world."[85] In addition to exploring the concept of permanent establishment, the United States noted that a server "is not a sufficiently significant element in the creation of certain types of income to be taken into account for purposes of determining whether a U.S. trade or business exists."[86]

Despite initially taking the lead on the tax implications of server location in early 2000, the United States noted the OECD as an authority in determining international tax issues.[87] In a report to Congress, the Advisory Commission on Electronic Commerce proposed "affirm[ing] support for the principles of the OECD's framework conditions for taxation of e-commerce, and support[ing] the OECD's continued role as the appropriate forum for (1) fostering effective

79. *See supra* note 65 at ¶ 42.9.
80. *See supra* note 65 at ¶ 42.9.
81. *Id.* ¶ 42.8.
82. HARDESTY, *supra* note 64, at *7.
83. Model Tax Convention, *supra* note 13, ¶ 45.5.
84. U.S. DEPT. OF THE TREASURY, *supra* note 5, § 7.2.3.1.
85. *Id.* §§ 3.1.2, 7.2.4.
86. *Id.* § 7.2.3.1.
87. ADVISORY COMMISSION ON ELECTRONIC COMMERCE, *supra* note 24, at 42.

international dialogues concerning these issues and (2) building international consensus."[88] However, these declarations were made several months before the OECD began providing its views on a server's effect on permanent establishment.[89]

Since the release of the OECD's commentary, the United States has not clarified whether it will follow its initial opinion or the OECD's approach.[90] Neither the United States' courts nor the Internal Revenue Service have provided opinions or rules to follow.[91] Outside of e-commerce, the Internal Revenue Service typically has interpreted permanent establishment narrowly, which effectively exempted many business activities as preparatory or auxiliary, which is in-line with the OECD approach.[92]

For a foreign company based in a non-treaty country, the question of which law to apply to servers is murkier. Since there is no simple test to determine whether a foreign e-commerce company is operating a U.S. trade or business, the Treasury has suggested replacing the concept of trade or business with the permanent establishment concept in our treaties.[93] For this reason, some commentators believe the OECD's guidance is still valid even without a treaty.[94]

However, without an official statement, the question of whether a foreign company's server on United States soil would be taxable depends on whether it is classified as a trade or business.[95] The threshold for a trade or business is much lower than the threshold for permanent establishment, making it more likely that a server would be taxed.[96] Without any significant guidance since the Treasury noted a server will not constitute a trade or business, each enterprise will be left with an uncertain tax position as to whether a United States-based server will qualify as a trade or business.[97]

88. *See supra* note 87, at 6.
89. *See supra* note 87, at 6; OECD COMMITTEE ON FISCAL AFFAIRS, *supra* note 60.
90. HARDESTY, *supra* note 64, at *4 n.29, *9 n.36.
91. *Id*.
92. Rev. Rul. 72-418, 1972-2 C.B. 661 (exempting the American office of a German bank from permanent establishment status because the office was primarily used to advertise and collect information on financial issues); Rev. Rul. 77-45, 1977-1 C.B. 413 (exempting the American office of a Canadian consulting engineering business from permanent establishment status because the Canadian staff members at the office were not authorized to make major decisions and their activities mainly involved planning and supervision).
93. U.S. DEPT. OF THE TREASURY, *supra* note 5, § 7.2.1.1 n.52.
94. Tax Advisors, *supra* note 25.
95. *Id*.
96. U.S. DEPT. OF THE TREASURY, *supra* note 5, § 7.2.2.
97. Tax Advisors, *supra* note 25.

III. INADEQUATE STANDARD AND UNCERTAINTY

A. EXPLORING A BAD STANDARD FOR TREATY COUNTRIES

At the time the OECD was contemplating new rules, the United States accounted for eighty percent of the e-commerce globally.[98] There was obviously a concern that the United States, under a friendly pro-resident country definition of permanent establishment, would become a practical monopoly over the tax base of e-commerce. The server was, therefore, an excellent target for pro-source country advocates due to its role in replacing brick-and-mortar offices, the former means for taxation of permanent establishments. Thus, to even the playing field, the OECD Commentary notes that servers create permanent establishments when a company uses a fixed server at its disposal to perform core activities.

In this section, the article will assume that the OECD Commentary will be used by the United States to determine whether a foreign company has a permanent establishment within its country. Additionally, the sections below assume Foreign Co. is located in a treaty country.

1. Servers Do Not Fit Well into the Concept of Permanent Establishment

Servers are not analogous to other forms of permanent establishments. Chain restaurants, which might be the most comparable in terms of volume, have to target customers and advertise in each location to earn revenue.[99] Warehouses, which have the ability to store products and enable delivery, have to consider access to transportation routes and speed of delivery from their location to their customer base.[100] An office, which is capable of providing both core and auxiliary activities to the profit-generating business, demands

98. OECD, *Economic and Social Impact of Ecommerce: Preliminary Findings and Research Agenda*, OECD DIGITAL ECONOMY PAPERS, NO. 40 (1999), http://dx.doi.org/10.1787/236588526334.

99. *See* Juliet Jargon, *Subway Runs Past McDonald's Chain*, WALL ST. J. (Mar. 8, 2011), http://online.wsj.com/article/SB10001424052748703386704576186432177464052.html.

100. *See* Patrick O'Healy, *Choosing a Warehouse Location: Look for More Than Just Price*, INBOUND LOGISTICS (Jan. 2005), http://www.inboundlogistics.com/cms/article/look-for-more-than-just-price-when-choosing-a-warehouse-location/.

qualified and available employees.[101] All of these examples require links to the local community and economy that a server does not need.

At the origination of the permanent establishment concept, there were methods of establishing foreign business that resembled the server's detachment from the local community and economy. Business practices such as solicitation through mail or through independent agents allowed a business to operate without a physical presence.[102] However, these methods were excluded from the definition of permanent establishment, and the drawbacks of these methods were so prohibitive, the originators did not envision them as practical: no direct negotiation with the company's representative, minimal ability to customize orders in the case of mass mailings, and long lag time for fulfillment of orders.[103] Presently, the server's interactivity, speed, and electronic payment mean that a company can conduct sales on a much grander scale without any physical presence in the consumer's jurisdiction.[104] Hence, the server also does not fit well with what the originators thought should be excluded from the permanent establishment concept.

For example, Foreign Co. could choose from thousands of sites to locate its new server and it would make little difference. "Servers can be located anywhere in the world and their users are indifferent to their location."[105] A server in the United States can immediately fulfill customized orders from users in Japan as easily as it can users in the United Kingdom. Not only are the users indifferent, so too are the operators. The ability of servers to be controlled remotely means that Foreign Co. does not need to employ local personnel. The new server wherever it is built can be turned on or off, rebooted, or reconfigured from anywhere in the world.[106]

Thus, a server is stuck awkwardly between the definition of what is a permanent establishment and what is not. Offices, warehouses, chains, etc. cannot be located anywhere in the world and demand a physical presence in the consumers' jurisdiction.[107] Their location is directly correlated to the production of profit. However, a server can perform the local functions that the originators of the permanent establishment concept thought were unlikely without a local presence:

101. *See* Maria Valdez Haubrich, *Should You Expand Your Chain Regionally, Nationally, or Globally?*, THE BUSINESS EXPANDER, http://www.thebusinessexpander.com/2011/04/should-you-expand-your-chain-regionally-nationally-or-globally/ (September 3rd, 2012).
102. *See* Avi-Yonah, *supra* note 33, at 535.
103. *See id.*
104. *Id.*
105. *See* OECD, *supra* note 13, ¶¶ 7, 42.6.
106. *Server (Computing)*, *supra* note 12.
107. *See* Pastukhov II, *supra* note 22, at 319.

negotiate with company's representative, customization of orders, and quick fulfillment of orders.[108] If the server does not fit in with the other examples of what is or is not a permanent establishments, then perhaps trying to fit this square peg into a round hole "sidesteps the need to introduce new tax concepts that address the economic and tax realties of the digital age."[109]

2. The Server's Software Is Not Fixed

Traditionally, a permanent establishment is a "fixed" place of business.[110] When the concept of permanent establishment originated, the fixed requirement made sense. Property, plant, and equipment were critical ingredients in order to serve a market. Hence, an office, branch, factory, workshop, or warehouse became common forms of permanent establishments.[111]

The Internet age freed companies from such "fixed" shackles of the past.[112] Property, plant, and equipment are still commonly required, but are becoming less associated with the product and the local market.[113] The server is also not key to the product or local market. "The most essential component in a digital transaction is often the software that enables the business to conduct the functions that generate the income being considered for taxation."[114]

The OECD Commentary on servers admits that the software is more important than the server.[115] The OECD places the emphasis on whether the server is performing auxiliary and preparatory tasks or core activities.[116] As the server only performs functions that the software commands,[117] it is the software, therefore, that is critical in deciding whether a permanent establishment exists.

However, in returning to the definition of a permanent establishment, the software is not fixed at all. For example, Foreign Co. currently runs all of its core profit generating activities on one server.

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108. *See* Avi-Yonah, *supra* note 33, at 535.
109. Aldo Forgione, *Clicks and Mortar: Taxing Multinational Business Profits in the Digital Age*, 26 SEATTLE U. L. REV. 719, 732 (2003).
110. U.S. International Portfolio, *supra* note 33.
111. *See* KUNTZ & PERONI, *supra* note 11, *1.
112. Bill Davidow, *Why the Web May Unleash the Largest Construction Boom in History*, MOHR DAVIDOW (Feb. 25, 2011), http://www.mdv.com/press-room/perspectives/why-web-may-unleash-largest-construction-boom-history
113. *Id.*
114. Forgione, *supra* note 109, at 731.
115. *See* Model Tax Convention, *supra* note 13, ¶¶ 42.7–9.
116. *Id.*
117. *Server (Computing)*, *supra* note 12.

However, with multiple servers at its disposal, Foreign Co. can quickly switch the software from a remote location and change servers activities from core business ones to preparatory and auxiliary. If Foreign Co. is to rotate the use of its servers at least every few months, it could easily avoid the "fixed" requirement of the test.[118] This is all accomplished without even moving the servers an inch.

3. The OECD Created Opportunities to Manipulate Taxes

The OECD wants to provide taxpayers with guidelines on servers in foreign jurisdictions, so that companies do not create a permanent establishment unknowingly.[119] This goal has generally been met with thorough explanations provided in the Commentary. However, the rules might have unintentionally provided companies with a guide how to avoid as much tax as possible. "Electronic commerce . . . makes it easy to manipulate activities of a business to minimize worldwide tax liability without incurring high costs or business interruptions. Electronic commerce affords businesses an unprecedented mobility, allowing them to easily migrate to a different jurisdiction in response to any adverse economic changes—including introduction of tax rules designed to 'catch' electronic commerce activities."[120] Servers under the OECD rules are now one of the easiest ways to manipulate the system.[121]

Additionally, the manipulation takes advantage of the very purpose of why the permanent establishment rule was created. The purpose was to protect domestic companies from foreign governments who were looking to make a profit off those companies in order to elevate their own economies.[122] Thus, the threshold for permanent establishment was set relatively high.[123] However, with servers added to the mix of ways to create permanent establishment, the companies are finding strategic ways to pass the "high" threshold.

For instance, Foreign Co. could locate its new server in a low-tax jurisdiction and migrate the core profit generating activities to this new server. These low tax jurisdictions do not only include so called "tax havens" with no treaty protections, but also new industrial powers with infrastructure and favorable laws and regulations that are seeking

118. HARDESTY, *supra* note 64, at *5.
119. OECD, *supra* note 13, ¶ 7.2.3.1.
120. Pastukhov II, *supra* note 22, at 321.
121. *Id.*
122. Graetz & O'Hear, *supra* note 37, at 1087–88.
123. *See supra* note 37, at 1088.

out companies to locate servers within their country's borders.[124] "Aside from the social advantages of attracting foreign investment to increase employment, such a state hopes to collect significant taxes from the less mobile factors of production, such as labor and land."[125] Moreover, Foreign Co. can use a combination of rotating servers and servers not at their "disposal" to provide core activities in countries with higher tax rates, and yet not meet the requirements for permanent establishment.

"[W]hile none of these tax avoidance activities are per se unique to electronic commerce, modern communications make it exceedingly easy for businesses to [manipulate the tax system]."[126] Prior to e-commerce, if Foreign Co. moved its business to another country for tax reasons, it could expect criticism from a lot of patriotic supporters. Now, Foreign Co. can make this move without upsetting the "patriotic feelings of the company's management, shareholders, and customers."[127] "If tax laws are not enforceable and taxpayers use the Internet to play a catch-us-if-you-can game of tax avoidance and evasion, then the resulting tax system is neither efficient, nor equitable nor sustainable."[128]

4. There Has Not Been Universal Adoption of the OECD's Approach

Perhaps the strongest argument for a country adopting the OECD approach is to create uniformity internationally on the issue. Nonetheless, many OECD member countries have taken approaches on servers inconsistent with the OECD. Tax authorities from England, Singapore, Ireland, and Hong Kong have issued administrative regulations noting that servers will never create a permanent establishment by itself.[129] Even within these countries there are competing viewpoints. For instance, Hong Kong believes that personnel are required in addition to servers for permanent establishment.[130] On the other hand, the United Kingdom has said a server will never create a permanent establishment.[131]

124. *See* Pastukhov II, *supra* note 22, at 323.
125. *Id.*
126. *Id.* at 321 (alteration to the original).
127. Pastukhov I, *supra* note 8, at *15.
128. Neil Warren, *Internet Challenge to Tax System Design*, *in* THE INTERNATIONAL TAXATION SYSTEM 78 (Andrew Lymer & John Hasseldine, eds., 2002).
129. Cockfield, *supra* note 7.
130. *See supra* note 7.
131. *Id.*

Some countries like Greece, Chile, and Portugal have noted they may not follow the OECD's guidance on servers until there is a final consensus.[132] Their hesitancy in adopting the OECD approach hinges on the fact they believe that a permanent establishment exists wherever a company regularly conducts e-commerce sales, irrespective of any servers.[133] Thus, much like the United States, their approach to taxation of servers is unclear.

Even countries that have adopted the OECD approach on servers have the ability to alter the exact definition of a permanent establishment to their countries preference.[134] For example, Italy warned that despite accepting the OECD approach, their "jurisprudence is not to be ignored . . . ."[135] Therefore, a country should not feel peer-pressured to adopt the OECD approach, because there is clearly no international accord on the taxation of servers.[136] Additionally, businesses like Foreign Co. have to monitor the intricacies of each country that place a server or they run the risk of creating permanent establishments.

B. UNCERTAINTY FOR NON-TREATY COUNTRIES

The current United States approach to foreign business servers from a non-treaty country located domestically operates as a barrier. The current state of the law is uncertain and the tax rates are high enough to dissuade risking the tax burden if servers do indeed create a United States trade or business. Conservative tax planning calls for companies to avoid taxation of United States source business profits due to the high tax rate.[137] Consequently, if Foreign Co. is from a non-treaty country, its tax advisers will certainly recommend against locating any servers within the United States.[138]

However, if Foreign Co. wanted to proceed with plans to locate a server, the *Piedras* case could provide a blue print.[139] The court in *Piedras* ignored the small physical presence of a hotel room and a post office box, and instead focused on the radio transmissions themselves, emphasizing that the station personnel, studio, power station, and

132. Model Tax Convention, *supra* note 13, ¶¶ 45.6, 45.11; *see* Cockfield, *supra* note 7.
133. Cockfield, *supra* note 7.
134. U.S. International Portfolios, *supra* note 9.
135. Model Tax Convention, *supra* note 13, ¶ 45.10.
136. *See* Pastukhov I, *supra* note 8, at *3.
137. Tax Advisors, *supra* note 25.
138. *See id.*; HARDESTY, *supra* note 64, at *8.
139. 43 B.T.A. 297 (1941), *aff'd* 127 F.2d 260 (5th Cir. 1942).

other broadcasting equipment was in Mexico.[140] The transmissions had an effect on the United States through the reception at radios therein, which in turn led to almost all of its advertising revenue and listeners.[141] However, all of those events were secondary to the transmission equipment and supporting labor in Mexico.[142]

In an e-commerce example, the foreign corporations headquarters would supply the labor, the software, and other equipment to transmit to a server what to do. The server itself is analogous to the combination of the radio waves, post office box, and hotel room. The server seeks out the consumers who are interested in the product much like the radio waves seek out consumers who turn the dial to its station. The server also provides a place for collection of income and communication much like the hotel room and post office box did for the radio station. The server's physical effect on the United States would be much less than a hotel room in size. Accordingly, a court could conclude that the corporation was not engaged in a United States trade or business.

However, even this analogy is left open for uncertainty. A court could easily point to a few distinctions. In *Piedras*, the consumer directly received transmission on a personally owned radio as opposed to the e-commerce example where the foreign company's direction flow first to a server it owns within the United States and then to a computer owned by the consumer. Additionally, the server will require power provided by the United States in order to run. Finally, the primary event generating the income is the software which will be housed within the server on United State's soil. Thus, the prudent advice would be to still locate a server in some other country in order to avoid being designated a United States trade or business.

IV. A PROPOSAL: A SHIFT TO CONSUMPTION BASED TAXES

Part III illustrates the problems and uncertainties of the United States' current polices regarding taxation of servers. All of the negatives surrounding the United States' current approach mean that it is ripe for a change. The United States was originally on the right approach when its Treasury Department noted that the location of servers should not matter.[143] However, removing permanent establishments or the United States trade or business completely from

140. *See supra* note 139 at 307–08.
141. *Id.* at 303.
142. *Id.* at 313.
143. *See* U.S. DEPT. OF THE TREASURY, *supra* note 5, § 7.2.3.1.

the equation does not make sense either. "[B]ecause electronic commerce can be carried out from any location on the globe connected to the Internet, and because it is very easy to set up a holding company in a "tax haven," then—in the absence of source-based taxation—a company might avoid all income taxes."[144]

The United States has a chance to once again take the lead in electronic commerce, because to this point it has not formalized an approach. The United States should shift its focus to a consumption-based approach. This new approach would not focus on physical presence, but rather in terms of a minimum floor of gross income and transactions within a jurisdiction. For instance, the rule could exclude from source-based taxation legal entities with less than $1 million of gross electronic commerce sales or less than 100 electronic commerce transactions. Conversely, enterprises with sales or transactions over these thresholds would be considered to have created a permanent establishment or a trade or business within the United States. Applying this to the Foreign Co. example, this would remove the United States as creating a permanent establishment or a trade or business, but would potentially create permanent establishments in Japan and the United Kingdom, because they represent practically all of Foreign Co.'s customers.

Focusing on gross income and transactions places the emphasis of the rule on where the consumption of goods or services takes place. A rule that focuses only on one aspect, either gross income or transactions is not enough. For example, if the rule only sets a minimum on income, a company with a high dollar value product might unintentionally create a permanent establishment with a few sporadic transactions. Conversely, if the rule only sets a minimum on transactions, a company with a low dollar value product like Foreign Co. might create a permanent establishment without really generating significant gross income in that jurisdiction.

The thresholds provided above are just examples. Clearly, there will need to be testing done to see what these proper thresholds should be. At a minimum, they should be high enough so that the income collected from the tax exceeds the cost of compliance.[145] The sales threshold should also be based on gross income, which includes all services, royalties, rents, and sales in electronic commerce, to avoid unduly burdening the tax administration with characterization issues.[146] Finally, in following with the United States' original purpose of the permanent establish rule, the threshold should be high enough

144. Pastukhov II, *supra* note 22, at 330.
145. *See* Avi-Yonah, *supra* note 33, at 536.
146. *See id.* at 536, 45.

to prevent business from being taxed in every country in which it operates.[147]

The change in policies would also have a big impact on the definition of a United States trade or business. By bringing the definition in line with the definition of permanent establishment, the United States would diminish any opportunities to manipulate tax results between treaty and non-treaty countries as the United States treasury already suggested.[148] Also, the change in policy eliminates any uncertainty over policy which held back tax advisers from recommending servers within the United States to clients.[149]

The first big challenge in implementing such a rule will be determining where the income is being created. Companies will already have some experience tracking transactions by geographic region, because this is already required under United States accounting and Securities and Exchange Commission rules.[150] Additionally, the government already has experience in tracking Internet use for other purposes of the government.[151] Privacy concerns can be respected by only authorizing the government to collect information on the country and amount paid by the consumer on each transaction.[152]

The second challenge will be the modernization of the entire system of international taxation domestically and in treaties. This challenge, however, might not be as difficult as it seems. The United States has already adopted stand-alone sets of rules for other challenging sources of taxation such as space and the ocean.[153] Cases with fact patters like *Piedras* will not be impacted by the new rule. "If new rules are limited to electronic commerce, it will be unnecessary to renegotiate all the existing tax treaties, except to the extent necessary to carve out an exception for electronic commerce."[154] The benefit of e-commerce being such a unique problem is that it only requires a unique solution.

147. Graetz & O'Hear, *supra* note 37, at 1087–88.
148. U.S. DEPT. OF THE TREASURY, *supra* note 5, § 7.2.1.1 n.52.
149. *See* Tax Advisors, *supra* note 25; HARDESTY, *supra* note 64, at *7–*8.
150. *See* CODIFICATION OF ACCOUNTING STANDARDS, ASC 280-10-50-41, 42 (Fin. Accounting Standards Bd.).
151. *See* SPENCER S. HSU & CECILIA KANG, *Obama Web-Tracking Proposal Raises Privacy Concerns*, WASH. POST (Aug. 11, 2009), http://www.washingtonpost.com/wp-dyn/content/article/2009/08/10/AR2009081002743.html.
152. *See* Avi-Yonah, *supra* note 33, at 536.
153. *See* 26 U.S.C.A. 863(d) (West 2012).
154. Pastukhov II, *supra* note 22, at 333.

V. CONCLUSION

Electronic commerce is not as new as it was when the international world first tried to tackle its taxation. Yet, a decade later, confusion remains. The United States, a dominant player in the world of electronic commerce, should be at the forefront of any solution instead of adding to the morass. The uncertainty around the taxation of servers is a perfect place to start. By thinking outside of the current taxation standards which were developed at the time of the horse and buggy, the United States' system of taxation could catch up to the Internet age. Focusing on the volume and amount of transactions to determine taxation instead of focusing on the physical presence of a server is a start. The effect on companies like Foreign Co. will be increased clarity and less ability to game the international tax system. This proposal further restores fundamental business decisions like risk management, power, and workforce, back into the determination of where to locate a server, instead of focusing on tax breaks. Ultimately, the United States must do something, because any approach is better than none at all.