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SPECIAL REPORTS

Selected Issues in the Denmark-U.S. Tax Treaty

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Geographical location or physical presence is central to many tax aspects of both Danish and U.S. inbound transactions.[1] This is because many of Denmark's and the U.S.'s tax treaties require a foreign entity to have a permanent establishment within Denmark or the U.S. for either country to apply its general tax regime to any profits of such an entity.[2] However, in the absence of a PE, either country may still tax the profit of the foreign entity by imposing a withholding tax on the gross amount of any payment made, provided that the transaction gives rise to certain types of income, such as interest.[3] With the development of e-commerce, however, entities engage in substantial economic activities in a country without ever physically being present in that country. Because the creation of a PE generally requires some kind of physical presence within the source country,[4] e-commerce transactions raise questions whether there is a need to revise the general principle of PEs to properly tax these kinds of transactions, or whether current regimes can be adequately applied to such transactions.[5]

Closely related to the PE issue is the source classification that results under a treaty, when the economic activities do not meet the level required to conclude that a PE exists. Thus, it is of paramount importance to determine the source of income acquired by a nonresident alien[6] that is not effectively connected with a Danish or U.S. trade or business. Denmark generally only taxes nonresident aliens on income that is Danish source (the U.S. also generally only taxes nonresident aliens on income that is U.S. source).[7] Yet, before applying the various source rules contained in the national tax laws of either country, the characterization of the income must first be determined. This is the conceptually correct approach, because without knowing the character of the income, it is impossible to assign it a source.[8] As this article shows, however, there

[1] *See, e.g.*, IRC section 864(c)(1)(B) (2000) (''in the case of a nonresident alien individual or a foreign corporation not engaged in trade or business within the United States during the taxable year, no income, gain, or loss shall be treated as effectively connected with the conduct of a trade or business within the United States.''); Danish Withholding Tax Act (DWTA) section 2(1)(4).

[2] *See* Joseph Isenbergh, *International Taxation* (2nd ed. 2005), 241.

[3] *See* Arthur J. Cockfield, ''Transforming the Internet Into a Taxable Forum: A Case Study in E-Commerce Taxation,'' 85 *Minn. L. Rev.* 1171, 1178 footnote 17 (2001). While the tax rate for withholding is generally 30 percent, the U.S. tax treaties generally reduce or eliminate the withholding altogether. *See* IRC section 881(1)(a); John P. Steines Jr., *International Aspects of U.S. Income Taxation* (3rd ed. 2007), 95.

[4] *See, e.g.*, ''OECD Model Income and Capital Tax Convention, Convention Between (State A) and (State B) With Respect to Taxes on Income and on Capital,'' July 17, 2008, (hereinafter

(Footnote continued in next column.)

OECD model treaty) article 5 (''the term 'permanent establishment' means a *fixed place* of business through which the business of an enterprise is wholly or partly carried on'') (emphasis added).

[5] In the subsequent discussion of this topic, the article will continue to use the terms ''residence country'' and ''source country.'' However, in the context of e-commerce there may not be any source country per se. For ease of the discussion, the term ''source country'' will nevertheless be used to describe the country, other than the residence country, that is implicated, in any way, in a given e-commerce transaction.

[6] *See* IRC section 7701(b)(1)(B) (2000); DWTA section 2.

[7] *See, e.g.*, IRC sections 61, 861(b), and 863; DWTA section 2.

[8] *See* Isenbergh, *supra* note 2, at 55.

are instances when characterizing the income becomes difficult, namely when determining whether income is for services or payments for the use of intangible property. The question therefore is whether the current statutory- and case-law-based rules are adequate, or whether there is a need for change.

I. Methodology and Overview of Arguments

The many cultural variances between the U.S. and Denmark are clear. Why then a comparative analysis between the tax regimes? The analysis and discussion that follows is based on a policy method or analysis — that is, a discussion of current law. The purpose is to analyze two selected issues in the tax treaty between the two countries. Analyzing the OECD model tax treaty and its commentaries is equally relevant because the Denmark-U.S. tax treaty is nearly identical to the OECD model treaty regarding the provisions analyzed here. Moreover, both countries rely on the OECD commentaries in interpreting the treaty between them. As such, the OECD model treaty and its commentaries are used interchangeably with the Denmark-U.S. tax treaty in this article.

II. Scope

Regarding e-commerce transactions and PEs, this article focuses on pure e-commerce transactions, meaning that the seller has no physical presence in the source country. It would be interesting to determine the tax implications of virtual income, however, that is the subject of an entirely different article.

III. The International Taxation Regime

A. Brief Background

In the 1920s, the League of Nations began analyzing solutions for the avoidance of double taxation, and it was from these efforts that the international tax regime developed.[9] Under this regime, two jurisdiction-based taxation methods exist: source-based taxation and residence-based taxation.[10] The source-based method of taxation places different economic activities into various categories, and taxes the income at the place giving rise to the activity.[11] Residence-based taxation allows a sovereign to tax its residents on their worldwide income.[12] The availability of these two different international taxation methods often leads to double taxation, for example when a resident of Country A produces income in Country B, and no treaty is in place.[13]

Economic studies commissioned by the League of Nations concluded that international taxation should be based on a doctrine of so-called economic allegiance.[14] Under this principle, taxation of cross-border transactions must strike an equitable balance between the contributions made by each sovereign nation in creating the wealth in question.[15] Such a weighing of equities is prone to conflicts. Capital-importing and capital-exporting countries have different views on the proper tax treatment of cross-border transactions.[16] Capital importers favor source-based taxation, while capital exporters favor residence-based taxation. Recognizing each other's plight, capital importers and exporters agreed that source-based and residence-based taxation had to coexist. The result was a bilateral model on the taxation of cross-border transactions that despite massive technological innovations has remained largely unrevised for almost 100 years.[17]

B. Principles of International Taxation

Overall, tax principles belong under either of two categories: efficiency and fairness. These two categories often seek to protect heterogeneous interests. Consequently, no tax system can be completely efficient while at the same time being completely fair.

1. Neutrality

In an international context, neutrality exists when the tax laws of different nations do not guide the actions of the taxpayer.[18] Thus, neutrality belongs in the efficiency category. If, for example, a taxpayer who is resident of Nation A wishes to purchase a new computer, and the taxpayer is indifferent whether to purchase the computer in Nation A or Nation B, the tax law is said to be neutral. If instead the tax laws of Nation A imposed a high tax on goods purchased outside its borders, Nation A's tax laws would be nonneutral, as they would discourage consumers from purchasing goods in nations other than A. Regarding international tax, neutrality is often divided into capital export neutrality and capital import neutrality. The focus continues to be on whether the tax laws affect taxpayer

[9]Reuven S. Avi-Yonah, ''The Structure of International Taxation: A Proposal for Simplification,'' 74 *Tex. L. Rev.* 1301, 1303 (1996).

[10]Rifat Azam, ''E-Commerce Taxation and Cyberspace Law: The Integrative Adaptation Model,'' 12 *Va. J.L. & Tech.* 5, 11-12 (2007).

[11]*See* Isenbergh, *supra* note 2, at 29.

[12]*See* Steines, *supra* note 3 at 1.

[13]*See* Azam, *supra* note 10.

[14]OECD Tax Policy Studies, ''E-Commerce: Transfer Pricing and Business Profits Taxation'' (2005), 82.

[15]*Id.* at 82-83.

[16]*See* Michael J. Graetz and Michael M. O'Hear, ''The 'Original Intent' of U.S. International Taxation,'' 46 *Duke L.J.* 1021, 1033-1034 (1997).

[17]*Id.* at 1023.

[18]*See generally* Laurie Malman et al., *The Individual Tax Base: Cases, Problems and Policies in Federal Taxation* (2nd ed. 2002), 9, on which the discussion is based.

behavior. As for e-commerce transactions, the principles have been invoked as an argument for treating these types of transactions the same way traditional transactions are treated to avoid providing either with a competitive advantage.[19]

2. Taxpayer Equity

Taxpayer equity, or fairness, is often subdivided into two categories: horizontal and vertical. Horizontal equity means equal treatment of taxpayers who are similarly situated, while vertical equity means equity between taxpayers at different economic levels.[20] These two types of equity support source-based and residence-based taxation, respectively.[21] A resident of Nation A, who has income from within Nation A, should be taxed the same as a nonresident of Nation A, who also has income from within Nation A. Similarly, when two residents of Nation A have the same amount of income, but one of them has foreign-source income only, they should be subject to the same tax burden. As with neutrality, in terms of e-commerce, taxpayer equity means that taxpayers engaged in traditional transactions should be treated the same as those engaged in e-commerce transactions.

3. Inter-Nation Equity

Closely related to taxpayer equity is inter-nation equity, meaning an equitable division of tax revenue between sovereign nations.[22] This depends on the allocation of the taxable activities between the source country and the residence country, and the tax rate in the source country. Inter-nation equity assumes that the source country and the residence country each contribute in creating value that is manifested in a cross-border transaction. If e-commerce transactions erode the existence of a source country, or make it increasingly difficult to enforce source-based taxation, creating rules in accordance with this principle becomes progressively more complicated.

4. Other Principles

There are a number of other principles of international taxation, such as administrative efficiency, simplicity, and nondiscrimination. Administrative efficiency and simplicity are closely related. The former requires that tax schemes be designed in a way that minimizes both the time and money needed for taxpayers and tax authorities to comply with the rules. The latter requires that the system be transparent, meaning that determining how a given transaction will be taxed should not require a master's degree in taxation.

[19]Richard Doernberg et al., *Electronic Commerce and Multijurisdictional Taxation* (2001), 68.

[20]Malman et al., *supra* note 18, at 14.

[21]*See* Doernberg et al., *supra* note 19, at 69.

[22]*Id.*

The principle of nondiscrimination is incorporated into tax treaties, and a typical nondiscrimination provision can be found in article 24 of the Denmark-U.S. tax treaty.[23] Generally, the nondiscrimination provision prohibits a treaty party from imposing less favorable or more adverse tax consequences on citizens or residents of the other treaty country. Thus, once a treaty has determined that the income in question is source based, the source country must tax the income as it would any other income of the same type.

IV. Taxation of the Sale of Goods

A. Basic Scheme of U.S. International Taxation

The U.S. has implemented both residence-based and source-based taxation into its federal taxation regime. Under section 61 of the Internal Revenue Code, gross income includes ''income from whatever source derived.''[24] The focus of the provision is the taxpayer, not his location. The provision effectively permits the U.S. to tax its residents on their earned income, and according to the U.S. Supreme Court, also permits the U.S. to tax its citizens on their worldwide income.[25] The U.S. is apparently the only economically developed country that allows for taxation based solely on citizenship.[26] As an example, consider a sale of jeans by a Danish retailer to a U.S. consumer. The result, perhaps obvious and logical, is that the Danish retailer is not subject to taxation in the U.S. If we reverse the roles, making the customer Danish and the retailer American, the income is taxable in the U.S. This would also be the case, even if the U.S. retailer resided in Denmark.[27]

As for source-based taxation and its categories of economic activity, the starting point is IRC section 865, under which gains from the sale of personal property are sourced where the seller has its ''residence,''[28] as that term is defined for purposes of this section under section 865.[29] Under section 865(g), a U.S. resident is an individual who is either:

[23]Convention Between the Government of the United States of America and the Government of the Kingdom of Denmark for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect to Taxes on Income, Aug. 19, 1999, article 24 (hereinafter Denmark-U.S. tax treaty).

[24]IRC section 61.

[25]*See Cook v. Tait*, 265 U.S. 47 (1924).

[26]*See* Michael S. Kirsch, ''Taxing Citizens in a Global Economy,'' 82 *N.Y.U. L. Rev.* 443, 446 (2007).

[27]The U.S. tax system contains provisions that help alleviate some of the adverse consequences of allowing the U.S. government to tax its citizens on their worldwide income. These include the foreign earned income exclusion of section 911, and the foreign tax credit of section 901(b). Both provisions include limitations, which may result in a U.S. citizen being taxed twice on the same income. Depending on the circumstances the sale might also generate income taxable in Denmark.

[28]IRC section 865(a).

[29]*Id.* at section 865(g).

- a U.S. citizen or resident alien with no ''tax home'' outside the U.S.; or
- a nonresident alien with a tax home in the U.S.[30]

A tax home entails either a substantial residential or business presence in a given place.[31] Inventory property, however, is specifically excluded from the scope of section 865 by virtue of section 865(b),[32] the latter of which defers to the source rules contained in section 861(a)(6).[33] Under section 861(a)(6), gains, profits, and income derived from the purchase of inventory property outside the U.S. and its sale or exchange within the U.S., is U.S.-source income.[34] Similarly, under section 862(a)(6), gains, profits, and income from inventory purchased within the U.S. and sold outside the U.S. is foreign-source income.[35] Determining where the sale takes place requires a determination as to where legal title passes.[36] Consider once more a sale of jeans by a Danish retailer to a U.S. consumer. Note that the jeans constitute inventory.[37] Whether the Danish retailer has U.S.-source income will therefore depend on where the sale takes place, which in turn depends on where the legal title to the goods passes.

B. Basic Scheme of Danish International Taxation

Similar to the U.S., Denmark has also implemented both source-based taxation and residence-based taxation. Under section 4 of the Danish State Tax Act (DSTA), the Danish government can tax its residents on any income, regardless of origin and form.

As for source-based taxation and its categories of economic activity, consider again the sale of jeans by a U.S. retailer to a Danish consumer. The Danish Withholding Tax Act (DWTA) contains the relevant rules for determining if and how the retailer will be taxed on the Danish-source income. Under section 2(1)(4) of the DWTA, income from the sale of goods is subject to taxation in Denmark only if the place from where the sale originates constitutes a business with a PE. A number of factors are relevant in making this determination, such as the level of economic activity and the independence of the seller from the American retailer. As such, where the sale takes place is also important under Danish law. Consequently, although the DWTA does not make taxation dependent on the place where legal title passes, this aspect is helpful in determining whether a sale is subject to taxation under the DWTA. Even if legal title passes within Denmark, the place of the sale must still rise to the level of a PE, before Denmark subjects the proceeds to taxation. Whether the U.S. retailer has Danish-source income depends on where the sale takes place, which in turn depends on, if the place is within Denmark, whether that place constitutes a PE.

C. Brick-and-Mortar Vs. Click-and-Mortar

As noted above, for inventory the IRC applies a place of sale rule to determine source, with the place of sale being where the legal title passes.[38] Similarly, the DWTA makes the place of sale determinative: Only if the place of sale rises to the level of a PE is the sale subject to taxation under the DWTA. Returning to our fictitious retailer, if, for example, it was an Italian retailer that had a place of business in the U.S. or Denmark, it would have U.S.- or Danish-source income. If, however, the sale takes place at the retailer's location in Italy, the sale would generate neither U.S.- nor Danish-source income.[39]

But what would result if the sale were completed by the U.S. or Danish consumer navigating onto the Italian retailer's website, which had been translated into English or Danish, and then received the jeans through the mail? It seems most logical to conclude that legal title to the jeans passes in Italy,[40] and thus, under IRC section 861(a)(6), the transaction does not give rise to any U.S.-source income. Also, since the retailer is not physically present in Denmark, there are no factors that would support a finding of a PE. Thus, under these facts, the Italian retailer would have neither U.S.- nor Danish-source income. But notice what has happened. Instead of setting up a bricks-and-mortar store to derive revenue from U.S. or Danish consumers, the retailer has set up a click-and-mortar store with much the same result, except that the retailer is no longer subject to either U.S. or Danish taxation. Section V.B of this article shows how the existence of a treaty may

[30] *Id.*

[31] Treas. reg. section 301.7701(b)-2(c).

[32] IRC section 865(b).

[33] *See id.* at section 865(b)(2).

[34] *Id.*

[35] *Id.* at section 862(a)(6).

[36] *See* Treas. reg. section 1.861-7(c); Steines, *supra* note 3 at 161.

[37] *See Black's Law Dictionary* (8th ed. 2004), ''inventory'' (defining inventory as goods held by a retailer for sale to consumers); *cf.* UCC section 9-102(a)(48).

[38] An exception to this general rule can be found in section 865(e)(2). Under that provision, even when title passes outside the U.S., a foreign person's income from the sale of inventory or other personal property is U.S.-source income, if a U.S. office materially participates in the sale. IRC section 865(e)(2)(A). This exception does not apply if a foreign office materially aides in the sale, and the goods are destined for foreign consumption. IRC section 862(2)(B). There are other source rules; however, under the facts of the hypothesis and assumptions made, they do not apply in this instance.

[39] *See* IRC section 865(b)(2); DWTA section 2(1)(4).

[40] This holds true even if the jeans never arrive at their destination, and the Italian retailer reships another pair of jeans after the customer's complaint. Presumably, the transaction is subject to free on board or similar rules, and the fact that the retailer would resend items that never arrived is probably due to EU consumer protection laws or internal company policy, rather than rules regarding passage of legal title.

help curtail such results, but as will also be seen, current treaties leave much to be desired regarding an effective international tax regime of e-commerce transactions.

D. The PE Requirement

When a treaty governs, its provisions determine whether source-based taxation is permissible. Thus, whether the jeans retailer is subject to taxation in the country of sale depends on whether the retailer's activity rises to the level of a PE as that term is understood according to international tax law. The creation of the PE principle, and its inclusion in tax treaties, in part was due to a desire to strike a fair balance between source countries' desire to tax commercial activity within their territory and residence countries' desire to tax their residents.[41] The idea was that whoever benefited from an economic location ought to pay taxes to that location.[42] The term ''trade with a fixed place of business,'' the predecessor to the PE concept, was introduced in the first international tax treaty between Austria-Hungary and Prussia in 1899.[43] The intention was to avoid double taxation of the same income under the system of different sovereigns.[44] The judicial branch of Prussia required the existence of a physical location, as well as a sizable business activity in the source state, before that state could tax the income in question.[45] As such, PE principles and corollary rules have helped minimize one of international taxation's central concerns, namely double taxation.[46] It is clear, however, that the risk of double taxation cannot be completely eliminated because situations exist when two countries apply different rules for determining the tax base, or when more than one country asserts jurisdiction over the taxpayer. The flip side of double taxation is that a transaction may go untaxed altogether. As one author explains, the same principles that guide the avoidance of double taxation also attempt to prevent nontaxation.[47]

As explained previously, Danish national tax law operates with a PE principle almost identical to the one found in international tax treaties. In fact, both commentators and the legislature have stated that the principle in national law should be understood and interpreted in accordance with its OECD twin.[48] An independent analysis of the term ''PE'' under Danish national law would be futile for this article's analysis, because if there is a PE under the OECD model treaty, it should follow that a Danish court or tribunal should similarly find the existence of a PE under national law.[49] It is important to note that the contrary is not necessarily true.

What is true, however, is that a PE is of significant fiscal importance in the tax-treaty-heavy world we live in. When a treaty governs, ''it supplants the taxing nexus of the domestic tax law of the host country.''[50] According to the Denmark-U.S. tax treaty, which is identical to the OECD model treaty in this respect, a PE ''means a fixed place of business through which the business of an enterprise is wholly or partly carried on.''[51] It goes on to state that ''the term 'permanent establishment' includes especially: a) a place of management; b) a branch; c) an office; [and] d) a factory.''[52] Also, a PE will exist where a dependent agent performs activities within the source country, provided that the agent habitually exercises authority to execute contracts on behalf of the principal.[53] What should be evident from this language is that a PE in the traditional sense requires some physical presence within the source country. As such, transactions that take place wholly through the Internet present interesting issues as to the taxation of the sale of goods by a Danish retailer solely to U.S. customers through a website maintained in Denmark.

V. E-Commerce Transactions

A. What Constitutes an E-Commerce Transaction

E-commerce transactions have many different definitions.[54] For example, the U.S. Internet Tax Freedom Act defines e-commerce as:

> any transaction conducted over the Internet or through Internet access, comprising the sale, lease, license, offer, or delivery of property, goods, services, or information, whether or not for consideration, and includes the provision of Internet access.[55]

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[41] *See* Cockfield, *supra* note 3, at 1180 (explaining further that the rule presented a compromise between the interests of net exporting nations, which derive revenue from taxing the corporation at the production stage, and net importing nations that derive revenue from taxing the actual sale to the end consumer).

[42] Richard L. Doernberg et al., *supra* note 19, at 249.

[43] *Id.*

[44] *Id.*

[45] *Id.*

[46] *See* Subhajit Basu, *Global Perspectives on E-Commerce Taxation Law* (2007), 29 (explaining the issues regarding double taxation, and how different countries' tax regimes, as well as various tax treaties, attempt to prevent such a result).

[47] *See id.*

[48] *See, e.g.*, Aage Michelsen et al., *Lærebog om Indkomstskat* (13th ed. 2009), 738.

[49] *Cf.* SKM2010.257.SR (in which the tax tribunal, in determining whether the economic activity amounted to a PE under section 2(1)(4) of the DWTA, explicitly relied on how ''PE'' is defined in the OECD model treaty and its commentaries).

[50] John Huston and Lee Williams, *Permanent Establishments: A Planning Primer* (1993), 1.

[51] Denmark-U.S. tax treaty, article 5(1).

[52] *Id.* at article 5(2).

[53] *Id.* at article 5(5).

[54] *See, e.g.*, Basu, *supra* note 46, at 14.

[55] P.L. 105-277, section 1105(3) (1998).

This article uses a slightly narrower definition of the term. Thus, e-commerce may properly be defined as commercial digital transactions that cross state or national borders facilitated by computer networks and the Internet.[56] For example, a consumer in the U.S. who purchases a pair of jeans from a Danish retailer's website engages in an e-commerce transaction.

B. E-Commerce Transactions Under a Treaty

As previously discussed, the purchase of jeans by a Danish retailer to a U.S. consumer over the Internet does not, under the IRC, generate U.S.-source income. Reversing the roles would similarly not create Danish-source income taxable in Denmark. The question is, however, whether a tax treaty could change the result. Does the fact that the Danish retailer targets U.S. customers change the conclusion that no U.S.-source income is generated on the sale? Absent a fixed place of business in the U.S., it seems that the retailer does not reach the threshold requirement of a PE.[57] Moreover, while the Denmark-U.S. tax treaty does not, by its language, specifically exclude from being a PE other types of business activity than those enumerated in article 5,[58] it probably would be difficult to argue that based on these facts, the Danish retailer would ever meet the PE requirement. But if we take this result to its logical conclusion, a U.S. company could set up base in Europe and sell goods through Internet transactions only to U.S. customers, without ever being subject to U.S. taxation. Thus, with the development of e-commerce, the Danish retailer can now do what it could not before conducting e-commerce was possible. That leaves the current international tax law open for abuse.

The OECD has taken steps to prevent such abuse by reinterpreting a PE.[59] Under the OECD's interpretation, computer servers may, under limited circumstances, constitute a PE.[60] More specifically, if an entity carries on a business through the Internet, and the entity can exercise control over the server on which its website is stored, the location of the server may constitute a PE.[61] The commentaries go on to state that in addition to the entity being able to exercise control over the server, a PE will exist only if the server is fixed in the location, which requires the server to remain at a specific location for a minimum duration.[62] When the entity is merely paying an Internet service provider to host its website content on the Internet service provider's (ISP) server, however, the activity does not give rise to a finding of a PE.[63] Note also that the use of an ISP will not give rise to a PE under article 5(5) of the OECD model treaty, because the ISPs do not fall within the definition of dependent agent. This is so because they lack the authority to execute contracts on behalf of the website-owning entity.[64] Since a company has the option of renting space on a server owned by an independent ISP, which is often the case, the OECD's broad interpretation of PE misses the target.[65]

Also, even when a company has ownership or control over the server on which its website is stored, it may simply choose to place that server in a jurisdiction with low or no taxation.[66] In a similar vein, because servers are highly mobile, a company that owns its own server, or has the power to exercise control over it, could move it around to defeat a finding of PE altogether.[67] While the OECD has clearly acknowledged this issue, it seems to fail to fully appreciate it.[68]

As noted, only when a server is actually moved, not just a possibility of it moving, may it serve to defeat a finding of PE.[69] If a finding of a PE depends on whether the server is actually moved, and because it is fairly easy to migrate a website from one server onto another, companies may regularly engage in such practices so as to never have a PE anywhere. Thus, while the OECD has recognized some of the challenges e-commerce raises regarding international taxation, its insistence on using existing tax principles falls short of a comprehensive approach to the taxation of international e-commerce. Any failure to address the issue could have substantial fiscal consequences.

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[56] *Cf.* Basu, *supra* note 46, at 14.

[57] *See* Denmark-U.S. tax treaty, article 5.

[58] *See id.* at 5(2).

[59] *See* Commentary on the Articles of the 2008 OECD Model Income and Capital Tax Convention article 5, paras. 42.1-42.10 (hereinafter OECD model treaty commentaries).

[60] *See id.* at para. 42.3.

[61] *Id.*

[62] *Id.* at para. 42.4.

[63] *Id.*

[64] *See id.* at para. 42.10.

[65] *See* Basu, *supra* note 46, at 13 (explaining that a corporation wishing to do business through the Internet may as soon rent server space from an independent ISP, than own or lease its own server).

[66] *See* Arthur J. Cockfield, ''Designing Tax Policy for the Digital Biosphere: How the Internet Is Changing Tax Laws,'' 34 *Conn. L. Rev.* 333, 335 (2002).

[67] *See id.* (arguing that ''the mobile nature of servers and related income-producing computer code has significantly diluted the traditional physical presence test''); Kyrie E. Thorpe, ''International Taxation of Electronic Commerce: Is the Internet Age Rendering the Concept of Permanent Establishment Obsolete?'' 11 *Emory Int'l L. Rev.* 633, 651 (1997) (explaining that ''the relatively mobile . . . configuration of the Internet is leading to much confusion as taxation officials attempt to apply traditional international tax treaty concepts,'' such as permanent establishment, to e-commerce, because the location of servers is irrelevant since they can be accessed by users around the world).

[68] *Cf.* OECD model treaty commentaries, para. 42.4.

[69] *Id.*

VI. New Approaches

The OECD, the Danish National Tax Board,[70] and the U.S. Treasury Department[71] want to use existing tax principles regarding the taxation of e-commerce.[72] However, existing tax principles may not work for all aspects of international taxation of e-commerce, specifically the PE issue.[73] A new framework is needed to balance the legitimate interests of the residence country on the one hand, and the source country on the other, to tax income generated by the existence of the source country.

A. Electronic Consumption Tax Intermediary

One solution to the PE issue as it relates to e-commerce transactions would be to implement a consumption-based tax on all e-commerce transactions, combined with the use of modern technology, to convert the problem into the solution.[74] Consumption tax is a tax imposed on sales of goods or services to be consumed, at the place where the goods are sold or services are rendered. Under this model, all transactions would be taxed at the time of sale regardless of the amount of revenue gained from the activities, but treaty parties would be free to determine the tax rate to any given transaction. Further, all treaty parties would need to require their domestic online retailers to register with an electronic tax collection intermediary.[75] When a sale is made online, the purchaser must input his location. That information is then sent to the electronic tax collection intermediary, who in turn determines the applicable tax rate for the transaction based on official information from the country in question.[76] The tax rate is determined based on the consumer's location and for intangible purchases such as downloadable software. This solution is therefore an implementation of a sales tax.[77] This information is then sent back to the retailer's website, where the consumer will be informed of the retail price for the specific item, and applicable tax.[78] All these steps take place instantaneously through the use of existing technology. When the consumer later pays the total price, the part of the payment that consists of the sales tax is then automatically remitted to the electronic tax intermediary, which in turn remits the payment to the source country's tax authorities.[79] The task of the electronic intermediary could be handled by any of the existing companies whose business is to facilitate online purchases, such as PayPal.

Note that a sales tax is closely akin to a VAT. The main difference between the two is the method through which it is determined. While a traditional VAT is a cascading tax imposed at each stage of manufacture or distribution, a sales tax is generally imposed only on the final stage of consumption. The tax incidence of a VAT, however, is placed on the consumer, by increasing the price of the goods or services purchased. Consequently, for both types of taxes, it is the consumer who ultimately bears the tax burden. As such, the two types of tax levying mechanisms could easily collide, and an implementation of the proposed solution would therefore have to be done in such a way to not conflict with Denmark's obligations under the EU VAT directive.

The following example shows how the solution would work in practice. Consider Carl Consumer, a resident of the U.S., who is shopping online for a new pair of jeans. Assume further that the e-commerce consumption tax rate in the U.S. on clothing is 25 percent. Carl navigates to clothingrus.com, an online clothing retailer based in Copenhagen. Carl selects a pair of jeans costing $100, and continues to the online checkout. In the address field, Carl indicates that he resides in the U.S. When he navigates to the next page of the checkout, the system will inform him that the final price, excluding handling and shipping, is $125. Carl then remits the purchase through an authorized electronic taxation intermediary, such as PayPal. The automated billing system that PayPal has in place then instantaneously separates the payment into two parts. One part, the $100, goes to clothingrus.com, while the other part, the $25, is transmitted to a newly established e-commerce department of the IRS.

While this solution involves double taxation, it does not involve double taxation in the traditional international taxation sense. The sale of the item is clearly being taxed twice, once when the item is purchased, and a second time through the annual taxation of the retailer. Yet, while double taxation traditionally involves the retailer being taxed twice, here it is the consumer who bears the tax burden in the first instance. While perhaps unacceptable to some U.S. legislators,

[70] *See, e.g.*, SKM2008.646.SR.

[71] *See* U.S. Dept of the Treasury, Office of Tax Policy, ''Selected Tax Policy Implications of Global Electronic Commerce'' 1, at 4 (Nov. 1996), *available at* http://www.ustreas.gov/offices/tax-policy/library/internet.shtml.

[72] *See* OECD Commission on Fiscal Affairs, ''Electronic Commerce: Taxation Framework Conditions'' (Oct. 1998), 3, at 4 *available at* www.oecd.org/dataoecd/46/3/1923256.pdf.

[73] *See* Cockfield, *supra* note 66, at 333, 384-385; Cockfield, *supra* note 3, at 1181; Thorpe, *supra* note 67.

[74] This solution is heavily inspired by the Streamlined Sales Tax Project, as that project is explained by Arthur J. Cockfield. *See* Cockfield, *supra* note 66, at 387-390, 397-400; *see also* Cockfield, *supra* note 3, at 1221-1263.

[75] *Cf.* Cockfield, *supra* note 66, at 388-389.

[76] *Cf. id.* at 398.

[77] *Cf. id.* at 359 (noting that the EU has acknowledged the necessity and inevitability of a sales tax, or VAT, in the e-commerce transaction context).

[78] *Cf. id.* at 398.

[79] *Cf. id.* at 359.

EU member states and other countries with a VAT system should find the model somewhat familiar.[80] The model effectively eliminates the uncertainties involved in relying on a PE, while balancing the interests of both the residence and the source country. Moreover, the solution also entails a high degree of administrative efficiency and simplicity.

The main objection to the solution is from a neutrality perspective. It may be argued that leaving it up to each treaty party to determine the applicable tax rate makes the system as neutral as any sales taxes levied on traditional transactions, thereby maintaining a status quo. This will only be true, however, if the treaty parties apply the same tax rate to e-commerce transactions as to bricks-and-mortar transactions. As this will likely not be the case for example, if the resident country has no national sales tax system like with the U.S., the system would heavily favor one country over another. Because of the ease with which Carl could probably find an identical pair of jeans from a national online retailer, the 25 percent sales tax would greatly affect his decision not to purchase the jeans from the Danish retailer, but instead invest a little more time and find a suitable replacement pair of jeans at a national online retailer. It would be possible to design a system that included a high level of neutrality, but it would be one that would likely be impossible to implement. It would require all treaty parties to agree on a uniform sales tax percentage that all parties would levy. Also, this sales tax would have to apply equally to national and international online purchases. That last point makes such a system difficult to implement. Recall that tax treaties only determine who may impose a tax on a given economic activity. They do not generally govern how that economic activity may be taxed,[81] and they certainly do not govern how economic activity that is of a purely national nature should be taxed. Increasing the level of neutrality of the consumption tax solution would require a regulation of purely national tax law, which in this instance would likely be unfeasible.

B. E-Commerce as a New Source Classification

Determining the source of income is paramount in international taxation.[82] A second possible solution to dealing with the taxation of e-commerce transactions is to create a new income classification that covers all e-commerce transactions. The solution is similar in effect to the one proposed in Section VI.A of this article, in that taxation would be based on the purchaser's residence. The solution proposes the use of rules applicable to sale of inventory under U.S. law.[83] In determining the place of sale, however, the passage of legal title should not be controlling. If this were the case, we would be back to where we started. Instead, place of sale should be the buyer's place of residence. The proposed rule would require first a determination as to whether a sale is facilitated through the use of e-commerce. If it is, the rule would source any income derived from such a sale at the buyer's residence. The rule thereby creates a new source classification — e-commerce transactions. Under the rule, e-commerce-source income is taxed at the buyer's residence only. Such taxation could be done either through an electronic tax intermediary akin to the one described above in Section VI.A, or through something a little more familiar, namely withholding.

E-commerce transactions warrant a different approach to the place-of-sale determination than do other sales of inventory. As previously explained, absent any applicable rules, e-commerce allows a retailer to effectively escape source country taxation, for example, by establishing a ''U.S. presence'' for its goods through a website stored on a server outside the U.S.[84] Absent e-commerce, the only way the retailer could establish the same kind of economic presence for its goods on the U.S. market would be to set up shop, directly or indirectly, in the U.S. As such, application of the passage of legal title principle to e-commerce would simply leave too much room for abuse.[85]

A buyer's residence rule allows online retailers to control the tax jurisdictions to which they expose themselves. Retailers can choose to limit the destinations to where they will send their goods. This solution also effectively limits the uncertainties involved with a PE and takes into account the interests of both the source and residence country. Since there are no other factors or thresholds that must be met under this solution in order for the buyer's country to levy a tax on the transaction, in the interest of tax simplicity, it heavily favors the source country over the residence country. This fact is one of the solution's greatest obstacles. An e-commerce seller generally needs to use the infrastructure of the buyer's place of residence to

[80] *See id.* (noting the ongoing debate between U.S. legislators whether *any* VAT system should ever be implemented).

[81] This is not to say that a treaty never includes a provision as to the given tax rate. For example, article 10 of the Denmark-U.S. tax treaty includes provisions that allow for a specified tax percentage on dividends in some circumstances.

[82] *Cf.* Isenbergh, *supra* note 2, at 29 (''the concept of source of income is essential mortar — if not the keystone — in the U.S. system of international taxation'').

[83] *See* IRC section 865(b)(2); *see also supra* notes 34-37 and accompanying text.

[84] *See supra* Section V.B.

[85] Traditional sales of inventory are also open to abuse because the parties can generally determine where legal title passes. It must be acknowledged, however, that there is an inherent difference between sales taking place face to face and sales conducted entirely through the Internet, as this article has shown, and the former is not susceptible to the same magnitude of abuse as are e-commerce transactions. *Cf.* Isenbergh, *supra* note 2, at 48-49.

effectuate the sale.[86] It is questionable, however, whether the seller's taking advantage of that infrastructure is a sufficient basis to levy tax.

First and foremost, this solution lacks proportionality by instituting a blanket tax rule for e-commerce transactions. Also, if the solution adopts a withholding tax approach, it would be inconsistent with an income tax, since the system would tax the seller on a gross income basis.[87] It may be argued that under the Denmark-U.S. tax treaty, a similar outcome results from article 10 regarding withholding tax on dividends. The income subject to article 10 is, however, a passive form of income, as opposed to income from the sale of goods, which is properly considered an active form of income.[88] Moreover, a withholding tax on e-commerce would be a tariff in disguise, which by its very nature is an inefficient method of taxation.[89] On the plus side, however, withholding tax is generally a simple and effective tax-levying mechanism.[90] Yet, while simple on the surface, classifying e-commerce as a new source is unfair and is inconsistent with the general determination of the income tax base.

C. Virtual PE

Although not a viable solution, it is appropriate to briefly discuss Luc Hinnekens's idea of a virtual PE. Even Hinnekens seems to find the idea unworkable,[91] making his discussion more of an academic exercise, possibly as a way to stimulate conversation on the problem of PEs and e-commerce. The PE principle, with its requirement of physical presence, was sound in a world where goods and services could be bought and sold only through face-to-face encounters. Repeated business demanded that the seller be physically present for an extended period of time within the buyer's territory. As the economy evolved and became mobile, however, the need for physical presence within the buyer's sphere eroded. Consequently, Hinnekens has suggested doing away with the physical presence requirement, and adapting the scope of the excluded ancillary activities.[92] He suggests implementing a system under which one could find a PE fiction, otherwise known as virtual PE.[93] The existence of a virtual PE would require a continuous, systematic, and focused performance of core business activities in the potential source country, which, according to the theory, could be where the server is located within that country.[94]

The theory suggests an alternative framework that excludes reliance on servers, but that is also why it fails. The theory suggests that a finding of a virtual PE could be based on the same test that U.S. courts use in determining whether a state court can exercise personal jurisdiction over an out-of-state defendant under the due process clause of the 14th Amendment to the U.S. Constitution. This three-prong test, based on the seminal U.S. Supreme Court case *International Shoe*,[95] requires the defendant to have some kind of minimum contact with the forum state. Unfortunately, however, as a substitution for the current regime, the *International Shoe* test suffers from a number of shortcomings.[96] Although its first requirement — that the seller must benefit, in one way or another, from the source country — is sound, the remaining two requirements would not help alleviate the problem at hand. The second prong, adapted to a virtual PE, requires the seller to have operations within the source country, while the third prong requires the seller's in-state activities to be continuous and systematic, as part of the seller's overall business within the state. As should be evident, these two prongs require the seller to have some kind of physical presence within the source country.[97] You can neither have operations nor systematic activities within a state without you or your employees or agents being present in that state.[98] Thus, a virtual PE based on *International Shoe* would simply re-implement a physical presence requirement that, although not as stringent as the physical requirement under article 5's PE, would still require some kind of physical presence by the vendor before the vendor would be subject to taxation in the buyer's state. That in turn might help alleviate some of the tax problems related to e-commerce transactions, but it does not present a viable solution to the issue at hand.

D. Substantial Revenue Purposefully Derived

Although a virtual PE is, as Hinnekens suggests, a fiction, its basic idea of doing away with a physical requirement to find a PE is sound. The last solution this article proposes, which also is the one it endorses, concerns eliminating the need for physical presence.

[86] This might not be the case, especially if the item in question is an intangible such as software, a video, or a music file.

[87] *See* OECD Tax Policy Studies, *supra* note 14, at 130.

[88] *See id.*

[89] *Id.*

[90] *Id.* at 130-131.

[91] *See* Doernberg et al., *supra* note 19, at 354.

[92] *See id.* at 351-352.

[93] *Id.* at 351.

[94] *Id.*

[95] *International Shoe v. Washington*, 326 U.S. 310, 316 (1945).

[96] Hinnekens does not analyze these shortcomings, perhaps because he believes they are too obvious.

[97] *See* Nathaniel T. Trelease and Andrew Swain, ''Nexus and Remote Sellers: The Taxation of Electronic Commerce,'' *Colo. Law.* Vol. 31, No. 2, Feb. 2002, at 75, 76 (explaining that generally, e-commerce vendors that deliver their goods through common carriers are exempt from sales and use tax liability because of the general lack of physical presence).

[98] *Cf. Quill Corp. v. North Dakota*, 504 U.S. 298, 311-312, 314 (1992).

This solution as it relates to e-commerce transactions focuses on the revenue purposefully derived from the source country, and the connection the seller has to, and the activities the seller conducts regarding, the source country. The starting point is a model similar to the one under the IRC, in which a foreign resident is taxed on income that is effectively connected with a U.S. trade or business.[99] There is at least one problem with adopting this model to apply to the matter at hand, however. First, while U.S. trade or business is not defined in the IRC, it is generally understood to mean a certain level of economic activity within the U.S.[100] To conduct business ''in the U.S.,'' legal title probably must pass inside the U.S.[101] Since legal title to goods in e-commerce transactions probably passes at the seller's place of business, using this standard would not provide a more meaningful result than having servers constitute a PE.[102]

Instead, we could use the IRC and create a different framework that is not tied to legal title. If the e-commerce retailer purposefully derives substantial revenue from the source country, it seems fair to tax the retailer on income derived from that source country because the retailer has availed itself of the resources of the source country in generating its income.[103] Interestingly, the U.S. Supreme Court has struck down a similar tax principle on constitutional grounds.[104] In *Quill Corp. v. North Dakota*, the Court reaffirmed a longstanding rule that in order to establish the required nexus under the dormant commerce clause[105] such that the jurisdiction in question could tax the vendor, the latter had to have physical presence within the taxing jurisdiction.[106] This does not necessarily prevent the implementation of a taxation model based on a retailer purposefully availing itself of the source jurisdiction. The Court noted that Congress was free to disagree with its line of reasoning by statutorily overruling the Court's determination as to the burden on interstate commerce.[107]

There are several factors that could be considered in determining whether an e-commerce vendor has availed itself of the source country in order to derive revenue from the sale of goods. Taxation of this category of income could, for example, be primarily determined based on the percentage of revenue collected by the retailer from the source country as compared to its annual overall revenue. A threshold of 25 percent of annual sales could be established, such that our Danish retailer would be subject to U.S. taxation, only if its combined annual revenue from the website in question consisted of at least 25 percent in sales to U.S. customers.[108] This threshold percentage would need to be regressive, meaning that the larger the overall revenue of the company, the smaller the threshold. This should further be combined with threshold amounts to prevent giving large companies an advantage over small and midsize companies. For example, a company like Dell Computers, whose business consists primarily of selling computers and related hardware and software through its website, posted revenues of $61 billion for the 2008 fiscal year.[109] Ignoring that Dell also derives revenue from bricks-and-mortar stores, if the threshold was set at 25 percent, Dell would have to sell for a minimum of $15.25 billion to Danish consumers, before having a PE in Denmark. Even if the threshold percentage were regressive down to 1 percent, Dell would still have to sell for $600 million to Danish consumers before we could consider whether Dell had a PE in Denmark. For this reason, the threshold percentage must be combined or substituted with two threshold amounts.

Borrowing from principles from the Danish Financial Statements Act,[110] a company whose annual revenue exceeds a regulated threshold of, for example, $1 billion would be purposefully deriving revenue from another country, if the company's revenue from that other country exceeds another regulated threshold amount, for example, $50,000. Thus, a company could have a PE within a source country through two different means:

- the company's revenue from the source country exceeds a percentage of the company's total annual revenue; or

[99]*See* IRC sections 871(b), 882(a).

[100]*See* Isenbergh, *supra* note 2, at 93-101; *cf. Comm'r v. Spermacet Whaling & Shipping Co., S/A*, 281 F.2d 646, 651-652 (6th Cir. 1960) (explaining that for a taxpayer to be engaged in a U.S. trade or business, it must be regularly and continuously engaged in transactions in the U.S.).

[101]Isenbergh, *supra* note 2, at 100.

[102]*See supra* note 42 and accompanying text.

[103]*Cf.* Cockfield, *supra* note 3, at 1223 (giving a number of reasons why it is fair to allow the source country to tax e-commerce transactions that are connected to its jurisdiction, absent an application of the PE principle).

[104]*Quill Corp. v. North Dakota*, 504 U.S. 298, 311-312, 314 (1992).

[105]U.S. Constitution, Article I, section 8, cl. 3.

[106]*Quill Corp.*, 504 U.S. at 311-312, 314.

[107]*Id.* at 318. The constitutional analysis of *Quill Corp.* is a topic for a different paper.

[108]Compare the so-called 25 percent rule contained in IRC section 861, under which dividends paid by a foreign corporation, provided that more than 25 percent of the corporation's gross income is effectively connected with a U.S. trade or business, is U.S.-source income in the proportion that its effectively connected income bears to its total income. IRC section 861(a)(2)(B).

[109]*See* ''Dell Fiscal Year 2008 in Review,'' *available at* http://content.dell.com/us/en/corp/d/corp-comm/ir-FY08-in-Review.aspx?c=us&l=en&s=corp&redirect=1.

[110]*See* the Danish Financial Statements Act section 7 (dividing companies into four accounting classes determined by the company's annual revenue).

- the company's annual revenue exceeds one threshold amount, and the company's revenue from the source country exceeds another threshold amount.

Schematically, the system would look like the one shown in the table.

Revenue-Based PE Thresholds

Total Annual Revenue (Million $)	Threshold Percentage	Threshold Amount (Thousand $)
0-1	25%	N/A
1-5	20%	N/A
5-10	15%	N/A
10-50	10%	N/A
50-100	5%	N/A
100-1,000	1%	N/A
>1,000	N/A	50

Note: The threshold numbers are for exemplification only.

Accordingly, if Dell's total annual revenue was $50 million, Dell would be purposefully deriving revenue from Denmark if Dell's Danish-source revenue equaled at least $2.5 million (5 percent of $50 million). If instead Dell's total annual revenue exceeded $1 billion, Dell would be purposefully deriving revenue from Denmark if Dell's Danish-source revenue exceeded $50,000.

An Internet proxy can be used to hide a computer's, and thereby a consumer's, Internet Protocol (IP) address. The IP address is the mechanism through which the physical location of the computer can be determined. If a substantial number of Dell's Danish consumers accessed Dell's website through a proxy located in another country, it is possible that the above-outlined approach would give that third country permission to tax the income in question, even if it was in reality Danish source. Yet, proxy servers are used for two reasons: to hide activity online, and to bypass local network restrictions that make some sites unavailable. It would make little sense to hide one's IP address when making online purchases because the purchased items must often be sent to a physical address. Even when purchasing intangibles, however, the necessary payment details would require the purchaser to input its address. Moreover, the security of Internet proxies is questionable, and one would be ill-advised to transmit credit card information via a proxy. Thus, this is a nonissue for purposes of this analysis.

A solution that implements threshold amounts and percentages would effectively eliminate the need to determine taxation based on any physical presence, while taking into consideration the legitimate interests of the source country to tax activities that are connected to its jurisdiction. At least one additional factor must be present, however, before it would be acceptable to tax the Internet retailer. E-commerce allows anyone anywhere with an Internet connection to purchase anything for sale online from a vendor regardless of the vendor's location.[111] An online retailer could therefore find itself subject to taxation in a country it had never heard of before.[112] Thus, it must be required that the retailer not only avail itself of the country in question, but also has targeted the tax jurisdiction before tax is imposed. This is in accordance with one of the traditional rationales of PEs, in that the retailer must have taken some affirmative action to derive revenue from a given tax jurisdiction. Affirmative action could be when the website is translated into the language of the tax jurisdiction. It could also be found when the retailer has purposefully included the country among the destinations where it will ship its goods. While size of revenue from a given country could be evidence of targeting that country, it should not, in and of itself, be considered sufficient.

Thus, no factor alone should justify a finding of targeting and deriving revenue from the country in question. While a single factor could cause a brick-and-mortar store to constitute a PE, this should not apply to click-and-mortar stores, because the two are not unconditionally comparable. For example, translating a website into a specific language is different from staffing an airport shop with employees who speak the native language of the travelers. A website can be translated into 52 different languages with the click of a button. While a weighing of factors, at least in theory, makes a determination of whether a PE exists less clear, the threshold rules discussed above are aimed at diminishing such uncertainty. For example, if a U.S. retailer's revenue from Danish customers constitutes 25 percent of the retailer's annual revenue, and the website either is translated into Danish or Denmark is one of the destinations where the retailer will ship its goods, then a PE exists. The whole becomes greater than the sum of its parts.

By adding this requirement, the solution considers the interest of the residence country, in that only e-commerce transactions that rise to a specific level of economic activity are subject to taxation in the source

[111]Note that many online retailers limit not only the places to where they will ship the goods, but also the form of payment they accept. For example, some online retailers accept only American credit cards. This effectively limits the potential customer base.

[112]This could be the situation when the retailer has not specifically limited the places to where it will ship its goods by not including a drop-down menu with a list of countries in its online ordering form. Instead, these retailers permit the customer to type the destination of the goods purchased into an online ordering form.

country, and only if the retailer has targeted the source country. The solution similarly takes into account the source country's interests, in that substantial economic activity that is related to its jurisdiction may be taxed by it. Implementing this model, however, may require more participation from the residence country than is currently the case, thereby compromising administrative efficiency. It will be very difficult for the source country not only to determine the existence but also the extent of these transactions. Tax treaties therefore need to implement a reporting system under which the residence country will report to the source country any e-commerce activity that meets the threshold requirements, based on the reporting made by the taxpayer to its domestic tax authorities. This reporting system could be implemented as a natural extension of article 26 of the OECD model treaty, which is also contained in the Denmark-U.S. tax treaty, albeit in its former version.[113] An alternative, or addition to the reporting system, would be an implementation of a mechanism through which each sovereign government would keep track of sales made by individual companies to its residents. It is just about impossible to pay with cash online.[114] Thus, to partake in an e-commerce transaction, consumers must use electronic payment methods. Governments could require that the banks or other financial institutions facilitating online purchases submit yearly data on the amount of revenue residents have spent online, allocated per business.[115] This would provide potential source countries with an independent basis through which they could determine whether companies meet the test for source-based taxation as herein proposed, provided that the companies are publicly traded, or otherwise subject to financial disclosure requirements.

In addition to the reporting system, and its alternative, national tax laws would have to be amended to properly tax the income from this new PE. As noted above, tax treaties only determine who may impose a tax on a given economic activity, not how that income can and will be taxed. The income generated under the solution herein proposed can be taxed in the U.S. under IRC section 865(c)(5), and in Denmark under DWTA section (2)(1)(4), as the solution merely suggests a different framework for determining whether a PE exists. It would be advisable to amend both sections to explicitly include income generated under the ''substantial revenue purposefully derived from the source country'' test, as an extension of the traditional PE principle. This should be done to eliminate any uncertainties regarding IRC section 864(e)(2) and DWTA section 2(9), both of which address the outer limits of the traditional PE principle.[116]

For the reporting system to be effective, it would have to also include an obligation for the national tax administrations to enact an enforcement mechanism.[117] The solution that would have the least implications for public international law would be for the national tax authorities to penalize a failure to pay taxes under the solution herein proposed, as they would penalize a similar failure under national law. Also, they should be permitted to collect the taxes on behalf of the foreign sovereign, at the taxpayer's expense. Although such a system might be subject to pitfalls, it would only be put to use in the event that the taxpayer fails to properly report and pay taxes owed to the foreign government.

Some scholars may take exception to the reporting system proposed here. They may argue that a country such as the U.S., whose judicial branch heavily favors U.S. taxation, would not easily enter into an agreement requiring them to share information that would result in revenue not being subject to U.S. taxation. Moreover, even if the agreement was in effect, the recipient country has no means to verify the information received. Addressing the second issue first, it is true that the reporting system does not include a method through which the information provided could be assessed for its veracity, although the alternative approach would provide such a method for public companies. At its core, however, the reporting mechanism implicitly relies on the honor system. Credit should be given where due, and there is no reason to believe that Denmark or the U.S. would be anything but honest and forthcoming with the information they would be obligated to provide under the reporting system.

Skepticism of government can be healthy, but it can also be taken too far. While politicians may often act in their own self-interest, we do not yet live in a pure Machiavellian society. Moreover, while perhaps politically an uphill battle, the so-called Feira agreement, under which EU member states as part of the EU's overall tax policy have agreed to exchange information

[113]Any reporting system would have to be designed to neither conflict with the Danish Act on Processing of Personal Data, nor the U.S. data privacy laws, such as the Privacy Act of 1974 and the Computer Matching and Privacy Act. More likely, these laws would have to be amended to make legislative room for the described reporting system.

[114]Prepaid credit cards can be use in limited circumstances for online purchases and provide the same kind of anonymity that cash provides.

[115]Again, the system would have to be designed to neither conflict with the Danish Act on Processing of Personal Data nor the U.S. data privacy laws. Perhaps consumers would give their consent to this reporting through the general terms and conditions in their agreements with the institution in question.

[116]Both provisions address the issue of when the activities of an agent constitute a PE, and as such, in essence negatively define the PE principle.

[117]*Cf.* Svend Gram Jensen, *Skattemyndighedernes Kompetence* (3rd ed. 1997), 55 (noting that for the competent tax authorities to collect taxes under the law, they need to be equipped with so-called material authority, that is, an enforcement mechanism).

on savings income, relies on a similar honor system.[118] The member states apparently did not find the lack of an information verification method to be grave enough to prevent the Feira agreement from taking effect.

The reporting system ought to prove more beneficial to the U.S. in the long run than the current rules. If e-commerce continues to develop and increase as it has done over the previous decade, U.S. companies may move their places of business outside the U.S., for example to Denmark. They would then market and sell their products and services online to U.S. customers, deriving substantial annual profits from those customers. If these companies are no longer physically present in the U.S., with their offices and servers located in Denmark, they will never be subject to taxation in the U.S. under the current regime. If instead the solution as herein proposed was in effect, together with the reporting system, Denmark would submit the necessary information to the IRS. The system would likewise be beneficial to Denmark. Companies may use this approach to selling goods and services online to Denmark from outside Denmark, thereby never being subject to Danish taxation. Since the solution offers a quid pro quo, a country such as the U.S. has substantial fiscal interests in such a system. Moreover, the U.S. has wholly embraced the idea that information exchange is the key to properly taxing cross-border transactions, as evidenced by the Foreign Account Tax Compliance Act (FATCA).[119] Although very one-sided, FATCA is a testament to the fact that the U.S. fully appreciates the importance of cross-border information sharing as a necessary tool for proper international taxation.[120] Thus, while the solution will face a number of obstacles as it moves toward implementation, countries like the U.S. and Denmark should support its enactment, provided they do not fall prey to legislative myopia.

Obviously, the solution is not completely neutral, nor completely equitable. However, it does not seem to have any effect on taxpayer behavior, in that consumers should be indifferent whether they purchase from a U.S. or a Danish retailer, because the consumers do not suffer any direct tax burden.[121] As for the sellers, it may be argued that the solution affects them no more than the tax system currently in effect, should they choose to open a physical store within a given jurisdiction. Yet, since it is possible that a retailer will not know, until the end of the tax year, whether it is subject to taxation in the source country, the solution is not as simplistic as, say, making e-commerce a new source. Because of the threshold amounts and additional factors needed to find a PE, however, e-commerce transactions might be preferred over brick-and-mortar stores, since at least some e-commerce activity can escape source taxation. Moreover, because the determination whether either type of transaction can be taxed by the source country relies on different factors, the result is that e-commerce transactions, and consequently e-commerce vendors, will be treated differently from traditional transactions and traditional sellers. Yet this might not be a negative aspect. Only an empirical study based on an actual implementation of the proposed solution would show whether e-commerce transactions are better or worse off than their traditional counterparts.

VII. Taxation of Payment for Services

Taxation of income under a treaty does not always depend on a finding of a PE. One might think that treaty rules that are generally unaffected by technological and economic progress are not in need of a change. That belief is wrong. Moreover, technological and economic advances have exacerbated many of the problems treaty rules face. The transactions on which tax can be levied even in the absence of a PE include payment for services and payment for the use of an intangible property right. While clearly two distinctive types of assets, distinguishing between them in practice is often a daunting task. That in turn compromises the proper tax treatment of the income derived from these transactions, as they each are subject to different source rules. The discussion that follows analyzes the taxation of these transactions and determines whether there is a need for a change.

A. U.S. Taxation of Intangible Property

Under IRC section 861(a)(4), U.S.-source income includes income for the privilege of using intangible property in the U.S.[122] Absent a sale, the source of income from intangible property thus depends on where it is used. The IRC generally refers to payments for the use of intangible property as payments of rentals or royalties.[123] While section 861(a)(4) may seem clear on its face, the U.S. Tax Court has read an exception into the IRC.[124] In *SDI Netherlands*, the Tax Court held that

[118] *See* Press Release, ''Santa Maria da Feira European Council: Presidency Conclusions,'' *available at* http://www.blue-21.de/PDF/ECTaxPackage.pdf; Wolfgang Schön et al., *Tax competition in Europe* (2003), 104-105.

[119] Enacted as part of the Hiring Incentives to Restore Employment Act, P.L. 111-147 (2010).

[120] In very broad terms, FATCA requires some foreign financial and nonfinancial institutions to comply with U.S. reporting requirements and disclose information about U.S. citizens. Failure to do so would subject the payments these institutions receive to substantial withholding.

[121] This is not to say that the consumers do not ultimately bear the tax burden. Companies are likely to shift any increased tax burden onto consumers via increases in prices, thus placing the tax incidence on the consumers.

(Footnote continued in next column.)

[122] *Id.* at section 861(a)(4); *but cf. id.* at section 865(d)(1).

[123] *Id.*

[124] *SDI Netherlands B.V. v. Comm'r*, 107 T.C. 161 (1996).

royalty payments made by a foreign parent, which included royalty payments the parent had received from a U.S. subsidiary to *its* foreign parent, were not U.S. source.[125] The case involved three related companies: SDI Bermuda, SDI Netherlands, and SDI USA. SDI Bermuda licensed intangible property rights to SDI Netherlands, which in turn sub-licensed the rights to SDI USA, for the purpose of having SDI USA market and sell the intangible in the U.S. Under the contracts between the entities involved, SDI USA made royalty payments to SDI Netherlands, which in turn made royalty payments to SDI Bermuda. While the payments made by SDI USA to SDI Netherlands were clearly U.S. source under section 861(a)(4), those payments were exempt from U.S. withholding tax under the Netherlands-U.S. income tax treaty. As for the payments made by SDI Netherlands to SDI Bermuda as a result of the payments received by SDI Netherlands from SDI USA, the IRS argued that those payments were U.S.-source income, because they were paid as consideration for the use of an intangible property right within the U.S. The court rejected the IRS's position, holding that since each of the three entities had separate agreements with each other, those agreements should be honored as being independent of one another. Consequently, the payments made by SDI Netherlands to SDI Bermuda, which payment SDI Netherlands had received in part from SDI USA, ''were not 'received from sources within the United States by' SDI Bermuda.''[126]

As for the sale of intangible property, the gain is sourced at the seller's place of the residence, provided that the payment is ''not contingent on the productivity, use, or disposition of the intangible.''[127] If payment is contingent, the same rule that is applicable to royalty payments applies, that is, payment is sourced at the place of use.[128]

B. Danish Taxation of Intangible Property

Under DWTA sections 2(1)(8) and 65C, Danish-source income includes payment for the use of an intangible property right, otherwise referred to in the statute as royalties. Unlike its U.S. counterpart, however, the DWTA's focus is not on where the royalty is being used, but where the money is coming from. Thus, if the royalty payments are being made from Danish sources to a person or entity outside Denmark, the royalties are subject to withholding taxation under sections 2(1)(8) and 2(2)(6). As a further distinction between U.S. and Danish law, it follows from section 65(C)(4) that royalties do not include payments for the right to use the copyright to a literary, artistic, or scientific work.

As for the sale of intangible property, the gain is Danish-source income only if the seller is fully taxable to Denmark, or subject to taxation because it is carrying on a business through a PE and the property belongs to that business.[129]

C. Treaty Taxation of Intangible Property

Under the Denmark-U.S. tax treaty, which mirrors the OECD model treaty, royalties received by a resident of a contracting state are generally only taxable in that state, provided that the income is not effectively connected with carrying on a trade or business in the other contracting state.[130] Similarly to the IRC, royalties under the treaty include the gain on the sale of intangible property, provided that the gain is contingent on the productivity, use, or disposition of the intangible. This effectively makes inapplicable the general 30 percent and 25 percent withholding set forth in the IRC and the DWTA, respectively, which continues to apply absent a treaty.[131] If, however, the royalties are attributable to income effectively connected with carrying on a trade or business in the other contracting state through a PE, the royalties are subject to taxation in that other state as ordinary business profits.[132] The term ''royalties'' is broadly defined, and, unlike under the DWTA, includes the payment for the use of a copyright to a literary, artistic, or scientific work.[133]

D. U.S. Taxation of Compensation for Services

Under the IRC, income from the performance of services is generally taxed at the place of performance.[134] One exception to this rule is the so-called 90-day rule, under which compensation for services received by a foreign individual, present in the U.S. for 90 days or less during the tax year, is foreign source if:

- the services are performed for a foreign person who is not engaged in a trade or business in the U.S.;
- the compensation paid does not exceed $3,000; and
- the compensation is made to the taxpayer in the taxpayer's capacity as an employee of, or under a contract with, a nonresident alien or foreign entity not engaged in a trade or business within the U.S., or if for a U.S. citizen or resident or U.S. entity,

[125] *Id.* at 176-177.

[126] *Id.*

[127] IRC section 865(d)(1)(A).

[128] *Id.* at section 865(d)(1)(B).

[129] *See* Danish Act on Amortization and Depreciation sections 40(6) and 41(2).

[130] *See* Denmark-U.S. tax treaty, article 12(1) and 12(3); *see also* OECD model treaty, article 12(1) and 12(3).

[131] *See* IRC sections 871, 881, 1441, and 1442; DWTA sections 2(1)(8) and 65C.

[132] *See* Denmark-U.S. tax treaty, article 12(3), 7; OECD model treaty, article 12(3), 7.

[133] *See* Denmark-U.S. tax treaty, article 12(2).

[134] IRC section 861(a)(3).

such services are performed on behalf of an office maintained in a foreign country by persons just described.[135]

E. Danish Taxation of Compensation for Services

Although the DWTA deploys a different systematic approach than does the IRC, the taxation of income from the performance of services will generally be taxed in a similar fashion.[136] Under section 2(1)(1), income from the performance of services is taxed at the place of performance, that is, it is Danish-source income,[137] provided that four conditions are met:

- the income is within the scope of section 2(1)(1) (for example, salary and perks);
- the income is earned during an employer-employee relationship;
- the employer's tax home is Denmark, or the employer has a PE in Denmark; and
- the services are performed in Denmark.[138]

F. Treaty Taxation of Compensation for Services

Until recently, treaties explicitly placed services into two categories:

- independent services, which generally equates to performance by an independent contractor or by a self-employed individual; and
- dependent services, which generally means services performed in a capacity as an employee under the direction of an employer.[139]

In 2000, however, the OECD removed this explicit distinction from former articles 14 and 15, reasoning that article 7 already covered taxation of performance of independent services.[140] The U.S. followed suit, removing the explicit distinction from its model treaty in 2006. Denmark, however, did not jump on the bandwagon. Recent Danish tax treaties therefore continue to explicitly distinguish between dependent and independent services through provisions identical to former articles 14 and 15 of the OECD model treaty.[141] Moreover, the Denmark-U.S. tax treaty was similarly not updated to reflect both the OECD's and the U.S.'s newfound opinion about the relationship between articles 7, 14, and 15. Nevertheless, since the OECD did not intend a substantive change, the effect is negligible, if noticeable at all.

Under article 14 of the Denmark-U.S. tax treaty, a foreign resident performing independent services within a contracting state is subject to taxation in that contracting state only if the compensation is attributable to carrying on a trade or business within that state through a PE.[142] As for dependent services, article 15 adopts a general rule that such services are taxable in the country where they are performed.[143] However, the employee is not subject to taxation in the country of performance if:

- the employee is present in the place of performance for 183 days or less during the tax year;
- the compensation is paid by an employer who is not a resident of the country of performance; and
- the compensation is not paid as a result of the employer's PE in the country of performance.[144]

VIII. Intangible Property or Services

Source characterization is necessary to apply the source rules under the IRC and the DWTA. For example, income from the disposition of real property could either be payment for brokerage services rendered in connection with the sale, or gain from the sale of the asset.[145] Although it may be easy to make this determination knowing all the facts, the example illustrates the importance of characterizing the income. Focusing on the U.S. for a moment, if the situation involves the sale of real property and the property is located outside the U.S., the nonresident alien will have no U.S.-source income.[146] If the situation involves payment of a brokerage fee, and the property is located outside the U.S., but the services are performed within the U.S., the nonresident alien could have U.S.-source income, depending on the application of the exceptions

[135] *Id.*

[136] The article focuses on traditional performances of services, thus excluding income from hired labor, board member compensation, and income from consulting.

[137] Under DSTA section 4(1), a person who is fully taxable to Denmark is taxable on salary earned outside Denmark. The Danish Tax Assessment Act section 33A, however, effectively exempts foreign-source salary income from taxation in Denmark, provided specific conditions are met.

[138] Services performed on board a Danish plane or ship are performed in Denmark, regardless of the location of the plane or ship. *See* Henrik Dam, et al., *Grundlæggende Skatteret* (1st Ed. 2009), 134.

[139] *See* Isenbergh, *supra* note 2, at 55.

[140] *See* OECD model treaty commentaries article 14, paras. 42.1-42.10.

[141] *See, e.g.*, the Denmark-Serbia tax treaty (May 19, 2009), and the Croatia-Denmark tax treaty (Sept. 14, 2007).

[142] Denmark-U.S. tax treaty, article 14. The provision uses the term ''fixed base'' as opposed to ''PE.'' As noted in the OECD model treaty commentary on the repeal of article 14, ''fixed base'' is not different from ''PE.'' *See* OECD model treaty commentaries, paras. 42.1-42.10.

[143] *Id.* at article 15(1).

[144] *Id.* at article 15(2).

[145] *See* Isenbergh, *supra* note 2, at 55.

[146] *See* IRC section 862(a)(5).

to the general source rule for services.[147] The same result could follow from the DWTA.[148]

As the example suggests, characterization of income is not always a difficult task. Rental income from real property,[149] interest,[150] and dividends[151] are all fairly easily determinable.[152] The line between intangible property rights and compensation for services, however, often becomes blurred. This gray area can create uncertainties for taxpayers and courts alike. Moreover, in instances when courts venture into this Bermuda Triangle of international tax law, the outcome can sometimes be seen as a result of what the judges had for breakfast. As outlined in the previous paragraphs, the tax rules applicable to the transfer of intangible property and the rules applicable to compensation for services are vastly different, and focus on different factors. Thus, being able to identify which is which is of utmost importance. As the following discussion will show, this determination is not always easy to make.

A. Case Law Approach

Although the literature has acknowledged the issue,[153] research reveals that there are no published Danish tribunal or court cases in which the issue of distinguishing between payments for intangible property rights and compensation for services has been analyzed, let alone discussed. That is not the case in the U.S., however. But since no clear line between the two types of income has been drawn, the issue remains important in light of the Denmark-U.S. tax treaty. In the seminal U.S. case of *Ingram v. Bowers*,[154] Enrico Caruso, who was a nonresident alien,[155] recorded several songs at Victor Co.'s studio, which was located in the U.S.[156] Caruso's commitment under his contract with Victor was "to sing for the purpose of enabling the Victor Company to make phonograph records of selections rendered by him."[157] In return for his obligation, the Victor Co. would pay Caruso royalties that were directly tied to the sale of the records.[158] Since Caruso's songs were all recorded at Victor's U.S. place of business, the IRS argued that the royalties were not in fact royalties, but compensation for services.[159] As such, Caruso's income from the sales made both within and outside the U.S. of the recorded records was U.S.-source income. The estate of Caruso in contrast argued that under the contract with Victor, Caruso had licensed the rights in the recorded songs to Victor.[160] This argument would not affect the source of the income from the sale of the records within the U.S., because those sales were U.S. source, as royalties from the use of property within the U.S.[161] For income derived from sales outside the U.S., however, such income would be foreign source.[162]

The court sided with the IRS, explaining that Caruso had no property rights in the records that were made, and therefore was compensated for services performed, not for transferring an intangible property interest to Victor.[163] On appeal, the Second Circuit Court of Appeals affirmed, noting that the contracts provided that Caruso granted Victor all rights to the records, and even assuming a copyright existed in the records, it would have required Caruso to retain an interest in the recordings, which he did not.[164]

From a purely legal standpoint, with a narrow focus on the terms of the Caruso-Victor contract, and the absence of any reservations by Caruso of an intangible property right, both courts were correct. The economic realities of the case, however, could paint a different picture. Not anyone could have performed the singing Caruso performed. Similarly to Tony Bennett, it was Caruso's capabilities to control his voice, and the unique sound of his voice, that made him so valuable.[165] On termination of the contract, Caruso, and only Caruso, could direct the place where these unique attributes would be used. Applying this view, at least part of the payments received from Victor could economically be seen as payment of rents for the use of Caruso's unique singing attributes.[166] As such, even though *Ingram* was correctly decided from a purely legal standpoint, it is interesting that both courts hardly

[147] *See* IRC section 861(a)(3).

[148] *See* DWTA sections 2(1)(1) and 2(1)(5).

[149] *See* IRC sections 861(a)(4), 862(a)(4); DWTA section 2(1)(5).

[150] *See* IRC sections 861(a)(1), 862(a)(1); DSTA section 4(e); Danish Personal Tax Act section 4(1)(1).

[151] *See* IRC sections 861(a)(2), 862(a)(2); DWTA section 2(5).

[152] *See* Isenbergh, *supra* note 2, at 55.

[153] *See* Niels Winther-Sørensen et al., *Skatteretten* (5th ed. 2009), 3, 241.

[154] 47 F.2d 925 (S.D.N.Y. 1931).

[155] *Id.* at 926.

[156] *Id.* at 925.

[157] *Id.*

[158] *Id.* at 926.

[159] *Id.*

[160] *Id.*

[161] *See* IRC section 861(a)(4).

[162] *See id.* at section 862(a)(4).

[163] *Ingram*, 47 F.2d at 926.

[164] *Ingram v. Bowers*, 57 F.2d 65 (2nd Cir. 1932).

[165] *See Ingram*, 47 F.2d at 925.

[166] *See* Isenbergh, *supra* note 2, at 57. As Isenbergh explains, economists view the $100,000 compensation received by Babe Ruth during his tenure with the New York Yankees in 1927 partly as rent paid for Ruth's unique attributes. *Id.* "Without his particular combination of eyesight, wrist strength, and coordination," Ruth could hardly have earned more than $2,000 in 1927, and "the $98,000 difference can be thought of as rent from Ruth's unique physical attributes." *Id.*

contemplated the economic realities of the transaction,[167] especially considering U.S. tax law's longstanding principle of substance over form.[168] This principle is generally used by the IRS to challenge positions taken by the taxpayer. At the heart of this principle, however, lies the notion that legal technicalities should not control if the substance of a given transaction shows a reality different from the one mandated by the legal rules. Thus, just because the contractual relationship did not create any intangible property rights under the existing U.S. intellectual property law, if the economic substance of the Caruso-Victor contract showed a different reality, both courts should at least have explained why the economic realities in this instance should be ignored.

Further blurring the line between payment for service and payments for the use of intangible property are *Oppenheim v. Commissioner*[169] and *Tobey v. Commissioner*,[170] although the latter involved tangible property and did not directly involve source categorization. In *Oppenheim* an author who was a nonresident alien contracted with a U.S. publisher to provide the publisher with the exclusive rights to distribute novels by the author in the U.S., and further promised to deliver a minimum of two novels a year.[171] In return, the publisher would pay the author royalties from the sales of the novels.[172] Because the author had taken out copyrights in the U.S., the court held that despite the obligation to produce two novels a year, the royalties were in fact royalties, and not compensation for services.[173] Compare that reasoning with *Tobey v. Commissioner*.[174] In *Tobey* a U.S. citizen living in Switzerland sold his painting through a U.S. gallery.[175] As noted by the court, the artist ''create[d] according to his own inspiration, not in response to buyers' wants or taste.''[176] As such, since Tobey was not obligated to create any paintings, the income derived from their sale could be viewed, at least in part, as income from the sale of tangible property, which under U.S. law is generally either taxed based on the seller's residence,[177] or, if inventory, at the place of passage of legal title.[178] Thus, regardless of which category the paintings fell in, Tobey would be subject to taxation in the U.S. on the sale of the paintings. Nevertheless, the court held that since the paintings were the result of Tobey's personal efforts, the income was compensation for services, and not for a transfer of tangible property.[179]

It may be difficult to comprehend why the income in *Oppenheim* was not similarly controlled by whether it had come about through the author's personal efforts, or whether the author was under an obligation to create anything at all. The *Tobey* court may have anticipated such questioning when it sought to explain the IRS's position on the tax treatment of authors. According to the IRS, whether payments to an author are compensation for services or payment of royalties, depends on who holds the copyright to the literary works — the author or the other contracting party.[180] That reasoning, however, would have altered the outcome of the case. At the time of creation, Tobey owned the copyright in his paintings by virtue of the then-applicable common-law copyright.[181] The court acknowledged this conundrum by rejecting the IRS's position, holding that such rules prevent creators of tangible and intangible property from ever receiving payments for services performed.[182]

Nevertheless, the IRS's position was later implicitly affirmed in *Boulez v. Commissioner*,[183] in which a nonresident alien orchestra conductor who received payments under a contract similar to the one in *Caruso* argued that the payments received were royalties, because under existing copyright laws, performers had property rights in their recordings.[184] Even though the court agreed with the conductor's interpretation of the copyright laws, it held that a property right in intangibles arises only through the express reservation of such rights.[185] Since the conductor had failed to reserve any such rights, while transferring all such rights to the recording studio, his compensation was for services, and did not constitute royalty payments.[186]

As a final example of the confusion created by U.S. case law in this area of international tax law, consider *Karrer v. U.S.*[187] Karrer, a scientist and nonresident alien, developed a technique to synthetically create B-2

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[167]*See Ingram*, 57 F.2d at 65-66; *Ingram*, 47 F.2d at 926.

[168]*See, e.g.*, *Rogers v. U.S.*, 281 F.3d 1108, 1116-1118 (10th Cir. 2002).

[169]*See* 31 B.T.A. 563 (1934).

[170]*See* 60 T.C. 227 (1973).

[171]*Oppenheim*, 31 B.T.A. at 563.

[172]*Id.*

[173]*Id.* at 564.

[174]60 T.C. 227.

[175]*Id.* at 228-229.

[176]*Id.* at 228.

[177]*See* IRC section 865(g).

[178]*See* IRC section 861(a)(6).

[179]*See Tobey*, 60 T.C. at 235.

[180]*See id.* at 234.

[181]*Black's Law Dictionary* (8th ed. 2004), ''copyright'' (explaining that up until 1978, a property right arose automatically when the work was created).

[182]*Tobey*, 60 T.C. at 235.

[183]83 T.C. 584 (1984).

[184]*Id.* at 584-595.

[185]*Id.* at 596.

[186]*Id.*

[187]*See* 138 Ct. Cl. 385 (1957).

and E vitamins.[188] Upon the discovery, Karrer contracted with a Swiss corporation, Basle, for the commercial exploitation of his findings.[189] Under that contract, Basle had the exclusive rights to take out patents in either its or Karrer's name, but all patents taken out in Karrer's name had to be transferred to Basle on request.[190] Basle then contracted with a U.S. corporation, and because only a natural person can make patent applications in the U.S., Basle directed Karrer to take out patents in the U.S.[191] Karrer then assigned the rights to use the patents to the U.S. corporation under the direction of Basle.[192] In return, the U.S. corporation paid Karrer for the use of those patents.[193] In spite of this, the court held that the payments received by Karrer from the U.S. corporation were not royalties but compensation for services, because under Swiss law, Basle owned all of Karrer's patents under the Karrer-Basle contract.[194] As such, Karrer could not transfer any rights to the U.S. corporation, and the payments therefore had to be compensation for services performed.[195]

At first glance, the court's reasoning seems sound. If Karrer owned nothing regarding the patents, he could not legally transfer rights in those patents to a third party. Yet the intent of the parties was to the contrary. The U.S. corporation paid Karrer a percentage of the sales of products that used his technique, and those payments were designated by the U.S. corporation as royalty payments.[196] Moreover, from a purely U.S. law standpoint, Karrer, and not Basle, owned the U.S. patents to the inventions. The fact that the court's analysis made Swiss law controlling on the issue is interesting, because it effectively circumvented whatever reasons the U.S. copyright law had for requiring that only natural persons could file a patent application. Also, the court's conclusion is interesting in light of the actions taken by the parties before the suit, namely that Karrer had taken out patents in his name. If Karrer did not own the patents, as the court concluded, how could he record a patent filing designating him as the owner?

B. Implications for the Denmark-U.S. Treaty

The inconsistencies in U.S. case law unfairly favor U.S. taxation over Danish taxation. Take, for example, *Ingram v. Bowers*. If instead of Caruso, imagine that Kim Larsen had contracted with a U.S. recording studio, for the purpose of recording music for sale both within and without the U.S. Under the Denmark-U.S. tax treaty, if the payments Larsen received for recording the music in question were characterized the same way as were Caruso's payments, the result would be the same as in *Ingram* — that is, the income would be U.S.-source income either under article 14 or 15, depending on the terms of the contract. If instead the payments were properly characterized as royalty payments, the income would be taxable in Denmark alone, under article 12. Note that article 12 overrides the narrower royalty definition in DWTA section 65(C)(4), and that the latter would not apply in any event, as Larsen, a resident of Denmark, is fully taxable to Denmark on his income under the DSTA section 4(1). *Karrer v. U.S.* similarly exemplifies how the status quo favors U.S. taxation over Danish taxation. If Niels Bohr, for example, had attempted to commercially exploit his contributions to quantum theory and atomic fission, and applied for and received the necessary patents in the U.S., any payments he would receive under these patents might be characterized by a U.S. court as compensation for services. This would undoubtedly be the case if Bohr had contracted with the University of Copenhagen; Bohr was obligated to assign any patent rights to the university. If the university then contracted with a U.S. corporation for the use of Bohr's patents, but, as in *Karrer*, the U.S. corporation paid Bohr because he would own the U.S. patents to his scientific findings, the payments Bohr would receive might be characterized as payment for services. If, as in *Karrer*, the payments Bohr would receive constituted compensation for services rendered in the U.S., they would be U.S.-source income. If, however, the payments for the exploitation of a patent were properly considered royalty payments, they would be Danish-source income under article 12.

U.S. courts tend to focus on what rights the owner of the intangible property transfers to the purchaser. Generally, unless the property owner transfers all rights associated with the property, payments received for the use of the property will be characterized as royalty payments. As the discussion of the case law also shows, however, reasonable people can sometimes disagree whether any rights have been retained by the original property owner.

Moreover, requiring an explicit reservation of copyright to find that payments constitute royalties[197] seems artificial[198] and inconsistent with general contract interpretation principles. The rule is artificial because it

[188] *Id.* at 388.

[189] *Id.* at 389.

[190] *Id.*

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

[192] *Id.* at 391.

[193] *Id.*

[194] *Id.* at 395-397.

[195] *Id.*

[196] *Id.* at 391.

[197] *See, e.g.*, *Boulez v. Comm'r*, 83 T.C. 584, 596 (1984); *Ingram v. Bowers*, 57 F.2d 65, 65 (2nd Cir. 1932).

[198] *See Tobey v. Comm'r*, 60 T.C. 227, 235 (1973) (arguing that "it is plain that the character of the income does not depend upon a mechanical reading of the terms of a contract or upon the existence or nonexistence of an end product — which is, after all, an arbitrary criterion.").

conflicts with economic realities. An owner of intangible property may grant others the right to use that property, but it should follow from the initial owner's ownership rights that whatever is not explicitly transferred is retained by the owner. If Person A composes a song and grants Person B the right to use that song in connection with a TV show, as well as the distribution rights to the song, does it necessarily follow that Person A has retained no rights to use the song for other purposes? Does Person A give up all rights to the song merely because the contract between A and B is silent on the issue of whether any rights are retained by A?

All else being equal, it would seem that Person B should be the one who should be detrimentally affected by any ambiguity in the contract regarding the use of the song. Holding ambiguities against B and not A is furthermore generally consistent with the basic contract law principle that holds that any ambiguities are to be interpreted against the drafter.[199] It is reasonable to presume that the drafters of intangible property transfers or use contracts are more often the purchasers rather than the creators. Consequently, if there is any doubt whether the initial owner reserved any rights in the property transferred, the creator, and not the purchaser, should be given the benefit of this doubt. Yet the case law, as has been discussed, has sided with the purchasers on this issue.

IX. Transfer of Intangible Property

A. Reasons We Need a Change

> It is impossible . . . to lay a flat rule as to what may constitute compensation for personal services actually rendered, with respect to an intellectual product. Clearly, the weekly wage paid by a newspaper to a reporter . . . would be. Quite as clearly, the income from the use . . . of an invention . . . would not be. Somewhere in the field between these two extremes must be found for each case the place which fits its facts.[200]

While tax law is a complex area, it may seem unacceptable to many owners and creators of intangible property that the tax treatment of the commercial exploitation of their property too often turns on how the fine print in a contract is interpreted.[201] It is objectionable because it makes tax planning very difficult, and it is contrary to the tax principle of simplicity.[202] Moreover, the current approach is open to abuse. Consider the case of Kim Larsen once more. If he had a contract with a U.S. recording studio similar to the one in *Ingram v. Bowers*, to avoid both U.S. and Danish taxation all he needs to do is to record the albums outside the U.S. but not in Denmark.[203] If all the records were recorded outside the U.S. but not in Denmark, the entire compensation received would be foreign-source income, even if the records were predominantly sold in the U.S.[204]

In the case of a U.S. resident,[205] the current approach is similarly subject to abuse. To avoid having his entire compensation constitute U.S.-source income, Tony Bennett, for example, could explicitly reserve a property right in his recordings for the purpose of reducing his U.S.-source income, with the result that compensation paid for records sold outside the U.S. would be foreign source.[206] While taxpayers are certainly permitted to use creative tax planning, the current rules may lead them to distort the economic realities of a given transaction. What is needed then is a new approach.

B. Predominant Motivation and Use Taxation

As noted above, no Danish tribunal or court has addressed the distinction between payment for services and payment for the use of intangible property rights. As such, since the status quo unfairly favors U.S. taxation because of U.S. law, the focus of change should be on the U.S. Adhering to Occam's razor, according to which the simplest solution is often the correct one, the proposed change offers a simple method that in essence requires the income to be taxed where it is effectively earned.

The proposed change finds its inspiration in a solution presented by some scholars to address a perceived shortcoming in the source rules resulting from the development of new technologies. To alleviate these concerns, it has been suggested that the U.S. Congress replace the current national source rules with rules based on intangible property.[207] Instead, it should adopt a regime with a source rule that focuses entirely on the

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[199] *See, e.g.*, *U.S. v. Trujillo*, 537 F.3d 1195, 1200 (10th Cir. 2008); *Royal Ins. Co. of Am. v. Orient Overseas Container Line Ltd.*, 525 F.3d 409, 425 (6th Cir. 2008). This is known in Danish contract law as *koncipistreglen*.

[200] *Oppenheim v. Comm'r*, 31 B.T.A. 563, 564 (1934); *see also Tobey*, 60 T.C. at 232 (citing *Oppenheim*, 31 B.T.A. at 564).

[201] *See Tobey*, 60 T.C. at 235.

[202] *See* Malman et al., *supra* note 18, at 12 (explaining the desire for simplicity in designing a tax regime, because taxpayers should be able to understand the law and comply with it, and complexity leads attorneys and accountants to spend time finding loopholes).

[203] *See* Isenbergh, *supra* note 2, at 58.

[204] *See* IRC section 862(a)(3) (stating that compensation for services performed outside the U.S. are foreign-source income).

[205] *See id.* at section 865(g).

[206] *See id.* at sections 862(a)(4), 865(d); Isenbergh, *supra* note 2, at 59.

[207] *See* Erin L. Guruli, ''International Taxation: Application of Source Rules to Income From Intangible Property,'' 5 *Hous. Bus. & Tax L.J.* 204, 235 (2005) (citations omitted).

place of use of the intangible, regardless of whether the transaction involves a sale, license, or other transfer, and without regard to the type of income derived.[208] While this is a good start, it is insufficient in that a finding of compensation for services under this model still requires a finding of a transfer of all rights in the intellectual property.[209] Rather, the model should be extended to apply to all commercial exploitations of intangible property and a determination of whether compensation is paid for services or use of the intangible property should focus on the predominant reason for the transaction. As such, this article suggests a new approach that consists of a two-step analysis. First, the predominant motivation for the transaction must be determined. If the predominant motivation is performance of services, the rules applicable to taxation of income from services apply, even if those services use an intangible asset. If the predominant motivation for the transaction is the acquisition or use of the intangible, the income should be sourced at the place where the intangible is being used, even if that use necessitates the performance of services.

Arguably, such an approach has the potential to create a new gray area, because it may be difficult to determine the predominant motivation for a given transaction. Yet, the Danish tax system already includes rules under which a determination of the predominant contract performance is necessary and often required.[210] More importantly, in other contexts, U.S. courts have experienced little difficulty in applying this principle to distinguish between a contract for services and a sales contract. As the U.S. Court of Appeals for the Second Circuit has explained:

> In determining whether or not a contract is one of sale or to provide services, we must look to the ''essence'' of the agreement, [and] when service predominates, the incidental sale of items of personal property does not alter the basic transaction.[211]

There seems to be little in the way of applying the essence of the contract to distinguish between service contracts and contracts for the sale, use, or other transfer of intangible property. Also, under this approach, both the IRS and the Danish Tax and Customs Administration (SKAT) can more easily issue regulations or guidance that specifically place various forms of intangible property transactions into either of the two categories. For example, assuming that one's voice can constitute an intangible property right,[212] the IRS and SKAT could determine that all recording contracts involve payments for the use of intangible property, to the extent such income is directly linked to the sale of the records, regardless of what rights are retained by the artist in the contract. The two agencies could similarly determine that a contract involving the transfer of rights to use a newly discovered scientific method constitutes a contract for the use of intangible property, even if the inventor is required to perform services for the other party. On the other end of the spectrum, the IRS and SKAT could reasonably conclude that payments under a contract in which an author obligates himself to provide X amount of novels per year constitutes payments for services and not a transfer of intangible property.

If a given transaction is found to predominantly involve payment for a right to intangible property, the source of the income should be taxed at the place of use for the same reasons that e-commerce transactions should be subject to taxation in the source country only if the seller has purposefully availed itself of that country. Ironically, this is how the U.S. taxes royalties.[213] It is the most logical approach, from both an economic and a taxation standpoint. It is the country of use that makes commercial exploitation of the intangible possible in the first place.[214] For example, if Kim Larsen, as a nonresident alien recording artist, records his records outside the U.S. and sells those records predominantly inside the U.S., he will directly benefit from the U.S. legal system and U.S. resources, but may never pay a penny for this use. Similarly, the U.S. resident recording artist's income that is directly linked to sales of records in Denmark should be Danish-source income for the exact same reasons.[215]

Because of the continued development of e-commerce, there may be situations when an intangible is used solely in the virtual world. In such an instance, the term ''predominant use'' must be interpreted broadly. Even when the intangible is not being directly used in the physical world, a physical person or entity will always be benefiting from the use of the intangible. In cases of a purely virtual use of the intangible, the payer will be the person or entity ultimately using the intangible. Thus, the proposed solution should include a rebuttable presumption that ''predominant use'' takes place at the payer's principal place of business. This rebuttable presumption follows from the solution's main principle, namely that the

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[208] *See id.* (citations omitted).

[209] *See id.* at 236 (citations omitted).

[210] Under the Value Added Tax Act, taxation of ancillary performances follows the taxation of the main performance.

[211] *See, e.g.*, *Marbelite Co. v. Nat'l Sign & Signal Co.*, 2 Fed. Appx. 118, 120 (2nd Cir. 2001); *see also Manes Organization, Inc. v. Standard Dyeing & Finishing Co.*, 472 F. Supp. 687, 690 n. 3 (S.D.N.Y. 1979).

[212] *See supra* notes 163-164 and accompanying text.

[213] *See* IRC section 861(a)(4); *c>f.* Guruli, *supra* note 207.

[214] *See* Guruli, *supra* note 207, at 235-236.

[215] If characterized as royalties for the use of a copyright to an artistic work, absent a PE the income would not be taxable in Denmark, because as noted above, the DWTA excludes these types of royalties from taxation.

country that makes the commercial exploitation of the intangible possible should be the jurisdiction that may impose taxes on that exploitation. The payer is a necessary part of the commercial exploitation of the intangible equation. Further, payment for this exploitation originates from the payer. Because the country where the payer has its principal place of business makes the payer's corporate existence possible, that country thereby indirectly makes commercial exploitation of the intangible possible.

As with the solution proposed for determining a PE regarding e-commerce transactions, the ''predominant motivation and use'' solution proposed here is not completely neutral. In cases of pure virtual use of the intangible, taxpayers would be well advised to have their principal place of business in a low-tax jurisdiction. This is not, however, significantly different from companies moving their headquarters to Switzerland, a growing trend over the past couple of years.[216] As for being equitable, the solution aims to subject taxpayers from the same country to the same tax burden, regardless of where the income originates. Also, since it focuses on the use of the intangible, taxpayers within the same country should be subject to the same tax scheme, regardless of their residence. It is acknowledged, however, that pure virtual use of the intangible would distort the picture.

The proposed solution shifts the focus away from the legal technicalities of a transaction that falls in the gray area between compensation for services and compensation for use of intangible property. Instead, the suggested approach focuses on the taxpayers' motivation for entering into the transaction in the first place, as well as their actions, and the location where those actions take place.[217] That in turn will better align the tax consequences with the economic realities of the transaction in question, which should generally result in an equitable division of tax revenue between the payer's and the payee's respective countries. Moreover, by eliminating the current approach used to distinguish between payment for services and payment for the use of intangible property, the solution should have a positive outcome on administrative efficiency, while simplifying the current tax regime applicable to these types of transactions.

Conclusion

The traditional source rules as they exist in bilateral tax treaties, and in the Denmark-U.S. tax treaty in particular, were developed at a time in which the economy and commercial activity was fixed and immobile. People and businesses have become increasingly mobile, which has led to new discoveries, technological advances, and the creation of new kinds of intangibles. The current definition of PE is not an effective measure of economic activity in the digital age, and therefore cannot be used in determining the international tax implications of digital economic activity. We must therefore move away from an insistence on applying traditional tax principles to this new world.

There will always be conservatives who insist that the existing rules and regulations can sufficiently address any issue that may arise down the road. As this article has argued, however, it is time to rethink a number of international tax rules. Only through such a shift can we adopt taxation schemes and principles that can withstand the test of time. That is, until economic evolution demands otherwise, or until another invention as remarkable as the Internet comes along. ◆

[216]Two such recent moves include those of McDonald's and Garmin. *See* ''British Tax Hike Forces McDonald's to Geneva,'' *available at* http://www.swissinfo.ch/eng/British_tax_hike_forces_McDonalds_to_Geneva.html?cid=987750; ''Garmin Receives Court Approval for Change of Place of Incorporation to Switzerland,'' *available at* http://garmin.blogs.com/pr/2010/06/garmin-receives-court-approval-.html.

[217]*Cf. Tobey v. Comm'r*, 60 T.C. 227, 235 (1973).