Copenhagen Research Group on International Taxation - CORIT
Discussion Paper No. 7. 2010

Selected Issues in the U.S.-DK Tax Treaty: Permanent Establishment in Relation to E-commerce Transactions and the Distinction Between Payment for Services and Payment for Intangible Property Rights

By
Kim David Lexner

Introduction

Geographical location or physical presence is central to many tax aspect of both Denmark and United States ("U.S.") inbound transactions.[1] This is so, because many, if not all, tax treaties between Denmark and a foreign country, and the U.S. and a foreign country, requires a foreign entity to have a permanent establishment within Denmark or the U.S., respectively, in order for either country to apply its general tax regime to any profits of such an entity.[2] Note, however, that in the absence of permanent establishment, 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 advent of the modern internet, however, entities can now engage in substantial economic activities through the use of e-commerce in a country without ever physically being present in that country. Because permanent establishment generally requires some kind of physical presence within the source country,[4] e-commerce transactions raises issues as to whether there is a need to revise the general principle of permanent establishment so as to properly tax these kind of transactions, or whether our current regime can be adequately applied to such transactions.[5]

Closely related to the issue of permanent establishment, is the source classification that results under a treaty, when the economic activities do not meet the level required to conclude that permanent establishment exists. Thus, paramount to the

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[1] *See, e.g.*, I.R.C. § 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 Section 2(1)(4).

[2] *See* JOSEPH ISENBERGH, INTERNATIONAL TAXATION 241 (2nd ed. 2005).

[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 n.17 (2001). While the tax rates for withholding is generally 30%, the U.S. tax treaties generally reduce or eliminate the withholding altogether. *See* I.R.C. § 881(1)(a); JOHN P. STEINES, JR., INTERNATIONAL ASPECTS OF U.S. INCOME TAXATION 95 (3rd ed. 2007).

[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 OECD Model Tax Treaty] Art. 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 Paper will continue to use the terms resident country and source country. As the discussion will show, 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 resident country, that is implicated, in any way, in a given e-commerce transaction.

taxation of income acquired by a non-resident alien[6] that is not effectively connected with a Danish or U.S. trade or business, is determining the source of that income. This is so, because Denmark, as well as the U.S., generally only taxes non-resident aliens on their income which is Danish or U.S. source, respectively.[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 Paper will show, however, there are instances when determining the characterization of income becomes difficult, namely when determining whether income is for services or payments for the use 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

It would be a stretch to argue that no two societies are more different than the U.S. and Denmark. For even an uninitiated observer, however, the many variances between the cultures are visible to the naked eye. Why then a comparative analysis between the two countries tax regimes, the observant reader might ask. In so asking, however, the reader would be mischaracterizing the scope and methodology of this Paper. The analysis and discussion that follows, is based on a policy methodology or analysis, that is, a discussion of current law, and an analysis as to whether it should be amended in accordance with one or more herein stated policy goals. As such, this Paper does not embark on an in-depth analysis of, nor will it contrast, as that word is usually understood in legal analysis, the tax systems of the U.S. and Denmark. Rather, the purpose is to analyze two selected issues in the tax treaty between the two countries. The Paper will therefore not conduct a comparative analysis, but rather incorporate U.S. and Danish tax law into an empirical analysis of these two issues. Any comparison that is nevertheless conducted is done purely as an academic exercise in emphasizing the similarities, or dissimilarities as the case may be, between the two, as well as identifying how national

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[6] *See* I.R.C. § 7701(b)(1)(B) (2000); Danish Withholding Tax Act Section 2.
[7] *See, e.g.,* I.R.C. §§ 61; 861(b); 863. Danish Withholding Tax Act Section 2.
[8] *See* ISENBERGH, supra note 2, at 55.

law affects the treaty in question. In this regard, analyzing the OECD Model Tax Treaty and its commentaries is equally relevant. This is so, because the U.S.-Danish Tax Treaty is based on, and is almost identical to the OECD Model Tax Treaty, with respect to the provisions herein analyzed. Moreover, both countries rely on the OECD commentaries in interpreting the treaty between them. As such, the OECD Model Tax Treaty and its commentaries are used interchangeably with the U.S.-Danish Tax Treaty in this Paper.

Before embarking on an analysis of this Paper's two main subjects, Part II first clarifies the exact scope of that analysis. Part III then proceeds by providing a brief background on the international taxation regime, as well as explains a number of central international tax principles. Subsequently, Part IV commences the discussion of the first subject of the Paper by describing U.S., Danish and treaty taxation of the sale of goods. In doing so, Part IV also identifies the Paper's first issue, and in relation hereto, provides an overview of the permanent establishment principle. Part V then analyzes sales of goods through the internet under the current international tax regime, as well as identifies the limitations of the rules as they relate to e-commerce transactions. Having concluded that the current rules suffer from a number of shortcomings, Part VI continues by suggesting four new approaches to address those shortcomings, ultimately favoring one of these approaches.

Having provided a new framework that could resolve the issue of permanent establishment as it relates to e-commerce transactions, Part VII proceeds by first identifying the second subject of this Paper, as well as outlines the current U.S., Danish and treaty rules as they relate to the taxation of payments for intangible property rights and taxation of compensation for services. Part VIII next analyzes and critiques the law that has developed in this area, explains why is inadequate, and identifies the implications of this inadequacy. Having identified the specific issues relating to the distinction between payment for services and payment for the use of intangible property rights, as well as the proper taxation hereof, Part IX continues by suggesting a new approach through which that distinction can be made, and through which these transactions can be properly taxed. Finally, Part X concludes.

II. Scope

The mere existence of an international tax treaty is quite remarkable, because not only does it represent an international agreement between two sovereign nations, it also represent a consensus about which of the two sovereigns can levy taxes on which types of income. Keeping in mind how difficult it is for national political parties to reach agreements about tax rules, the significance of two sovereigns reaching such an agreement cannot be overstated. For this reason, and because a tax treaty affects national tax law profoundly, and vice versa, a number of related issues arise in relation to national law and the issues identified in the introduction. In order to properly focus the analysis within the framework of the academic exercise at hand, however, many of these issues will not be addressed, and therefore fall outside the scope of this Paper.

In relation to the first issue to be addressed, that is, e-commerce transactions and permanent establishment, the analysis will focus on pure e-commerce transactions, meaning that the seller has no physical presence whatsoever within the source country. In relation hereto, it would be interesting to determine the tax implications of virtual income, e.g. income earned in virtual realities such as Second Life's Linden Dollars that can be used to purchase virtual goods or be converted into real-world currency. That, however, is the subject of an entirely different Paper.

Although the various transactions used as exemplifications of the issues herein addressed might properly fall within the scope of the Danish Value Added Tax Act, in order to get to the heart of those issues, that Act must necessarily fall outside the scope of this Paper. An analysis of the Value Added Tax Act, and the EU directive upon which it is based, would also necessitate a discussion of tax credits and exemptions, which in turn would jeopardize the coherence of the analysis, as well as steal focus away from the main issues. For all these reasons, the substantive rules of the Act will not be addressed. For many of the same reasons, rules promulgated by the World Trade Organization similarly fall outside this Paper's scope, as does public international law and EU laws and regulations, except insofar as relevant Danish law is reflection hereof.

Lastly, in relation to the second issue to be addressed, that is, the distinction between payment for services and payments for the use of an intangible property right, and the taxation of these transactions, the Danish Composer's Rights, also known as KODA, and their method of collecting royalties on behalf of Danish artists will not be taken into account. While a tax treaty may permit Denmark, as the source country, to tax specific royalties, the Danish Withholding Tax Act does not apply to royalties for the use of music, movies and the like. Thus, even where Denmark can tax these types of royalties as the source country pursuant to a treaty, no national statutory provision allows for the taxation of such income. Additionally, should KODA's rules conflict with a treaty, the treaty will govern under the principle of lex superior, as well as pursuant to Denmark's obligations towards its treaty partner.

III. The International Taxation Regime

A. Brief Background

In order to properly understand why the subjects herein addressed present germane issues in the international taxation context, we must first understand the basic international taxation methods that are implicated. 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] The residence-based taxation allows a sovereign to tax its residents on their worldwide income.[12] The availability of these two different international taxation methods can often lead to double taxation, for example where a resident of Country A produces income in Country B, and no treaty is in place.[13]

[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, Jr., *supra* note 3 at 1.
[13] *See* Azam, *supra* note 10.

Economic studies commissioned by the League of Nations concluded that international taxation should be based on a doctrine of so-called economic allegiance.[14] Pursuant to this principle, taxation of cross-border transactions had to 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, however, prone to result in conflicts. Capital-importing and capital-exporting countries obviously share heterogeneous views on the proper tax treatment of cross-border transactions.[16] Capital importers favor source-based taxation, while capital exporters favor residence-based taxation. Apparently recognizing each other's plight, capital importer and exporters agreed that source-based and residence-based taxation had to co-exist. The result was a bilateral model scheme on the taxation of cross-border transactions that, despite mass-market production techniques, innovations in assembly line production, iPhones, iPads, and other revolutionizing progress unfathomable to the original League of Nations participants, has remained largely unrevised for almost 100 years.[17]

B. Principles of International Taxation

A baseline, or measuring rod if you will, is a prerequisite to a proper policy analysis of law. At the outset then, the analysis must begin by identifying the principles against which rules will be measured. Some of these are basic principles of tax theory and policy, although they have a specific meaning in the international taxation context, and in particular within the taxation of e-commerce. Overall, tax principles belong to either of two categories, namely 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.

a. Neutrality[18]

[14] OECD TAX POLICY STUDIES, E-COMMERCE: TRANSFER PRICING AND BUSINESS PROFITS TAXATION, 82 (2005).
[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, 1033-34 (1997).
[17] *See* Graetz and Michael M. O'Hear, *supra* note 16, at 1023.
[18] *See generally*, LAURIE MALMAN ET AL., THE INDIVIDUAL TAX BASE: CASES, PROBLEMS AND POLICIES IN FEDERAL TAXATION 9 (2nd ed. 2002) on which the discussion is based.

While being a fundamental principle of tax law in general, in the international context, neutrality exists when the tax laws of different nations do not guide the actions of the taxpayer. 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 as to 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 without its borders, Nation A's tax laws would be non-neutral, as they would discourage consumers from purchasing goods in nations other than A. In relation to international tax, neutrality is often divided into capital export neutrality ("CEN") and capital import neutrality ("CIN"). The focus continues to be on whether the tax laws affect taxpayer behavior. CEN exists when the tax system does not distort the choice between investing at home and investing abroad.[19] Thus, a system that taxes residents on their worldwide income meets the CEN standard, if it provides a foreign tax credit or exclusion. CIN in turn exists where all income within a given territory is subject to the same taxation scheme. CIN's purpose is to avoid rules, pursuant to which taxpayers are subject to a higher effective tax burden in foreign markets than the taxpayers' competitors. One way to avoid such a result is for the resident country to exempt all foreign-source income from domestic taxation.[20] As the discussion below will show, both national and international tax rules contain features of CEN and CIN, although not in their purest form. 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, in order to avoid providing either with a competitive advantage.[21]

b. Taxpayer Equity

Taxpayer equity, or fairness, is often subdivided into two categories, namely horizontal and vertical equity. Horizontal equity means equal treatment of taxpayers who are similarly situated, while vertical equity means equity between taxpayers at different

[19] RICHARD L. DOERNBERG, ET AL., ELECTRONIC COMMERCE AND MULTIJURISDICTIONAL TAXATION 68 (2001).
[20] *Id.*
[21] *id.*

economic levels.[22] These two types of equity supports source-based and residence-based taxation respectively.[23] 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, where 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.

c. Inter-nation Equity

Closely related to taxpayer equity is inter-nation equity, or fairness, meaning an equitable division of tax revenue between sovereign nations.[24] This in turn depends on the allocation of the taxable activities between the source country and the resident country, and the tax rate in the source country. Inter-nation equity assumes that the source country and the residence country each contributes in creating value that is manifested in a cross-border transaction. If e-commerce transactions erode the existence of a source country, or makes it increasingly difficult to enforce source-based taxation, creating rules in accordance with this principle becomes progressively more complicated.

d. 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. If a system is not simplistic, it discourages productive activity. Tax in general, and international tax in particular, is not, however, generally associated with a high

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[22] MALMAN ET AL., *supra* note 18, at 14.
[23] *See* DOERNBERG, ET AL., *supra* note 19, at 69.
[24] *Id.*

degree of efficiency or simplicity. The reason for this is, that a system that is both highly administratively efficient and simplistic would be so at the cost of fairness.[25]

The principle of nondiscrimination is incorporated into tax treaties, and a typical nondiscrimination provision can be found in the U.S.-Danish Tax Treaty Art. 24.[26] Generally, the nondiscrimination provision prohibits a treaty party from imposing less favorable or more adverse tax consequences upon citizens or residents of the other treaty party. 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.

There are other principles of international taxation, but as noted earlier, all principles are generally considered either one of efficiency or one of fairness, with the two categories not being mutually exclusive, but requiring a balancing between heterogeneous interests. It is with this and the described principles in mind, that the Paper will develop its analysis and proposed amendments.

IV. National and International Taxation of the Sale of Goods

A. Basic Scheme of United States International Taxation as it Relates to the Sale of Goods

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 ("Code"), gross income includes "income from whatever source derived."[27] The focus of the provision is the taxpayer, not his or her location. The provision effectively permits the U.S. to tax its residents on their earned income, and, according to the United States Supreme Court, also permits the U.S. to tax its citizens on their worldwide income.[28] The U.S. is apparently the only economically developed country that allows for taxation based solely on citizenship.[29] By way of example, if we 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

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[25] *See* MALMAN ET AL., *supra* note 18, at 12.

[26] 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, August 19, 1999, Art. 24 [hereinafter U.S.-DK Tax Treaty].

[27] I.R.C. § 61.

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

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

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.[30]

As for sourced-based taxation and its categories of economic activity, the starting point is Code Section 865, pursuant to which, gains from the sale of personal property is sourced where the seller has its residence,[31] as that term is specifically defined for purposes of this Section under Section 865.[32] Under Section 865(g), a U.S. resident is an individual who is a (1) U.S. citizen or resident alien with no "tax home" outside the U.S.; or (2) nonresident alien with a "tax home" in the U.S.[33] A tax home entails either a substantial residential or business presence in a given place.[34] Inventory property, however, is specifically excluded from the scope of Section 865 by virtue of Section 865(b),[35] the latter of which defers, *inter alia*, to the source rules contained in Section 861(a)(6).[36] Pursuant to Section 861(a)(6) gains, profits and income derived from the purchase of inventory property without the U.S. and its sale or exchange within the U.S., is U.S. source income.[37] Similarly, under Section 862(a)(6), gains, profits and income from inventory purchased within the U.S. and sold without the U.S., is foreign source income.[38] Determining where the sale takes place requires a determination as to where legal titles passes.[39] Consider once more a sale of jeans by a Danish retailer to a U.S. consumer. Note that the jeans constitute inventory.[40] 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.

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[30] The U.S. tax system does contain 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. The sale might also, depending on the circumstances, generate income taxable in Denmark.
[31] I.R.C. § 865(a).
[32] *Id.* at § 865(g).
[33] *Id.*
[34] Treas. Reg. § 301.7701(b)-2(c).
[35] I.R.C. § 865(b).
[36] *See id.* at § 865(b)(2).
[37] *Id*.
[38] *Id.* at § 862(a)(6).
[39] *See* Treas. Reg. § 1.861-7(c); Steines, *supra* note 3 at 161.
[40] *See* BLACK'S LAW DICTIONARY, Inventory, (8th ed. 2004) (defining inventory as goods held by a retailer for sale to consumers); *cf.* UCC § 9-102(a)(48).

B. Basic Scheme of Danish International Taxation as it Relates to the Sale of Goods

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

As for sourced-based taxation and its categories of economic activity, reconsider the sale of jeans by an American 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. Pursuant to 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 permanent establishment. A number of factors are relevant in making this determination, such as the level of economic activity, and the independency of the seller from the American retailer. As such, where the sale takes place is similarly 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 given sale is subject to taxation under the DWTA. One should bear in mind, however, that even if legal title passes within Denmark, the place of the sale must still rise to the level of permanent establishment, before Denmark subjects the proceeds to taxation. Whether the American retailer has Danish source income will therefore depend on where the sale takes place, which in turn depends on, if the place is within Denmark, whether that place constitutes permanent establishment.

C. Identifying the Issue – International Taxation of Brick-and-Mortar vs. Click-and-Mortar

As noted above, for inventory the Code applies a place of sale rule to determine source, with place of sale being where the legal title passes.[41] Similarly, the DWTA

[41] An exception to this general rule can be found in Section 865(e)(2). Pursuant to that provision, even where 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. I.R.C. § 865 (e)(2)(A). This exception does not apply if a foreign office materially aides in the sale, and the goods are destined for

makes the place of sale determinative, in that, only if the place of sale rises to the level of permanent establishment, 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, respectively. If, however, the sale takes place at the retailer's location in Italy, the sale would generate neither U.S. nor Danish source income.[42]

But what result if the sale was facilitated by the U.S. or Danish consumer navigating onto the Italian retailer's website, which had been translated into English or Danish for the purpose of attracting U.S. or Danish consumers respectively, completed the transaction on the website, and subsequently received the jeans through the mail? It seems most logical to conclude that legal title to the jeans passes in Italy,[43] and thus, pursuant to Code Section 861(a)(6), the transaction does not give rise to any U.S. source income. Additionally, since the retailer is not physically present within Denmark, there are no factors that would support a finding of permanent establishment. Thus, under these facts, the Italian retailer will have neither U.S. nor Danish source income. But notice what has happened. Instead of setting up a brick-and-mortar store to derive revenue from U.S. or Danish consumers respectively, 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. Part V.B below shows how the existence of a treaty may help curtail such results, but as will also be discussed, current treaties leave much to be desired of an effective international tax regime of e-commerce transactions.

D. Taxation of the Sale of Goods Under a Treaty – The Permanent Establishment Requirement

Where a treaty governs, its provisions are determinative as to 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 permanent

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foreign consumption. I.R.C. § 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.

[42] *See* I.R.C. § 865(b)(2); DWTA § 2(1)(4).

[43] This holds true even if the jeans never arrive at their destination, and the Italian retailer reships another pair of jeans subsequent to the customer's complaint. Presumably, the transaction is subject to FOB 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.

establishment as that term is to be understood according to international tax law. The creation of the permanent establishment principle, and its inclusion in tax treaties, was borne in part by 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.[44] The idea was that whoever benefited from an economic location, ought to pay taxes to that location.[45] The term "trade with a fixed place of business", the predecessor to permanent establishment, was introduced into the first international tax treaty between Austria-Hungary and Prussia in 1899.[46] The intention was to avoid double-taxation of the same income under the system of different sovereigns.[47] 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. [48] As such, principles of permanent establishment and corollary rules have helped minimize one of international taxation's central concerns, namely double taxation.[49] It is clear, however, that the risk of double taxation, no matter how sophisticated the rules one conjurers up are, cannot be completely eliminated, because situations may exist where two countries apply different rules for determining the tax base, or where 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 non-taxation.[50]

As explained previously, Danish national tax law operates with a permanent establishment 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

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[44] *See* Cockfield, *supra* note 3 at 1180 (explaining further that the rule presented a compromise between the interests of net-exporting nations, who derive revenue from taxing the corporation at the production stage, and net-importing nations who derive revenue from taxing the actual sale to the end consumer).
[45] RICHARD L. DOERNBERG, ET AL., *supra* note 19, at 249.
[46] *Id.*
[47] *Id.*
[48] *Id.*
[49] *See* SUBHAJIT BASU, GLOBAL PERSPECTIVES ON E-COMMERCE TAXATION LAW 29 (2007) (explaining the issues regarding double taxation, and how different countries' tax regimes, as well as various tax treaties, attempt to prevent such a result).
[50] *See id.*

should be understood and interpreted in accordance with its OECD twin.[51] An independent analysis of the term permanent establishment under Danish national law would therefore be futile for this Paper's analysis. This is so, because if there is permanent establishment pursuant to the OECD Model Tax Treaty, it should follow that a Danish court or tribunal should similarly find the existence of permanent establishment under national law.[52] It is important to note that the contrary is not necessarily true.

What is true, however, is that permanent establishment is of significant fiscal importance in the tax-treaty heavy world we live in. Where a treaty governs, "it supplants the taxing nexus of the domestic tax law of the host country."[53] According to the U.S.-DK Tax Treaty, which is identical to the OECD Model Tax Treaty in this respect, permanent establishment "means a fixed place of business through which the business of an enterprise is wholly or partly carried on."[54] It further goes on to state that "[t]he term "permanent establishment" includes especially: a) a place of management; b) a branch; c) an office; [and] d) a factory . . . ."[55] Additionally, permanent establishment will also 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.[56] What should be evident from this language, is that permanent establishment in the traditional sense requires some physical presence within the source country. As such, transactions that take place wholly through the internet presents some interesting issues as to the taxation of, *inter alia*, sale of goods by an Danish retailer solely to U.S. customers through a website maintained in Denmark.

V. E-Commerce Transactions in an International Taxation Setting

A. What Constitutes an E-commerce Transaction

Before delving into the issues raised by e-commerce transactions *vis a vis* the principle of permanent establishment, this Paper must briefly attempt to define what such

[51] *See, e.g.*, AAGE MICHELSEN ET AL., LÆREBOG OM INDKOMSTSKAT 738 (13th Ed. 2009).
[52] *Cf.* SKM2010.257.SR (where the Tax tribunal, in determining whether the economic activity in question amounted to permanent establishment pursuant to the DWTA Section 2(1)(4), explicitly relied on how that term is defined in the OECD Model Tax Treaty and its commentaries).
[53] JOHN HUSTON & LEE WILLIAMS, PERMANENT ESTABLISHMENTS: A PLANNING PRIMER 1 (1993).
[54] U.S.-DK Tax Treaty Art. 5(1).
[55] *Id.* at Art. 5(2).
[56] *Id.* at Art. 5(5).

a transaction is. E-commerce transactions enjoy many different definitions.[57] For example, the United States 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."[58] This Paper will use 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.[59] For example, a consumer in the U.S. who purchases a pair of jeans off a Danish retailer's website, partakes in an e-commerce transaction.

B. International Tax Implications of an E-commerce Transaction Under an Applicable Treaty

This Paper has previously discussed the international tax implications of the sale of jeans by a Danish retailer to a U.S. consumer through the internet, and concluded that such a sale does not, under the Code, generate U.S. source income. Reversing the roles would similarly also 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 purposefully 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 permanent establishment.[60] Moreover, while the U.S.-DK Tax Treaty does not, by its language, specifically exclude other types of business activity than those explicitly enumerated in Art. 5 from falling within the realm of permanent establishment,[61] it probably would be difficult to argue that based on these facts, the Danish retailer would ever meet the permanent establishment requirement. But if we take this result to its logical conclusion, an American 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,

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[57] *See, e.g.*, BASU, *supra* note 49 at 14.
[58] Pub. L. 105-277, § 1105(3) (1998).
[59] *Cf.* BASU, *supra* note 49 at 14.
[60] *See* U.S.-DK Tax Treaty Art. 5.
[61] *See id.* at 5(2) ("[t]he term "permanent establishment" includes especially . . .).

with the advent of the modern internet, the Danish retailer can now do what it could not do before e-commerce was created, and leaves the current international tax law open for abuse.

The OECD has taken steps to prevent such abuse by reinterpreting permanent establishment.[62] Under the OECD's interpretation, computer servers may, under limited circumstances, constitute permanent establishment.[63] 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 said server may constitute permanent establishment.[64] The commentaries go on to state that in addition to the entity being able to exercise control over the server, permanent establishment 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.[65] Where the entity is merely paying an Internet Service Provider ("ISP") to host its website content on the ISP's server, however, the activity cannot give rise to a finding of permanent establishment.[66] Note also that the use of an ISP will not give rise to permanent establishment under the OECD Model Tax Treaty Art. 5(5), because the ISPs do not fall within the definition of dependent agent. This is so, particularly because they lack the authority to execute contracts on behalf of the website owning entity.[67] 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 permanent establishment misses the target.[68] Additionally, even where 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.[69] Along a similar vein, because servers are highly mobile, a company who owns its own server, or has the power to exercise control over it, could move it around so as to defeat a finding of permanent

[62] *See* Commentary on the Articles of the 2008 OECD Model Income and Capital Tax Convention Art. 5, paragraphs 42.1-42.10 [hereinafter OECD Model Tax Treaty Commentaries].
[63] *See id.* at paragraph 42.3.
[64] *Id.*
[65] *Id.* at 42.4.
[66] *Id.*
[67] *See id.* at 42.10.
[68] *See* Basu *supra* note 49 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).
[69] 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).

establishment altogether.[70] While the OECD has clearly acknowledged this issue, it seems to fail to fully appreciate it.[71] As noted in the commentary, only where a server is actually moved, not the existence of a possibility that it can be moved, may it serve to defeat a finding of permanent establishment.[72] If a finding of permanent establishment 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 engage in such practices on a regular basis so as to never have permanent establishment anywhere. Thus, while the OECD has recognized some of the challenges e-commerce raises in regards to international taxation, its insistence on utilizing existing tax principles to these challenges fall short of a comprehensive approach to the taxation of international e-commerce. It should be noted, that a failure to address the issue could have substantial fiscal consequences. According to the U.S. Census Bureau, for example, in 2008, e-commerce grew faster than the total economic activity in three of the four major economic sectors covered by its economic electronic reporting.[73] Moreover, in the first quarter of 2010, revenue from online retail represented $38,707M of overall retail sales of $960,474M, which was a 14.3% increase from the first quarter of 2009.[74] Traditional retail sales only experienced an increase from the previous year of 6.3%.[75] Absent proof to the contrary, if this trend is properly viewed as being indicative of e-commerce revenue on a worldwide and cross-border scale, source countries could be loosing out of significant amount of tax revenue.

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[70] *See id.* (arguing that [t]he 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 "[t]he 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] . . . [t]he location of servers is irrelevant since they can be accessed by users around the world.").
[71] *Cf.* OECD Model Tax Treaty Commentaries paragraph 42.4.
[72] *Id.*
[73] *See* U.S. Census Bureau, *The 2008 E-commerce multi-sector "E-Stats" report (May 27, 2010), available at*, http://www.census.gov/econ/estats/2008/2008reportfinal.pdf. Unfortunately, the most recent data from the OECD is from 1998, and as such, cannot be used to draw any conclusions about the current trends, given the technological advances, and increase in online transactions that have occurred in the last decade.
[74] *See* U.S. Census Bureau, *Quarterly Retail E-commerce Sales 1st Quarter 2010, available at* http://www.census.gov/retail/mrts/www/data/html/10Q1.html. It is unclear, however, how much of the revenue originates from nonresident consumers.
[75] *Id.*

VI. New Approaches to the Taxation of International E-commerce Transactions

The OECD, the Danish National Tax Board[76] and the United States Department of the Treasury[77] have expressed an interest in utilizing existing tax principles in relation to the taxation of e-commerce.[78] As the previous discussion has shown, and as many commentators have noted, however, existing tax principles may not work for all aspects of international taxation of e-commerce, specifically the issue of permanent establishment.[79] What is needed then is a new framework in which to balance the legitimate interests of the resident country on the one hand, and the source country on the other, to tax income generated by the existence of the source country.

A. Consumption Tax and Electronic Taxation Intermediary.[80]

One solution to the issue of permanent establishment as it relates to e-commerce transactions would be to implement a consumption-based tax on all e-commerce transactions, combined with a utilization of modern technology, converting the problem into the solution. 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.[81] When a sale is made online, the purchaser must input his or her location, which information is then sent to the electronic tax collection intermediary, who in turn determines the applicable tax rate to the transaction based on official information from

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[76] *See, e.g.*, SKM2008.646.SR.
[77] *See Off. of Tax Pol'y, U.S. Dept. of the Treasury, 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.
[78] *See* OECD Comm'n on Fiscal Affairs, Electronic Commerce: Taxation Framework Conditions 3, at 4 (Oct. 1998), *available at* www.oecd.org/dataoecd/46/3/1923256.pdf.
[79] *See* Cockfield, *supra* note 69, at 333, 384-85; Cockfield, *supra* note 3, at 1181; Thorpe, *supra* note 70 (1997).
[80] This solution is heavily inspired by the Streamlined Sales Tax Project, as that project is explained by Arthur J. Cockfield. *See* Cocfield, *supra* note 69, at 387-90, 397-400; *see also* Cockfield, *supra* note 3, at 1221-1263.
[81] *Cf.* Cockfield, *supra* note 69, at 388-89.

the country in question.[82] The tax rate is determined based on the consumer's location, – also for intangible purchases such as downloadable software – and this solution is therefore an implementation of a sales tax.[83] 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.[84] All these steps of course take place instantaneously through the use of existing technology. When the consumer subsequently pays the total price, the part of the payment that consists of the sales tax is then automatically remitted to the electronic tax intermediary, who in turn remits the payment to the source country's tax authorities.[85] The task of the electronic intermediary could be handled by any of the existing companies, who's business it currently is to facilitate online purchases, such as PayPal.

As noted in Part II, the Paper will not address in detail the Danish Value Added Tax Act, or the EU directive upon which the act is based. It should nevertheless be noted, that a sales tax is closely akin, and for some, even synonymous with, a value-added tax. The main difference between the two is the method through which is it determined. While traditional value-added tax is a cascading tax imposed at each stage of manufacturing, a sales tax is generally only imposed on the final stage of consumption. The tax incidence of a value-added tax, 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, so as to not conflict with Denmark's obligations under EU's Value Added Tax 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%. 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 check-out. In the address

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[82] *Cf. id.* at 398.
[83] *Cf. id* at 359 (noting that the European Union has acknowledged the necessity and inevitability of a sales tax, or value-added tax, in the e-commerce transaction context).
[84] *Cf. id.* at 398.
[85] *Cf. id.* at 359.

field, Carl indicates that he resides in the U.S. When he navigates to the next page of the check-out, 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, for example PayPal. The automated billing system that PayPal has in place then automatically and 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 Internal Revenue Service ("Service").

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, where 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, European Union member states, as well as other countries with a value-added tax system, should find the model somewhat familiar.[86] The model effectively eliminates the uncertainties involved in relying on permanent establishment, while balancing the interests of both the resident 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 form of status-quo. This will only be true, however, if the treaty parties apply the same tax rate to e-commerce transactions as they do brick-and-mortar transactions. As this might very likely not be the case, for example if the resident country has no national sales tax system, as is the case 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% sales tax would greatly affect his behavior not to purchase the jeans from the Danish retailer, but instead invest a

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[86] *See id.* (noting, among other things, the ongoing debate between U.S. legislators as to whether *any* value-added tax system should ever be implemented).

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 upon a uniform sales tax percentage, that all parties would levy. Additionally, 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, but they do not generally govern how that economic activity may be taxed,[87] and they certainly do not govern how economic activity that is of a pure 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 an issue of such political magnitude as to be insurmountable, and might conflict with national law on constitutional grounds.

B. E-Commerce as a New Source Classification

As this Paper has previously discussed, determining the source of income is paramount to international taxation.[88] This Paper's second possible solution to dealing with the taxation of e-commerce transactions proposes to create a new income classification that covers all e-commerce transactions. The solution is similar in effect to the one proposed under VI.A above, in that taxation will be based on the purchaser's residence. The solution proposes the use of rules applicable to sale of inventory under U.S. law.[89] 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 buyer's place of residence. The rule herein proposed would require first a determination as to whether a sale is facilitated through the use of e-commerce. If this is answered in the affirmative, the rule will source any income derived from such a sale at the buyer's residence. The rule thereby creates a new source

[87] This is not to say that a treaty never includes provision as to the given tax rate. For example, the U.S.-DK Tax Treaty Art. 10, includes provisions that allow for a specified tax percentage on dividends in certain circumstances.

[88] *Cf.* ISENBERGH, *supra* note 2, at 29 ("[t]he concept of source of income is essential mortar – if not the keystone – in the U.S. system of international taxation.").

[89] *See* I.R.C. § 865(b)(2); *see also infra* notes 35-38 and accompanying text.

classification – e-commerce transactions. Pursuant to 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 under solution VI.A above, 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. This is so, because as was 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.[90] 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.[91]

A buyer's residence rule allows online retailers to control the tax jurisdictions to which they expose themselves. This is so, because retailers can choose to limit the destinations to where they will send their goods. This solution also effectively limits the uncertainties involved with permanent establishment, and similarly to the other solutions herein proposed, takes into account the interests of both the source and resident 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 resident country. This fact is also, however, one of the solution's greatest obstacles. An e-commerce seller generally needs to utilize the infrastructure of the buyer's place of residence in order to effectuate the sale.[92] It is questionable, however, whether the extent to which the seller takes advantage of that infrastructure is a sufficient basis on which tax can be levied. First and foremost, this solution therefore lacks proportionality by instituting a blanket tax rule for e-commerce

[90] *See supra* V.B.
[91] 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 Paper has shown, and the former is not susceptible to the same magnitude of abuse as is e-commerce transactions. *Cf.* ISENBERGH, *supra* note 2, at 48-49.
[92] This might not be the case, especially if the item in question is an intangible such as software, a video or music file.

transactions. Additionally, 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.[93] It may be argued, that pursuant to the U.S.-DK Tax Treaty, a similar outcome results from Art. 10 regarding withholding tax on dividends. The income subject to Art. 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.[94] Moreover, a withholding tax on e-commerce would be a tariff in disguise, which by its very nature is an inefficient method of taxation.[95] On the plus side, however, withholding tax is generally a simple and effective tax-levying mechanism.[96] Yet, while simple on the surface, classifying e-commerce as a new source lacks fairness, and is inconsistent with the general determination of the income tax base.

C. Virtual Permanent Establishment

Although not a viable solution to the issue, it is appropriate at this point to briefly discuss Luc Hinnekens' idea of virtual permanent establishment. It should be noted, that even Hinnekens seems to find the idea unworkable,[97] making his discussion more of an academic exercise, possibly as a way of stimulating conversation regarding the problem of permanent establishment and e-commerce. As noted earlier, the principle of permanent establishment, 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 between the merchants in question. 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.[98] He suggests implementing a system under which one could find a permanent

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[93] *See* OECD TAX POLICY STUDIES, *supra* note 14, at 130.
[94] *See id.*
[95] *Id.*
[96] *Id.* at 130-31.
[97] *See* DOERNBERG, ET AL., *supra* note 19, at 354.
[98] *See id.* at 351-52.

establishment fiction, otherwise known as virtual permanent establishment.[99] The existence of virtual permanent establishment 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.[100]

The theory, however, also suggest an alternative framework that excludes the reliance on servers, but that also serves as its doom. The theory suggests, that a finding of virtual permanent establishment 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 United States Constitution. This three-prong test, based on the seminal U.S. Supreme Court case of *International Shoe*, requires the defendant to have some kind of minimum contacts with the forum state.[101] Unfortunately, however, as a substitution for the current regime, the *International Shoe* test suffers from a number of shortcomings.[102] 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 issue at hand. The second prong, adapted to virtual permanent establishment, 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.[103] You can neither have operations, nor systematic activities, within a state, without you or your employees or agents being present in that state.[104] Thus, virtual permanent establishment based on *International Shoe*, would simply re-implement a physical presence requirement that, although not as stringent as the physical requirement under Art. 5's permanent establishment, would still require some kind of physical presence by the vendor, before the vendor would be subject

[99] *Id.* at 351.
[100] *Id.*
[101] *International Shoe v. Washington*, 326 U.S. 310, 316 (1945).
[102] Hinnekens do not analyze these shortcomings, perhaps because he believes they are too obvious.
[103] *See* Nathaniel T. Trelease and Andrew Swain, *Nexus and Remote Sellers: The Taxation of Electronic Commerce*, 31-FEB COLAW 75, 76 (2002) (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).
[104] *Cf. Quill Corp. v. North Dakota*, 504 U.S. 298, 311-12, 314 (1992).

to taxation in the buyer's state. That in turn might help alleviate some of the tax issues related to e-commerce transactions, but does not present a viable solution to the issue at hand.

D. Substantial Revenue Purposefully Derived from the Source Country

Although Virtual Permanent Establishment is, as Hinnekens suggests, a fiction, its basic idea of doing away with a physical requirement in order to find permanent establishment, is sound. The last solution this Paper proposes, which also happens to be the one it endorses, finds its origins in this idea of eliminating a need for physical presence in order to tax a given transaction. This solution to the issue of permanent establishment 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, *vis a vis* the source country. The starting point is a model similar to the one currently in effect under the Code, pursuant to which a foreign resident is taxed on income that is effectively connected with a U.S. trade or business.[105] There is, however, at least one issue with adopting this model to apply to the matter at hand. First, while U.S. trade or business is nowhere defined in the Code, it is generally understood to mean a certain level of economic activity within the U.S.[106] Additionally, however, to conduct business "in the U.S.", legal title probably must pass inside the U.S.[107] 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 result that would be more meaningful than having servers constitute permanent establishment.[108]

Instead, we could use the discussed principles of the Code 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. This is so, because the retailer has availed itself of the

[105] *See* I.R.C. §§ 871(b), 882(a).
[106] *See* ISENBERGH, *supra* note 2, at 93-101; *cf. Comm'r v. Spermacet Whaling & Shipping Co.*, S/A, 281 F.2d 646, 651-52 (6th Cir. 1960) (explaining that in order 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.).
[107] ISENBERGH, *supra* note 2, at 100.
[108] *See supra* note 43 and accompanying text.

resources of the source country in generating its income.[109] Interestingly, the United States Supreme Court has struck down a similar tax principle on Constitutional grounds.[110] 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[111] such that the jurisdiction in question could tax the vendor, the latter had to have physical presence within the taxing jurisdiction.[112] This does not, however, necessarily prevent the implementation of a taxation model based on a retailer purposefully availing itself of the source jurisdiction. This is so, because the Court noted that the United States Congress was free to disagree with its line of reasoning by statutorily overruling the Court's determination as to the burden on interstate commerce.[113]

There are a number of factors that could be considered in determining whether an e-commerce vendor has purposefully 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% 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% from sales to U.S. customers.[114] This threshold percentage would need to be regressive, meaning that the larger the overall revenue of the company in question, the smaller the threshold. This should further be combined with threshold amounts, in order to prevent giving large companies an unjust advantage over smaller and mid-size companies. For example, a company like Dell Computers, whose business consists primarily of selling computers and related hardware and software through its

[109] *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 permanent establishment principle).
[110] *Quill Corp. v. North Dakota*, 504 U.S. 298, 311-12, 314 (1992).
[111] U.S. CONST. ART. I, § 8, cl. 3.
[112] *Quill Corp.*, 504 U.S. at 311-12, 314.
[113] *Id.* at 318. The constitutional analysis of *Quill Corp.* is, alas, a topic for a different paper.
[114] *Cf.* the so-called 25% rule contained in Code Section 861, pursuant to which dividends paid by a foreign corporation, provided that more than 25% of the corporation's gross income is effectively connected with a U.S. trade or business, is U.S. source income in the proportion its effectively connected income bears to its total income. I.R.C. § 861(a)(2)(B).

website, posted a revenue of $61 billion for the 2008 fiscal year.[115] Ignoring for the moment that Dell also derives revenue from brick-and-mortar stores, if the threshold was set at 25%, Dell would have to sell for a minimum of $15,25 billion to Danish consumers, before having permanent establishment within Denmark. Even if the threshold percentage were regressive down to 1%, Dell would still have to sell for $600 million to Danish consumers, before we could begin to consider whether Dell had permanent establishment within 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,[116] a company whose annual revenue exceeds a regulated threshold amount of for example $1 billion, would be per se 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 permanent establishment within a source country through two different means: (1) the company's revenue from the source country exceeds a percentage of the company's total annual revenue, or (2) 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 this:[117]

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
100-1000	1%	N/A
>1000	N/A	50

[115] *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.
[116] *See* the Danish Financial Statements Act Section 7 (dividing companies into four accounting classes determined, *inter alia*, by the company's annual revenue).
[117] The threshold numbers are for exemplification only.

Accordingly, if Dell's total annual revenue was $50 million, Dell would per se be purposefully deriving revenue from Denmark, if Dell's Danish source revenue equaled at least $2,5 million (5% of $50 million). If instead, Dell's total annual revenue exceeded $1 billion, Dell would per se be purposefully deriving revenue from Denmark, if Dell's Danish source revenue exceeded $50,000.

Although currently a non-issue, it is appropriate at this point to briefly address the issue of internet proxies. An internet proxy can be used to hide a computer's, and thereby a consumer's, 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 consumer 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: (1) to hide activity online, and (2) to by-pass local network restrictions that make certain 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 where purchasing intangibles, however, the necessary payment details would require the purchaser to input his, hers, or 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, for purposes of the analysis, the issue is as noted a non-issue.

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.[118] An online retailer could therefore find itself

[118] It should be noted, however, 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.

subject to taxation in a country it had never heard of before.[119] Thus, it must be required that the retailer not only purposefully avails itself of the country in question, but also has purposefully targeted the tax jurisdiction in question before tax is imposed. This is in accordance with one of the traditional rationales of permanent establishment, in that the retailer must have taken some affirmative action to derive revenue from a given tax jurisdiction. Affirmative action could be where the website is translated into the language of the tax jurisdiction, but it could also be found where the retailer has purposefully included the country in question among the destinations to where it will ship its goods. While size of revenue from a given country could be evidence of per se targeting that country, it should not, in and of itself, be considered sufficient.

Thus, no factor alone should justify a finding of purposefully targeting and deriving revenue from the country in question. While a single factor could find that a brick-and-mortar store constitutes permanent establishment, 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 quantitatively different from staffing an airport shop with employees who speak the native language of certain shopping-happy travelers. This is so, because through the use of Google translate for example, a website can be translated into 52 different languages by the click of a button. While a weighing of factors, at least in theory, certainly makes a determination of whether permanent establishment exists less lucid, the threshold rules discussed above is aimed at diminishing such uncertainty. For example, if a U.S. retailer's revenue from Danish customers constitutes 25% of the retailer's annual revenue, and the website is either translated into Danish, or Denmark is one of the destinations to where the retailer will ship its goods, then permanent establishment exists. The whole thereby becomes greater than the sum of its parts.

By adding this additional requirement, this solution considers the interest of the resident country, in that only e-commerce transactions that rise to a certain level of economic activity are subject to taxation in the source country, and only if the retailer has

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

purposefully 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 resident 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 resident country will report to the source country any e-commerce activity that meet 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 the existing Art. 26 of the OECD Model Tax Treaty, which is also contained in the U.S.-DK Tax Treaty, albeit in its former version.[120] 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 virtually impossible to pay with cash online.[121] Thus, in order to partake in an e-commerce transaction, consumers have to 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.[122] 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 in order to properly tax the income from this new permanent establishment. As noted earlier, tax treaties only determine who may impose a tax on a

[120] Any reporting system would have to be designed so as 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 so as to make legislative room for the described reporting system.

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

[122] Again, the system would have to be designed so as 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.

given economic activity, not how that income can and is to be taxed. The income generated under the solution herein proposed can be taxed in the U.S. under Code Section 865(c)(5), and in Denmark under the DWTA Section (2)(1)(4), as the solution merely suggests a different framework for determining whether permanent establishment exists. It would be advisable, however, to amend both sections to explicitly include income generated pursuant to the "Substantial Revenue Purposefully Derived from the Source Country" test, as an extension of the traditional permanent establishment principle. This should be done, in order to eliminate any uncertainties *vis a vis* Code Section 864(e)(2) and the DWTA Section 2(9), both of which address the outer limits of the traditional permanent establishment principle.[123]

In order 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.[124] The solution that would have 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. Additionally, 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, one should bear in mind that it would only be put to use, in the event that the taxpayer fails to properly report and pay taxes owed to the foreign national.

Some scholars may take exception to the reporting system herein proposed. These commentators may appropriately argue that a country such as the U.S., whose judicial branch, as a later discussion will show, heavily favors U.S. taxation, would not easily enter into an agreement, pursuant to which they would have to share information that would result in revenue not being subject to U.S. taxation. Moreover, it may be also argued that even if the agreement was in effect, the recipient country has no means by which it can 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 truth and veracity, although the alternative approach

[123] Both provision addresses the issue of when the activities of an agent constitutes permanent establishment, and as such, in essence negatively defines the permanent establishment principle.

[124] *Cf.* SVEND GRAM JENSEN, SKATTEMYNDIGHEDERNES KOMPETENCE 55 (3rd ed. 1997) (noting that in order for the competent tax authorities to collect taxes pursuant to the law, they need to be equipped with so-called material authority, i.e. an enforcement mechanism).

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. will be anything but honest and forthcoming with the information they would be obligated to provide under the reporting system. Skepticism of government can be positive, but 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, pursuant to which EU member states, as part of EU's overall tax policy, have agreed to exchange information on, *inter alia*, savings income, relies on a similar honor system.[125] The member states apparently did not find the lack of an information verification method to be a grave enough of an issue that should prevent the Feira Agreement from taking effect.

As for the first issue, 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 proceed by marketing and selling 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 Service, in order for the Service to tax the companies in question that meet the "Substantial Revenue Purposefully Derived from the Source Country" test. The system would likewise be beneficial to Denmark, in as much as companies may utilize the approach just described, 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 the existence of said system. Moreover, the U.S. has wholly embraced the idea that information exchange is the key to properly taxing cross-border transactions in

[125] *See* Press Release, Santa Maria da Feira European Council: Presidency Conclusions, *available at* www.blue-21.de/PDF/ECTaxPackage.pdf; WOLFGANG SCHÖN ET AL., TAX COMPETITION IN EUROPE 104-05 (2003).

our new economy, as evidenced by recent legislation known as FATCA.[126] 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.[127] Thus, while the solution will face a number of obstacles as it moves towards implementation, countries like the U.S. and Denmark should support its enactment, provided that they do not fall prey to legislative myopia.

Obviously, the solution is not completely neutral, nor completely equitable. It should be noted though, that the solution does not seem to have any effect on taxpayer behavior, in that consumers should be indifferent as to whether they purchase from a U.S. or a Danish retailer, because the consumers do not suffer any direct tax burden.[128] 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, for example, making e-commerce a new source. Because of the threshold amounts and additional factors needed to find permanent establishment, 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 as to whether either type of transaction can be taxed by the source country relies on different factors, the end result is that e-commerce transactions, and consequently e-commerce vendors, will be treated differently than 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, however, show whether e-commerce transactions are better or worse off than their traditional counterparts, as well as determine just how different the transactions are being treated.

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[126] Foreign Account Tax Compliance Act, enacted as part of the Hiring Incentives to Restore Employment Act, Pub. L. 111-147 (2010).

[127] In very broad terms, FATCA requires certain foreign financial as well as non-financial 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.

[128] 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.

Thus, the solution is not without its faults, but a tax system without faults is utopia. The "Substantial Revenue Purposefully Derived from the Source Country" test is superior to the other proposed solutions, as well as to the existing tax scheme. First, the solution better weighs the interest of the source country and the resident country, in that only economic activity that rises to a certain level is subject to taxation in the source country. Second, these legitimate interests are further protected and weighed by requiring a showing that the retailer purposefully availed itself of, and targeted, the source country in question, before the source country may impose a tax on the transaction. As such, the solution strikes the necessary and proper balance between fairness and efficiency, and is the essential fundamental change needed to appropriately tax e-commerce profits going forward.

VII. Taxation of Payment for Services and Payment for the Use of Intangible Property

Reanalyzing permanent establishment in light of advances in technology and the natural evolution of the economy is all well and good, but taxation of income under a treaty does not always depend on a finding of permanent establishment. One might think that treaty rules that are generally unaffected by technological and economical progress, rests on a sound basis, and therefore not in need of a change. Were one to have such a belief, however, one would be gravely mistaken. Moreover, technological and economical advances have exacerbated many of the issues existing treaty rules face, including the treaty rules that will be discussed in the following analysis. The transactions upon which tax can be levied even in the absence of permanent establishment 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 greatly 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 will analyze the taxation of these transactions, and determine whether there is a need for a change.

A. Taxation of Intangible Property Under U.S. Law

Under Section 861(a)(4), U.S. source income includes income for the privilege of using intangible property in the U.S.[129] Absent a sale, the source of income from intangible property thus depends on where it is used. The Code generally refers to payments for the use of intangible property as payments of rentals or royalties.[130] While Section 861(a)(4) may seem clear on its face, the United States Tax Court has read an exception into the Code.[131] In *SDI Netherlands*, the Tax Court held that 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.[132] The case involved three related companies: SDI Bermuda, SDI Netherlands and SDI USA. SDI Bermuda licensed certain intangible property rights to SDI Netherlands, who in turn sublicensed the rights to SDI USA, for the purpose of having SDI USA market and sell the intangible in the U.S. Pursuant to the contracts between the entities involved, SDI USA made royalty payments to SDI Netherlands, who 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 U.S.-Netherlands 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 Service 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 Service'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."[133]

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

[129] *Id.* at § 861(a)(4); *but cf. id.* at § 865(d)(1).
[130] *Id.*
[131] *SDI Netherlands B.V. v. Comm'r*, 107 T.C. 161 (1996).
[132] *Id.* at 176-77.
[133] *Id.*

disposition of the intangible."[134] If payment is so contingent, the same rule that is applicable to royalty payments applies, that is, payment is sourced at the place of use.[135]

B. Taxation of Intangible Property Under Danish Law

Pursuant to the 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 pursuant to 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 of carrying on a business through permanent establishment and the property belongs to that business.[136]

C. Taxation of Intangible Property Under the Treaty

Under the U.S.-DK Tax Treaty, which mirrors the OECD Model Tax Treaty in this respect, 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.[137] Similarly to the Code, 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% and 25% withholding set forth in the Code and the DWTA respectively, which continues to apply absent the existence of a treaty.[138] If, however, the royalties are attributable to income effectively connected with carrying on a trade or business in the other contracting state through permanent establishment, the

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[134] I.R.C. § 865(d)(1)(A).
[135] *Id.* at § 865(d)(1)(B).
[136] *See* Danish Act on Amortization and Depreciation §§ 40(6) and 41(2).
[137] *See* U.S.-DK Tax Treaty Art. 12(1) and 12(3); *see also* OECD Model Tax Treaty Art. 12(1) and 12(3).
[138] *See* I.R.C. §§ 871, 881, 1441, 1442; DWTA §§ 2(1)(8) and 65C.

royalties are subject to taxation in that other state as ordinary business profits.[139] The term royalties is broadly defined, and, unlike the DWTA, includes the payment for the use of a copyright to a literary, artistic or scientific work.[140]

D. Taxation of Compensation for Services Under U.S. Law

Pursuant to the Code, income from the performance of services is generally taxed at the place of performance.[141] One exception to this rule is the so-called 90-day exception rule, under which compensation for services received by a foreign individual, present in the U.S. for 90 days or less during the taxable year, is foreign source if: (1) the services are performed for a foreign person who is not engaged in a trade or business in the U.S.; (2) the compensation paid does not exceed $3,000; and (3) the compensation is made to the taxpayer in the taxpayer's capacity as an employee of, or pursuant to a contract with, a non-resident 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, such services are performed on behalf of an office maintained in a foreign country by persons just described.[142]

E. Taxation of Compensation for Services Under Danish Law

Although the DWTA deploys a different systematic approach than does the Code, the taxation of income from the performance of services will generally be taxed in a similar fashion.[143] Pursuant to Section 2(1)(1), income from the performance of services are taxed at the place of performance, i.e. Danish source income,[144] provided that four conditions are met: (1) the income must be within the scope of Section 2(1)(1), e.g. salary and perks, (2) the income is earned during an employer-employee relationship, (3) the

[139] *See* U.S.-DK Tax Treaty Art. 12(3), 7; OECD Model Tax Treaty Art. 12(3), 7.
[140] *See* U.S.-DK Tax Treaty Art. 12(2),
[141] I.R.C. § 861(a)(3).
[142] *Id.*
[143] The Paper focuses on traditional performances of services, thus excluding, among others, income from hired labor, board member compensation and income from consulting.
[144] Pursuant to DSTA Section 4(1), a person who is fully taxable to Denmark is taxable on salary earned without Denmark. The Danish Tax Assessment Act Section 33A, however, effectively exempts foreign-source salary income from taxation in Denmark, provided certain conditions are met.

employer's tax home is Denmark, or the employer has permanent establishment within Denmark, and (4) the services are performed within Denmark.[145]

F. Taxation of Compensation for Services Under the Treaty

Until recently, treaties explicitly placed services into two categories: (1) independent services, which generally is equated with performance by an independent contractor, or by a self-employed individual; and (2) dependent services, which generally means services performed in a capacity as an employee under the direction of an employer.[146] In 2000, however, the OECD removed this explicit distinction from former Articles 14 and 15, reasoning that Art. 7 already covered taxation of performance of independent services.[147] 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 Tax Treaty.[148] Moreover, the U.S.-DK Tax Treaty was similarly not updated to reflect both the OECD's and the U.S.' newfound opinion about the relationship between Articles 7, 14 and 15. Nevertheless, since the OECD did not intend a substantive change, the effect hereof is negligible, if noticeable at all.

Under Art. 14 of the U.S.-DK 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 permanent establishment.[149] As for dependent services, Art. 15 adopts

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[145] Services performed on board a Danish plane or ship, is performed within Denmark, regardless of the location of said plane or ship. *See* HENRIK DAM, ET AL., GRUNDLÆGGENDE SKATTERET 134 (1st Ed. 2009).
[146] *See* ISENBERGH, *supra* note 2, at 55.
[147] *See* OECD Model Tax Treaty Commentaries Art. 14, paragraphs 42.1-42.10.
[148] *See, e.g.*, Convention Between the Government of the Kingdom of Denmark and the Government of the Republic of Serbia for the avoidance of double taxation with respect to taxes on income and on capital, May 19, 2009; Agreement between The Kingdom of Denmark and The Republic of Croatia for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income, September 14, 2007.
[149] U.S.-DK Tax Treaty Art. 14. The wording of the provision uses the term "fixed base" as opposed to permanent establishment. As noted in the OECD Model Tax Treaty commentary on the repeal of art. 14, "fixed base" is not different from permanent establishment. *See* OECD Model Tax Treaty Commentaries paragraphs 42.1-42.10.

a general rule that such services are taxable in the country where they are performed.[150] If, however, (1) the employee is present in the place of performance for 183 days or less during the taxable year; (2) the compensation is paid by an employer who is not a resident of the country of performance; and (3) the compensation is not paid as a result of the employer's permanent establishment in the country of performance, then the employee is not subject to taxation in the country of performance.[151]

VIII. The Conundrum: Drawing the Line Between Intangible Property Rights and Performance of Services

As noted in the introduction, source characterization is necessary in order to apply the source rules under the Code and the DWTA, respectively. 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.[152] 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 without the U.S., the nonresident alien will have no U.S. source income.[153] If the situation involves payment of a brokerage fee, and the property is located without 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 to the general source rule for services.[154] The same result could follow from the DWTA.[155]

As the example suggests, characterization of income is not always a difficult task. Rental income from real property,[156] interest[157] and dividends[158] are all fairly easily determinable.[159] The line between intangible property rights and compensation for services, however, often becomes blurred. This gray area often creates uncertainties for

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[150] *Id.* at Art. 15(1).
[151] *Id.* at Art. 15(2).
[152] *See* ISENBERGH, *supra* note 2, at 55.
[153] *See* I.R.C. § 862(a)(5).
[154] *See* I.R.C. § 861(a)(3).
[155] *See* DWTA Sections 2(1)(1) and 2(1)(5).
[156] *See* I.R.C. §§ 861(a)(4), 862(a)(4); DWTA § 2(1)(5).
[157] *See* I.R.C. §§ 861(a)(1), 862(a)(1); DSTA § 4(e); Danish Personal Tax Act § 4(1)(1).
[158] *See* I.R.C. §§ 861(a)(2), 862(a)(2); DWTA § 2(5).
[159] *See* ISENBERGH, *supra* note 2, at 55.

taxpayers and courts alike. Moreover, in those instances where 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 those applicable to compensation for services are vastly different, and focuses on different factors. Thus, being able to identify which is which is of utmost importance, but 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,[160] research has revealed that there are no published Danish tribunal or court cases where the issue of distinguishing between payments for intangible property rights and compensation for services has been analyzed, let alone discussed. Since the contrary is the case in the U.S., and since no clear line between the two types of income has been drawn, the issue remains ever important in light of the U.S.-DK Tax Treaty. In the seminal U.S. case of *Ingram v. Bowers*,[161] pursuant to a contract with the Victor Company, Enrico Caruso, who was a nonresident alien,[162] recorded several songs at Victor's studio, which was located in the U.S.[163] Enrico's commitment pursuant to the contract was "to sing for the purpose of enabling the Victor Company to make phonograph records of selections rendered by him."[164] In return for his obligation, the Victor Company would pay Caruso royalties that were directly tied to the sale of the records.[165] Since Caruso's songs were all recorded at Victor's U.S. place of business, the Service argued that the royalties were not in fact royalties, but compensation for services.[166] As such, Caruso's income, both from the sales made within, and from sales made without, the U.S. of the recorded records was U.S. source income. The estate of Caruso in contrast argued that pursuant to the contract with Victor, Caruso had licensed the rights in the recorded songs to Victor.[167] This

[160] *See* NIELS WINTHER-SØRENSEN, ET AL. SKATTERETTEN 3 241 (5th ed. 2009).
[161] 47 F.2d 925, 925 (S.D.N.Y. 1931).
[162] *Id.* at 926.
[163] *Id.* at 925.
[164] *Id.*
[165] *Id.* at 926.
[166] *Id.*
[167] *Id.*

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.[168] For income derived from sales without the U.S., however, such income would be foreign source.[169]

The court sided with the Service, 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.[170] 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.[171]

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.[172] Upon 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.[173] As such, even though *Ingram* was correctly decided from a purely legal standpoint, it is interesting to note that both courts hardly contemplated the economic realities of the transaction,[174] especially considering U.S. tax law's long standing principle of substance over form.[175] This principle is generally used by the Service to challenge positions taken by the taxpayer. At the heart of this principle, however, lies the

[168] *See* I.R.C. § 861(a)(4).
[169] *See id.* at § 862(a)(4).
[170] *Ingram*, 47 F.2d at 926.
[171] *Ingram v. Bowers*, 57 F.2d 65, 65 (2nd Cir. 1932).
[172] *See Ingram*, 47 F.2d at 925.
[173] *See* ISENBERGH, *supra* note 2, at 57. As Isenbergh explains, economist view the $100,000 compensation received by Babe Ruth during his tenure at 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.*
[174] *See Ingram*, 57 F.2d at 65-66; *Ingram*, 47 F.2d at 926.
[175] *See, e.g.*, *Rogers v. US*, 281 F.3d 1108, 1116-18 (10th Cir. 2002).

notion that legal technicalities shall 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 then-existing U.S. intellectual property law, if the economic substance of the Caruso-Victor contracts 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 intangible property are *Oppenheim v. Commissioner*,[176] and *Tobey v. Commissioner*,[177] although the latter involved tangible property and did not directly involve source categorization. In *Oppenheim*, a nonresident alien foreign author 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.[178] In return, the publisher would pay the author royalties from the sales of the novels.[179] 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.[180] Contrast that reasoning with *Tobey v. Commissioner*.[181] In *Tobey*, a U.S. citizen living in Switzerland sold his painting through a U.S. gallery.[182] As noted by the court, the artist "create[d] according to his own inspiration, not in response to buyers' wants or taste."[183] 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,[184] or, if inventory, at the place of passage of legal title.[185] 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

[176] *See* 31 B.T.A. 563 (1934).
[177] *See* 60 T.C. 227 (1973).
[178] *Oppenheim*, 31 B.T.A. at 563.
[179] *Id.*
[180] *Id.* at 564.
[181] 60 T.C. 227.
[182] *Id.* at 228-29.
[183] *Id.* at 228.
[184] *See* I.R.C. § 865(g).
[185] *See* I.R.C. § 861(a)(6).

were the result of Tobey's personal efforts, the income was compensation for services, and not for a transfer of tangible property.[186]

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 Service's position on the tax treatment of authors. According to the Service, whether payments to an author is compensation for services or payment of royalties, depends on who, the author or the other contracting party, holds the copyright to the literary works.[187] That reasoning, however, would have altered the outcome of the case. This is so, because at the time of creation, Tobey owned the copyright in his paintings by virtue of the then-applicable common-law copyright.[188] The court acknowledged this conundrum by rejecting the Service's position, holding that such rules prevent creators of tangible and intangible property from ever receiving payments for services performed.[189]

Nevertheless, the Service's position was later implicitly affirmed in *Boulez v. Commissioner*,[190] where 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 then-existing copyright laws, performers had property rights in their recordings.[191] 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.[192] 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.[193]

As a final example of the confusion created by U.S. case law in this area of international tax law, consider *Karrer v. US*.[194] Karrer, a scientist and non-resident alien,

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[186] *See Tobey*, 60 T.C. at 235.
[187] *See id.* at 234.
[188] BLACK'S LAW DICTIONARY, *Copyright*, (8t ed. 2004) (explaining that up until 1978, a property right arose automatically when the work was created).
[189] *Tobey*, 60 T.C. at 235.
[190] 83 T.C. 584 (1984).
[191] *Id.* at 584-95.
[192] *Id.* at 596
[193] *Id*.
[194] *See* 138 Ct. Cl. 385 (1957).

developed a technique whereby one could synthetically create B-2 and E vitamins.[195] Upon the discovery, Karrer contracted with a Swiss corporation, Basle, for the commercial exploitation of his findings.[196] Pursuant to 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 upon request.[197] Basle subsequently 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.[198] Karrer then assigned the rights to use the patents to the U.S. corporation under the direction of Basle.[199] In return, the U.S. corporation paid Karrer for the use of those patents.[200] Despite 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 pursuant to the Karrer-Basle contract.[201] As such, Karrer could not transfer any rights to the U.S. corporation, and the payments therefore had to be compensation for services performed.[202]

At first glance, the court's reasoning seems sounds. If Karrer owned nothing with respect to 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 utilized his technique, and those payments were designated by the U.S. corporation as royalty payments.[203] 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. Additionally, the court's conclusion is interesting in light of the actions taken by the parties prior to the suit, namely the fact

[195] *Id.* at 388.
[196] *Id.* at 389.
[197] *Id.*
[198] *Id.* at 390-91
[199] *Id.* at 391.
[200] *Id.*
[201] *Id.* at 395-97.
[202] *Id.*
[203] *Id.* at 391.

that Karrer had taken out patents in his name. If, as the court concluded, Karrer did not own the patents, how could he record a patent filing designating him as the owner?

B. Implications for the U.S.-DK Tax 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 U.S.-DK Tax Treaty, if the payments Kim 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*, i.e. the income would be U.S. source income either pursuant to Art. 14 or Art. 15, depending on the terms of the contract. If instead, however, the payments were properly characterized as royalty payments, the income would be taxable in Denmark alone, pursuant to Art. 12. Note that Art. 12 overrides the narrower royalty definition in the DWTA Section 65(C)(4), and that the latter would not apply in any event, as Kim, a resident of Denmark, is fully taxable to Denmark on his income pursuant to the DSTA Section 4(1). *Karrer v. US* 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 hereto in the U.S., any payments he would receive pursuant to these patents might be characterized as compensations for services by a U.S. court. This would undoubtedly be the case if Niels had contracted with the University of Copenhagen, pursuant to which contract, Niels was obligated to assign any patent rights to the University. If the University then contracted with a U.S. corporation for the use of Niels' patents, but, as in *Karrer*, the U.S. corporation paid Niels in connection herewith, because he would own the U.S. patents to his scientific findings, the payments Niels would receive might be characterized as payment for services. If, as in *Karrer*, the payments Niels 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 pursuant to Art. 12.

Based on the foregoing discussion, it seems clear that 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 said property will be characterized as royalty payments. As the discussion of the case law has also shown, however, reasonable people can sometimes disagree as to whether any rights have been retained by the original property owner.

Moreover, requiring an explicit reservation of copyright, in order to find that payments constitute royalties,[204] seems artificial[205] and inconsistent with general contract interpretation principles. The rule is foremost artificial if we look at the 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 said 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 with respect to the scope of 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.[206] 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 as to 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 discussed has sided with the purchasers on this issue.

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[204] *See, e.g., Boulez v. Comm'r*, 83 T.C. 584, 596 (1984); *Ingram v. Bowers*, 57 F.2d 65, 65 (2nd Cir. 1932).
[205] *See Tobey v. Comm'r*, 60 T.C. 227, 235 (1973) (arguing that "[i]t 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.").
[206] *See, e.g., US 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.

IX. Transfer of Intangible Property or Payment for Services: A New Approach

A. Reasons Why We Need a Change

> [I]t 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.[207]

While tax law is certainly a complex area of law, 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.[208] It is objectionable, because it makes tax planning very difficult, and it is contrary to the tax principle of simplicity.[209] 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*, in order 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.[210] 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 within the U.S.[211]

In the case of a U.S. resident,[212] the current approach is similarly subject to abuse. In order to avoid that his entire compensation constitutes 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

[207] *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*)*.
[208] *See Tobey*, 60 T.C. at 235.
[209] *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 lead attorneys and accountants to spend time finding loopholes).
[210] *See* ISENBERGH, *supra* note 2, at 58.
[211] *See* I.R.C. § 862(a)(3) (stating that compensation for services performed outside the US, are foreign source income).
[212] *See id.* § 865(g).

records sold outside the U.S. would be foreign source.[213] 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. A New Approach: Predominant Motivation and Use Taxation

As noted earlier, 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, pursuant to which the simplest solution is often the correct one, the proposed change offers a simple methodology 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 what they consider to be a shortcoming of the existing source rules, as a consequence of the development of new technologies. To alleviate these concerns, it has been suggested that the U.S. Congress replace the current national source rules for intangible property.[214] Instead, it should adopt a regime with a source rule that focuses entirely on the 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.[215] While this 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.[216] 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 Paper 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 require the need to use an intangible

[213] *See id.* §§ 862(a)(4), 865(d); ISENBERGH, *supra* note 2, at 59.
[214] *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).
[215] *See id.* (citations omitted).
[216] *See id.* at 236 (citations omitted).

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 of creating a new gray area, because it may sometimes be difficult to determine the predominant motivation for a given transaction. Yet, the Danish tax system already includes rules pursuant to which a determination of the predominant contract performance is necessary and often required.[217] 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 United States Court of Appeals for the Second Circuit has explained, "[i]n 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."[218] There seems to be little in the way of applying the predominant motivation, or essence of the contract, principle, to distinguish between service contracts and contracts for the sale, use or other transfer of intangible property. Additionally, under this approach, both the Service 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,[219] the Service 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 Service and SKAT could reasonably conclude that payments

[217] Pursuant to the Value Added Tax Act, taxation of ancillary performances follows the taxation of the main performance.

[218] *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).

[219] *See supra* note 172-173 and accompanying text.

pursuant to a contract under which an author obligates him or herself 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. currently taxes royalties.[220] 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.[221] 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, as well as 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.[222]

Because of the continued development of e-commerce, there may be situations where an intangible is used solely in the virtual world. In such an instance, the term "predominant use" must be interpreted broadly. Even where the intangible is not being directly used in the physical world, because we are all physical beings, 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 payor 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 payor's principal place of business. This rebuttable presumption follows from the solution's main principle, namely that the country that makes the commercial exploitation of the intangible possible, should be the jurisdiction that may impose taxes on that exploitation. The payor is a necessary part of the commercial exploitation of the intangible equation. Furthermore, payment for this exploitation originates from the payor. Because the country where the payor has its

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[220] *See* I.R.C. § 861(a)(4); c*f.* Guruli, *supra* note 214.
[221] *See* Guruli, *supra* note 214, at 235-36.
[222] If characterized as royalties for the use of a copyright to an artistic work, absent permanent establishment the income would not currently be taxable in Denmark, because as noted earlier, the DWTA excludes these types of royalties from taxation.

principal place of business makes the payor's corporate existence possible, that country indirectly thereby makes commercial exploitation of the intangible possible.

As with the solution proposed for determining permanent establishment in relation to e-commerce transactions, the "Predominant Motivation and Use" solution herein proposed 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, quantitatively different from companies moving their headquarters to Switzerland, a trend that has become more prevalent over the past couple of years.[223] As for being equitable, the solution aims at subjecting taxpayers from the same country to the same tax burden, regardless of where the income originates. Additionally, 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.[224] 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 payor'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 concurrently significantly simplifying the current tax regime applicable to these types of transactions.

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[223] Two such recent moves include 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.
[224] *Cf. Tobey v. Comm'r*, 60 T.C. 227, 235 (1973).

X. Conclusion

The traditional source rules as they exist in bilateral tax treaties, and in the U.S.-DK Tax Treaty in particular, were developed in a time where the economy and commercial activity was fixed and immobile. Due to the natural evolution of the economy, however, people and businesses have become, and are today becoming, increasingly more mobile. This is has led to new discoveries, technological advances, and creations of intangibles that was beyond anyone's comprehension just a decade ago. This Paper has analyzed three different categories of source rules in the U.S.-DK Tax Treaty, which it believes raises two of the most predominant issues tax law must address, due to the increased sophistication of the economy. A failure to address these issues will only lead to an exacerbation of the problems, making them even more pervasive.

This Paper first analyzed the issue of permanent establishment as it relates to online transactions. That analysis exemplified the current regime's primary shortcoming, namely its focus on a physical presence. As was demonstrated, the current regime leads to inaccurate tax consequences, and only through a change will sovereigns be able to properly levy taxes on e-commerce transactions going forward. That change should take the form of a new type of scheme through which e-commerce transactions should be taxed, namely the "Substantial Revenue Purposefully Derived from the Source Country" test. Pursuant to this solution, e-commerce transactions should be taxed in a source country, if the seller meets a test that requires it to purposefully derive substantial revenue from that country. As discussed under the analysis of this proposed solution, there are certain issues relating to its implementation. These issues are, however, far from being insurmountable. Moreover, the model should be considered an improvement over the current status quo of finding permanent establishment based on a server's location or not at all, in relation to e-commerce transactions. As has been shown, the current definition of permanent establishment is not an effective measure of economic activity in the digital age, and cannot therefore be used in determining international tax implication of digital economic activity. We must therefore move away from an insistence of applying traditional tax principles to this brave, not so new, world.

The Paper then proceeded with an analysis of the distinction between payment for services and payment for intangible property rights. That analysis illustrated why U.S.

case law unfairly and often arbitrarily favors U.S. taxation. In relation to the U.S.-DK Tax Treaty, this bias represents a significant issue for Denmark, in that Denmark could potentially lose out on revenue that properly constitutes Danish source income from an economic point of view. Thus, the analysis concluded that the current approach used to analyze whether payments are made for services or use of intangible property is artificial, sometimes arbitrary, and in many instances inconsistent with the economic realities. Moreover, the approach is contrary to the principle of simplicity in taxation, and sometimes contrary to contract interpretation principles. Consequently, a new approach was suggested, pursuant to which, taxation depends on the predominant motivation for the transaction in question, and if that motivation relates to the intangible, the place where the intangible is being used. The new approach is not a radical departure from the current regime, in that the focus is still on whether payments are made for services or transfers of intangible property rights. Rather than relying on legal technicalities as to the distribution of rights to the intangible under a given contract, however, the new approach focuses on the economic realities of the transaction, and therefore better aligns with the parties' intent. With an increase in the creation and discovery of new types of intangible property, the new approach should help alleviate many of the concerns shared by various tax scholars, that a need for modification of the existing rules is long overdue.[225]

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 Paper has shown, however, it is time to rethink a number of international tax rules, without throwing the baby out with the bathwater. Only by proceeding with such a shift, can we adopt taxation schemes and principles that can withstand the test of time. That is, until the natural evolution of the economy demands otherwise, or until something as remarkable as the internet again comes along.

[225] *See* Guruli, *supra* note 214, at 238-39.

XI. Summary

The source-based taxation rules as they exist in the U.S.-Danish Tax Treaty, were developed in a time where the economy and commercial activity was fixed and immobile. Consequently, they often rely on a physical presence requirement, before they will allow for source-based taxation. This is especially true for the permanent establishment principle, pursuant to which a foreign resident's income is generally taxed in the source country, if the foreign resident carries on a business through a permanent physical location in that source country. As the economy has matured, however, and as new technologies have been developed, the internet in particular, physical presence is no longer a prerequisite for carrying on even a substantial business, as companies today can have market presence within a country through e-commerce. Moreover, due to the evolution of our economy and the many innovations during the past century, lines that were blurry to begin with, have become even more so, to the point where some courts unjustifiably favors taxation in their home jurisdiction. These blurry lines are especially prevalent when distinguishing between payment for services and payments for intangible property rights.

In light of this progress, this Paper first analyzes whether there is need to revise the permanent establishment principle, which is answered in the affirmative. The Paper then proceeds to suggest a number of solutions that could apply to the taxation of e-commerce transactions, ultimately embracing a solution that would require an expansion and revision of the permanent establishment principle. Pursuant to this solution, e-commerce transactions should be taxed in a source country if the seller meets a test that requires it to purposefully derive substantial revenue from that country. Although the solution will necessitate some fundamental changes, it should be considered a vast improvement over existing law.

Having reached a conclusion as to the permanent establishment principle, the Paper then examines the issue of distinguishing between payment for services and payment for intangible property rights. It exemplifies how U.S. courts often arbitrarily, and not surprisingly, decides in favor of U.S. taxation, even if such decisions contradicts or directly collides with U.S. court precedent. The Paper then examines whether a change in the way the aforementioned items are taxed is prudent. It concludes once again in the affirmative, suggesting an approach that focuses on the predominant motivation for a given transaction, and the place where the subject matter of that transaction is going to be used. Although that solution too is not without its faults, it should similarly be favored over the existing rules.

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