Source, Character and Taxable Presence in a Digital World: International Taxation of Online Advertising

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Citation
Source, Character and Taxable Presence in a Digital World: International Taxation of Online Advertising

By

Assaf Y. Prussak

A dissertation submitted in satisfaction of the requirements for the degree of Doctor of the Science of Law at The University of Michigan April 2017

Doctoral Committee:
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In memory of my grandfather Gershon Weinstein, who instilled in me the love for books and the passion for learning.

In dedication to my parents, my mother-in-law, my kids Alma, Maayan and Noam, and to my wife Shadmit, whose sacrifice and care for me and our children has made it all possible.

I am extremely grateful to Professor Reuven S. Avi-Yonah for his invaluable support, guidance and comments.
# TABLE OF CONTENTS

## CHAPTER

1. Introduction .................................................................................................................................................. 1

2. A Technological Revolution – Untwining the Physical Strings of Trade and Commerce..... 5

3. New Sources of Income.................................................................................................................................. 13

4. Basic Concepts of Online Advertising ........................................................................................................... 35

5. Understanding the Business is an Essential Step in Designing Good Tax Law .................. 54

6. Distinguishing Online Advertising ............................................................................................................... 74

7. Interim Summary ........................................................................................................................................... 82

8. Taxation of Income from Online Advertising Under the Existing U.S. and International Tax Regimes ........................................................................................................................................ 83

9. The Inadequate Results of the Taxation of Online Advertising under Existing Law ....... 159

10. Taxation of Online Publishers by the Jurisdictions of the Users......................................................... 221
## DETAILED TABLE OF CONTENTS

### CHAPTER

1. **Introduction** ........................................................................................................................................... 1

2. **A Technological Revolution – Untwining the Physical Strings of Trade and Commerce** ........ 5
   2.1. The Physical Quality of Traditional Trade and Commerce ................................................................. 5
   2.2. A Technological Revolution – Removing the Physical Restraints ...................................................... 7

3. **New Sources of Income** ......................................................................................................................... 13
   3.1. Software ............................................................................................................................................... 14
   3.2. Electronic Commerce .......................................................................................................................... 17
   3.3. Cloud Computing ............................................................................................................................... 22
   3.4. Online Advertising ............................................................................................................................ 28
   3.5. What All This Has to Do with Tax? ....................................................................................................... 32

4. **Basic Concepts of Online Advertising** ............................................................................................... 35
   4.1. Pricing Models .................................................................................................................................... 36
   4.2. Personalization and Targeted Advertising .......................................................................................... 40
   4.2.1. Cookies and Other Tracking Technologies ...................................................................................... 42
   4.2.2. Personalized Ads in a Heartbeat ...................................................................................................... 45
   4.2.3. “Major League” Personalization ..................................................................................................... 47
   4.2.3.1. Google Inc .................................................................................................................................. 47
   4.2.3.2. Facebook Inc ............................................................................................................................. 50
   4.2.4. The Future of Online Personalized Advertisement .......................................................................... 52

5. **Understanding the Business is an Essential Step in Designing Good Tax Law** ........................... 54
   5.1. Means to An End ................................................................................................................................ 54
   5.2. The Tax Should Follow the Economics ............................................................................................... 57
   5.2.1. The Gap between Economics and Tax ............................................................................................. 59
   5.2.2. Under-Taxation and Over-Taxation ................................................................................................. 62
   5.2.3. Can We Close the Gap? .................................................................................................................. 65
   5.2.3.1. Get More Blocks = Add More Rules ............................................................................................ 66
   5.2.3.2. Filling in the Gaps Between the Blocks = Add Standards ............................................................. 68
   5.2.4. What About Over Taxation? ............................................................................................................ 71

5.3. **Conclusion** ......................................................................................................................................... 72
<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>6. Distinguishing Online Advertising</td>
<td>74</td>
</tr>
<tr>
<td>6.1. Physical Fingerprint</td>
<td>74</td>
</tr>
<tr>
<td>6.2. The Parties to the Transaction</td>
<td>77</td>
</tr>
<tr>
<td>6.3. The Revenue-Generating Factor</td>
<td>78</td>
</tr>
<tr>
<td>7. Interim Summary</td>
<td>82</td>
</tr>
<tr>
<td>8. Taxation of Income from Online Advertising Under the Existing U.S. and International Tax Regimes</td>
<td>83</td>
</tr>
<tr>
<td>8.1. Source vs. Residence</td>
<td>84</td>
</tr>
<tr>
<td>8.2. Where it All Began: The Early Days of International Taxation</td>
<td>88</td>
</tr>
<tr>
<td>8.3. The Importance of Determining the Source of Income</td>
<td>94</td>
</tr>
<tr>
<td>8.4. Source Rules</td>
<td>100</td>
</tr>
<tr>
<td>8.4.1.1. Existing Source Rules</td>
<td>101</td>
</tr>
<tr>
<td>8.4.1.2. Determining the Character of Income</td>
<td>107</td>
</tr>
<tr>
<td>8.4.1.3. No Source Rule? No Problem: The Analogy Method</td>
<td>111</td>
</tr>
<tr>
<td>8.4.2. Source Rules in Tax Treaties</td>
<td>116</td>
</tr>
<tr>
<td>8.5. Determining the Source of Income from Online Advertising Under Existing U.S. Federal Income Tax Law</td>
<td>123</td>
</tr>
<tr>
<td>8.5.1. Character of the Income Derived from Online Advertising</td>
<td>124</td>
</tr>
<tr>
<td>8.5.1.1. Income from the Provision of Personal Services</td>
<td>124</td>
</tr>
<tr>
<td>8.5.1.2. Income from Rents and Royalties</td>
<td>128</td>
</tr>
<tr>
<td>8.5.2. The Analogy Method and its Unfitting Results</td>
<td>131</td>
</tr>
<tr>
<td>8.6. The Tax Consequences of Sourcing Income from Online Advertising According to Existing Rules</td>
<td>140</td>
</tr>
<tr>
<td>8.6.1. No Treaty Scenario – United States Trade or Business</td>
<td>141</td>
</tr>
<tr>
<td>8.6.2. Treaty Scenario – Permanent Establishment</td>
<td>149</td>
</tr>
<tr>
<td>8.7. Summary</td>
<td>156</td>
</tr>
<tr>
<td>9. The Inadequate Results of the Taxation of Online Advertising under Existing Law</td>
<td>159</td>
</tr>
<tr>
<td>9.1. Why Do Existing Rules of Taxation Yield Improper Results When Applied to Income from Online Advertising?</td>
<td>159</td>
</tr>
<tr>
<td>9.1.1. Ignoring the Economic Reality Leads to Inadequate Taxes</td>
<td>159</td>
</tr>
<tr>
<td>9.1.2. The Consequence: Double Irish with a Dutch Sandwich</td>
<td>169</td>
</tr>
<tr>
<td>9.2. “Sources” of the Problem – Part I: Characterization and Source Rules</td>
<td>177</td>
</tr>
</tbody>
</table>
10. Taxation of Online Publishers by the Jurisdictions of the Users .................................................. 221

10.1. Justifying the Taxation of Online Publishers by the Jurisdictions of the Users .................. 221

10.1.1. Jurisdiction to Tax – Theory ....................................................................................... 221
10.1.2. Jurisdiction to Tax – Application ............................................................................... 232
10.1.3. Does Taxation of Online Publishers by the Jurisdictions of the Users Coincide with Fundamental Principles of the International Tax Regime? .................................................. 236

10.2. Proposed Framework for Taxing the Income of Online Publishers .................................. 242

10.2.1. Character and Source ................................................................................................. 244
10.2.1.1. The Source Rule for Income from Natural Resources Under U.S. Tax Law .... 246
10.2.1.2. The Source Rule for Income from Natural Resources Under Tax Treaties ..... 250

10.2.2. Crossing the PE Threshold .......................................................................................... 252

10.2.2.1. Proposing an Additional PE Threshold .................................................................... 253
10.2.2.2. Review of Prior and Existing Proposals for a Digital PE ..................................... 254
10.2.2.3. Economic Nexus under U.S. State Tax Laws ......................................................... 274
10.2.2.4. Proposal for an Economic-presence-based PE Threshold ....................................... 285
10.2.2.5. Application of the Proposed PE Threshold to Online Advertising .................. 291
10.2.2.6. The Proposed PE Threshold – a Standard for Closing the Gap ........................... 292

10.2.3. Flat-Rate Tax on Gross Revenues ................................................................................ 295

10.2.3.1. Double Taxation ................................................................................................... 301
10.2.3.2. Discrimination and Subsidy ................................................................................... 303

10.2.4. Adoption of the Proposal .......................................................................................... 305
10.2.5. Enforcement and Collection ................................................................. 306

10.3. What are Countries Doing? A Review of Unilateral Measures to Tax Digital Companies .......... 313

10.3.1. United Kingdom – Diverted Profits Tax ................................................. 317
10.3.2. Australia – Multinational Anti-Avoidance Law & Diverted Profits Tax ........... 322
   10.3.2.1. Multinational Anti-Avoidance Law .............................................. 322
   10.3.2.2. Diverted Profits Tax .................................................................... 324

10.3.3. India – Equalization Levy ...................................................................... 328
10.3.4. Israel – Significant Economic Presence PE ............................................. 334
10.3.5. Other Countries ..................................................................................... 338
   10.3.5.1. France ............................................................................................ 339
   10.3.5.2. Italy ............................................................................................... 341
   10.3.5.3. Turkey ........................................................................................... 341

10.3.6. Final Words ............................................................................................ 342
1. **INTRODUCTION**

The purpose of this dissertation is to examine the application of the U.S. and international tax rules and norms to income derived from online advertising, to consider the challenges and problems that arise when these rules are applied to such a purely-digital type of income, to propose an alternative framework for the taxation of online advertising, and to discuss the legislative measures adopted by various countries in an attempt to tax this type of income (and other income derived from digital-based activities).

* * *

The digital revolution created a new medium for trade and commerce – the internet. This unique platform created opportunities for generating revenues in novel ways that were not previously possible. One of these internet-based revenue-generators is online advertising. Anyone using the internet knows what online advertising is. Whether it is on Google’s search page, the feed on Facebook, the banner on a random website, or that pesky ad for sneakers that you considered buying last week that keeps following you to every website you visit – online advertising is everywhere.

Despite the magnitude of this industry (estimated to generate $230 billion of revenues in 2017 alone), its major players (Google and Facebook), as well as other multinational companies operating in the digital economy, have become known of their elaborate tax structures and schemes that allow such companies to significantly minimize their tax liabilities. To be clear, if these multinational companies would have been evading taxes by adopting illegitimate tax positions and hiding revenues from tax administrators, that would have been an easy problem to solve. The problem with income derived from the digital economy is (generally) not a problem of tax evasion but rather of tax avoidance.
The unique characteristics of income derived from digitally-based activities challenge the traditional tax rules. Source, character and taxable presence are all concepts that were formed in the pre-digital age, and such concepts simply fail when confronted with digital-based types of income, resulting in inadequate tax treatment that ignores the underlying economic components of such activities.

The interaction between the existing tax rules and income from online advertising is especially interesting because of the unique characteristics of online advertising – it has no physical fingerprint; it is generated in a multi-party transaction comprised of a publisher, an advertiser and a user, each of whom could be located in a different jurisdiction; it involves “mining” and exploiting of users’ personal information and data for purposes of targeting the advertisements to the users; and the party that generates the revenue (i.e., the user who views, clicks or acts upon the advertisement) is neither the payee nor the payor of the income. This dissertation explores these special characteristics, explains why the application of the existing tax rules to income from online advertising yields improper results that allow online publishers to avoid paying proper taxes, and explains what are the underlying problems with the existing tax rules that cause such results.

The main argument advocated by this dissertation is that income derived from online advertising should be taxed “at source” by the jurisdictions in which the users are located. According to this argument, the key factor that generates the value in the income-generating process of online advertising are the users. Such income is generated by the mining of personal data of the users and ultimately by the actions of the users themselves. The dissertation argues that (1) user information and data are assets the value of which is made possible by the efforts of the jurisdiction of the users whose data is being mined and exploited, and (2) the online advertising income, which relies on the mining of such personal information, is generated as a result of the active participation of the users. These factors justify the sourcing of the income from online advertising to the jurisdiction of the users and further justifies the finding of taxable presence for the online publisher in such jurisdictions. Based on this argument, the jurisdiction of the users has a legitimate claim to tax online publishers with respect to income generated by users from within that jurisdiction. Such result it justified based on the prevailing theory of jurisdiction to
tax (the benefits theory) and it also complies with two of the fundamental building blocks of international tax policy – the benefits principle and the single tax principle.

Because existing tax rules do not allow the jurisdictions of the users to tax online publishers, and because such taxation is nonetheless justified, this dissertation includes a proposed framework for the taxation of online publishers that would achieve such result. The suggested framework includes a new proposed threshold for creating taxable presence (a permanent establishment) for online publishers in the jurisdiction of the users. Such taxable presence would exist when a foreign person exploits an economic resource or enjoys an economic benefit from within a jurisdiction, the resource and/or benefit enjoyed/exploited is a material factor in the realization of the income, and the activity has crossed a de-minimis threshold. The proposal further includes a new tax that would be applied to income of online publishers by the jurisdictions of the users, as well as a suggested solution for enforcement and collection of the proposed tax.

* * *

This dissertation is organized as follows: chapters 2 and 3 provide an overview of the technological revolution and the development of new digital industries. Chapter 4 includes an in-depth review of the special features of online advertising (user-based pricing models and targeted advertising). Chapter 5 introduces the concept that good tax law should follow the economics of the transaction being taxed, and what are the consequences when such principle is not followed (as in the case of online advertising). Chapter 6 includes a discussion of the unique characteristics involved in generating income from online advertising. Such discussion will serve as a bridge between the previous chapters that discussed the business aspects of online advertising (and other digital industries), and the following chapters, that discuss and analyze the taxation of income from online advertising. In addition, this chapter explains why online advertising is the ultimate study case for discussing the challenges raised by the digital economy with respect to the applicability of the existing tax rules. Chapter 7 includes an interim summary, follow by chapter 8 which explores the manner in which income from online advertising is taxed under the existing U.S. and international tax regimes. Based on the discussion in this chapter I conclude that the application of such rules yield inappropriate results. Chapter 9 explains why such results should be considered improper and what are the leading factors that contribute to
such results. Finally, chapter 10 will discuss the legal justification for the taxation of online publishers by the jurisdictions of the users. The chapter then includes a proposed framework for the taxation of online publishers (including a discussion of character, source, and taxable presence). The final part of chapter 10 includes a review and discussion of the main unilateral measures adopted by various countries in an attempt to tax the digital economy, and the application of such measures to the taxation of online publishers.
2. A TECHNOLOGICAL REVOLUTION – UNTWINING THE PHYSICAL STRINGS OF TRADE AND COMMERCE

“And they sat down to eat bread: and they lifted up their eyes and looked, and, behold, a company of Ishmeelites came from Gilead with their camels bearing spicery and balm and myrrh, going to carry it down to Egypt.”

2.1. The Physical Quality of Traditional Trade and Commerce

People have been engaging in trade and commerce since the dawn of man. Archeological excavations have shown that humans have been trading with each other since the pre-historic era. Recorded written history has evidence of advanced commerce and trade practices since the days of the Egyptian and Babylonian empires. Later on it was the Phoenicians and the Greeks who developed new commerce and trade practices in the Middle East and Mediterranean, and it was the “pax Romana”—the peace that the Roman Empire had managed to sustain for centuries—that allowed modern commerce to develop in ways previously unheard of. In the middle ages it was the town markets and guilds, followed by the evolution of maritime commerce, led by the Scandinavian people of the north, which eventually led to the incorporation of the (some say) first multinational corporations—the Dutch West India

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1. Genesis 37:25 (King James, Cambridge Ed.).
2. The lexical definition of the term “Commerce” is “[t]he exchange of goods and services, esp. on a large scale involving transportation between cities, states and nations.” BLACK’S LAW DICTIONARY, 304 (9th ed. 2009); “Trade” is defined as “The business of buying and selling or bartering goods or services.” Id. at 1629.
4. Id. at 10.
5. Id. at 17–23.
6. Id. at 26.
7. Id. at 41.
8. Id. at 49.
9. Id. at 70.
Company, the British East India Company and the like—which reigned the seas during what is considered in international commerce as the golden age of sail. From that point on, expansion of international commerce and trade into all outskirts of the globe was swift, aided by such inventions as the steam locomotive, the aircraft, and the internal-combustion engine.

The camel caravan of Ishmaelite coming from Gilead, the then-unparalleled marine commerce of the Phoenicians, the town markets of the middle ages, and the modern Walmart super stores are all landmarks in the fast-evolving history of human commerce and trade. While centuries and even millennia separate them, all past revolutionary empires of trade and commerce have had one very important character in common—they were all “playing” on the same field. Whether by land, sea or air, the sphere in which people engaged in trade and commerce was always physical and material. It was very much like a game of “connect the dots”—exchanging one type of goods for another (including money) required the parties either to meet in one location to make an exchange, or to transport or ship the merchandise from one geographical location to another. The same applies to services, which had to be provided at the physical location of either the customer or the service provider.

Even the development of intangible property did not change this characterization of commerce. Designs, patents, trademarks and copyrights are all physical manifestations of ideas. The trade of intellectual property, made possible by the protection provided by intellectual property law, has a distinct physical feature. Whether it be a copyrighted book, a patent or a commercial logo, the laws of intellectual property do not protect mere ideas, but rather their physical expression. For example, under the Copyright Act of 1976 copyright protection is granted only to “original work of authorship fixed in any tangible medium of expression.” Thus, one of the basic

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11 DAY, supra note 3, at 191.
12 This observation refers to the time before the development of computer software, which has substantial non-physical qualities and yet is also protected under copyright laws (following the 1980 amendments to the Copyright Act of 1976, which made it clear that computer programs are copyrightable as literary works. See Deborah F. Buckman, Annotation, Copyright Protection of Computer Programs, 180 A.L.R. Fed. 1 (2002)). The computer revolution and its influence on the role of the physical element in commerce are discussed later in this chapter.
15 Id. at §102 (emphasis added).
requirements for qualifying for copyright protection is that the work is fixed in a tangible form. However, the ideas behind such copyrighted material are not protected. A similar analysis applies to patents. According to U.S. patent law, an invention is patentable only if it meets several requirements, two of which are commonly referred to as utility and enablement. The utility requirement, that states that an invention must be “useful” to be patentable, was construed by courts as a requirement aimed to prevent mere ideas from being patented. The enablement requirement provides that the patent must also include a description of the invention sufficient to enable a skilled person in the relevant field to make and use the invention. Both requirements emphasize the physical dimension of a patent and the inability of patent law to protect mere ideas, good as they may be.

2.2. A Technological Revolution – Removing the Physical Restraints

The above review demonstrates that all traditional trade and commerce transactions, whether tangible or intangible, leave some physical impression, and are conducted in a very material manner. Absent any other development, this observation would have been redundant, self-explanatory and even strange. Until not too long ago this was true – there was no other way to perform trade or provide services other than in a physical manner. But then the invention of the computer and telecommunication technologies, as well as the birth and evolution of the internet, started a snowball phenomenon, the results (or the continuing development) of which we are

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19 See In re 318 Patent Infringement Litig., 583 F.3d 1317, 1324 (Fed. Cir. 2009).

20 35 U.S.C. § 112 (2012). This requirement has been part of the common law even before its codification in the U.S. Code. See Mowry v. Whitney, 81 U.S. 620, 644 (1871); see also Beidler v. U.S., 253 U.S. 447, 453 (1920).

21 The “earthly” nature of patents can also be learned from the committee reports that accompanied the enactment of the 1952 Patent Act (later revised), which indicate that Congress intended for this act to “include anything under the sun that is made by man.” (S. Rep. No. 1979, 82d Cong., 2d Sess., 5 (1952); H.R. Rep. No. 1923, 82d Cong., 2d Sess., 6 (1952), as cited by Diamond v. Chakrabarty, 447 U.S. 303, 309 (1980)).

22 While the European Patent Convention does not include a “utility” prerequisite, it instead requires that a patentable invention be “susceptible of industrial application.” An invention will meet this requirement if it “can be made or used in any kind of industry.” See EPC 2000, Articles 52, 57. Thus, the physical manifestation requirement of the protected patent exists in the European context as well.
experiencing to this very day. These technological breakthroughs had tremendous effect on the world of commerce, especially with respect to its traditional physical nature. The following paragraphs include a short recap of the history of the computer and the internet.

Long before the invention of the first mechanical computing machine, and dated back as far as the mid-seventeenth century, the word “computer” was originally used to describe a person whose profession was carrying out calculations. These human computers (aided by mechanical calculators) took part in some of the most ambitious projects ever known to man at that era, such as the British Nautical Almanac – the world’s first comprehensive collection of maritime navigational charts and data, published consecutively since 1766. This human-computed project brought such great improvements to maritime navigation capabilities it had become known as the Seaman’s Bible. However, since these charts were based on human calculations, they were susceptible to errors, and indeed after the original computers of the Almanac died in the early 1800s, it has lost its eminence because of abundant errors. Surprisingly, these human errors of calculation are to be thanked for, as correcting them was the goal which drove Charles Babbage – known to this very day as the “father of the computer” – to invent the first programmable computer. This was in 1833, when Babbage invented the Difference Engine, which in 1840, after some refining and redesigning, became the Analytical Engine – an automatic machine that could be programmed using a punch card mechanism to perform extremely complex calculations.

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24 The first mechanical calculator was invented in 1642 by Blaise Pascal, a French mathematician and physicist, and it could add or subtract two numbers. It was Gottfried Wilhelm Leibniz, a German mathematician and philosopher, who in 1672 invented a calculator which performed all four basic arithmetic operations. Leibniz’s calculator’s mechanism was in use for over 200 years. GERARD O’REGAN, A BRIEF HISTORY OF COMPUTING 25 (2nd ed. 2012).
28 CHRISTOS J. P. MOSCHOVITIS ET AL., HISTORY OF THE INTERNET: A CHRONOLOGY, 1843 TO THE PRESENT 7 (1999). Despite the fact that Babbage’s invention eventually remained on the drawing board (after the British Government withdrew its financial support from the project. Id. at 7), it earned its honorable place in history when in 1991 the British Science Museum constructed and operated the Analytical Engine, and confirmed that it can perform highly complex calculations as originally claimed by Babbage (id. at 3) It was mechanical computing pioneer Leslie Comrie who argued that the British Government’s failure to support Babbage’s project to the end had “…cost Britain the leading place in the art of mechanical

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Babbage’s invention was the opening shot for what will turn out to be one the most influential eras in the development of computer and communications technology, running from mid-1800s to the early 1900s. During that period, Samuel Morse transmitted the world’s first long-distance communication message via telegraph between Washington D.C. and Baltimore (1844); the British completed laying the first inter-continent telegraphic communication cable between Ireland and Newfoundland (1866); Alexander Graham Bell invented the telephone (1876); for the first time the U.S. census was processed by automated machines (1890); Guglielmo Marconi made the first transatlantic radio transmission (1901); And Alan Turing introduced the principles of digital computing (1936).\(^{29}\) It was in the 1940’s that the word “computer” was first associated with the automatic calculating machine, which up until then was referred to as “calculator”\(^ {30}\)

The great industrial and military efforts of *World War II* were the catalysts for a burst of further technological innovation during the years of the war and beyond it. With an aim at providing greater computation capabilities to solve practical problems, scientists across the globe (from such countries as the United States, England, Germany and Australia) developed new and more advanced types of computers,\(^ {31}\) which ultimately had a significant role in the Allies’ victory (such computers were used, for example, to create better naval navigation tables and decipher the German Enigma code).\(^ {32}\) While the post-World War II technological advances were inspired mainly by military necessities, the next quantum leap in computer and communication technology was driven first and foremost by national pride. The launch of the Sputnik satellite by the Soviets in 1957 struck the United Stated with amazement and fear. The *Race to Space* which followed had a significant role in the technological breakthroughs, especially in the field of computer communications, which laid the foundations of the modern internet.\(^ {33}\) With the goal of

\(^{29}\) [CHRISTOS J. P. MOSCHOVITIS ET AL., * supra* note 28, at 8–14.]

\(^{30}\) [Paul E. Ceruzzi, *HISTORY OF MODERN COMPUTING* 1 (2d Ed., 2003).]

\(^{31}\) [GERARD O’REGAN, *supra* note 24, at 35–36.]

\(^{32}\) [CHRISTOS J. P. MOSCHOVITIS ET AL., *supra* note 28, at 20–22.]

\(^{33}\) Many publications that address taxation aspects of internet activity try to thoroughly explain the technical operation of the internet and its basic terminology (including such terms as TCP/IP protocols, HTML, routers, switches, and client/server architecture). *See, e.g.*, RICHARD L. DOERNBERG & LUC HINNEKENS, *ELECTRONIC COMMERCE AND INTERNATIONAL TAXATION* 61 (1999). I believe such a description is superfluous here. Not only it is not necessary for understanding the arguments of this dissertation, but also

*Continued on the next page...*
beating the Russians to the moon, President Eisenhower decided to dramatically increase funding for scientific research. Consequently, among other initiatives, the U.S. Department of Defense founded the Advance Research Projects Agency (ARPA), which created the ARPAnet, the ancestor of the internet.

While the 140 years which part Babbage’s first computer and the ARPAnet were indeed affluent with technological breakthroughs, it was nevertheless incomparable to the intensity and speed of the technological outburst of the second half of the twentieth century that brought about true revolution in the means employed for local and international trade and commerce. The integrated circuit (the “chip”) and microprocessors emerged in the early 1970s; in 1981 IBM introduced the first personal computer, bringing the power of computing to the masses; Microsoft released MS-DOS in 1982, Word in 1983 and Windows in 1985, revolutionizing personal computer software; Apple’s Macintosh made its debut in 1984, and in 1991 the World Wide Web was developed in CERN (the European Laboratory for Practical Physics in Geneva), allowing for information, commerce, banking, media, marketing, and social life to transfer into the digital world in exponentially growing rates, resulting in the creation of a new modern society in cyberspace.

what was considered unfamiliar territory in the late 1990s is common knowledge today, at least with respect to the basic operations of the internet.


In 1995, the Federal Networking Council (under charter from the U.S. National Science and Technology Counsel) published one of the first official definitions of the term internet, which reads as follows: “Internet” refers to the global information system that -- (i) is logically linked together by a globally unique address space based on the internet Protocol (IP) or its subsequent extensions/follow-ons; (ii) is able to support communications using the Transmission Control Protocol/Internet Protocol (TCP/IP) suite or its subsequent extensions/follow-ons, and/or other IP-compatible protocols; and (iii) provides, uses or makes accessible, either publicly or privately, high level services layered on the communications and related infrastructure described herein.” (The Networking and Information Technology Research and Development program, Definition of “Internet” (October 24, 1995), http://www.nitrd.gov/fnc/Internet_res.aspx).

MARTIN CAMPBELL-KELLY AND WILLIAM ASPRAY, supra note 25, at 210.

GERARD O’REGAN, supra note 24, at 64. The influential role of the personal computer in the technological revolution during the 1980s can be learned from the fact that in January 1983 the Time magazine named the IBM PC to be “The Machine of the Year”, breaking a long tradition of naming a human being “Man of the Year”. Apparently, during that year, the IBM PC’s influence surpassed that of any other human, at least according to the Time editors’ opinion.

Id. at 86–87.

Id. at 106–107.

The term “Cyberspace” was first introduced in 1984 by author William Gibson in his science-fiction novel Neuromancer (CHRISTOS J. P. MOSCHOVITIS ET AL., supra note 28, at 119). Gibson describes cyberspace as

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This prominent age of technological innovation and ingenuity, referred to by some as the computer or internet revolution,\(^{41}\) is undoubtedly a significant turning point in the history of mankind. This new-age revolution gave birth to profound economic and social changes across the globe. The computer and internet radically changed practically all aspects of human life — both personal and business ones. One of the most prominent changes was in the field of trade and commerce.

With fast-growing demand and increasing investment in high-technology, the expansion of computer networks and internet around the world was just a matter of time. This sprawling effect created a global network of computers, which expanded even further with the appearance of mobile communication devices such as smart-phones, tablet personal computers, global positioning devices, etc. This global network enabled instant cross-border connectivity, ignoring geographical barriers or distances which up until recently served as an impeding factor in any type of international transaction. In the pre-computer and internet era, such physical barriers shaped human interactions and particularity influenced international commerce and trade. Selling products to customers across jurisdictional borders required complicated operations, as well as the use of middle men and other intermediary techniques in order to overcome both the physical barriers and their implications for international commerce (such as assuring payment and delivery, time zone differences, currency exchange rates and the like).\(^{42}\) The computer revolution, followed by incredible developments in communication technologies, has created a new medium for trade and commerce is not only more sophisticated in its advanced ability to bridge many of the existing inter-jurisdictional problems, but also represents a true revolution in the way people trade with one other.


\(^{42}\)One example of such intermediary techniques was the letter of credit, issued by banks to guaranty payment of credit granted by the seller to a distant purchaser. It is believed that letters of credit have been used centuries ago by the first bankers of Genoa and Venice in the middle of the twelfth century, and there is also evidence pointing to letters of credit being used in the days of the Roman and Greek empires and even in ancient Egypt. See Rufus J. Trimble, *The Law Merchant and the Letter of Credit*, 61 HARV. L. REV. 981, 982–85 (1948).
The market place of the middle ages has been transformed into a virtual Market Space, where merchants, retailers and wholesalers alike gather, sometimes from the four corners of the earth, to put their products and services up for sale without ever leaving their home jurisdiction. This new virtual trading space created the first opportunity for the world of commerce to sever some of the earthly ties and constraints that had hindered its expansion.

43 The term “Market Space” is used to describe a virtual market which is accessible only via the internet, and it is used to differentiate it from a physical market place, accessible in the tangible world. See ALAN CHARLESWORTH, KEY CONCEPTS IN E-COMMERCE 161 (2007).

44 See Rolf T. Wigand, Electronic Commerce: Definition, Theory, and Context, 13 INFO. SOC’Y 1, 3 (1997).
3. **New Sources of Income**

Technological innovations have always been generators of new sources of income. The Write brothers’ first successful flight in 1903 ended up creating a multi-billion aviation market;\(^45\) Henry Ford’s revolutionary assembly line technique of mass production gave birth to the automotive industry as we know it today; and the seemingly less exciting invention of plastic generated endless new sources of income – just ask the people at Tupperware Inc. From the biggest of things to the smallest ones, technological breakthroughs enable the production of new and better goods and the provision of new types of services. This was no different in the case of the computer and internet revolution.

The unique virtual platform of the internet for engaging in trade and commerce created new opportunities for generating value and profit in ways not previously available. This virtual platform has a unique influence on trade and commerce. While most technological inventions allow for the production of new goods and the development of new services, these goods and services are nevertheless delivered (in the broad sense of the word) via traditional methods of commerce. For example, a discovery of a new chemical can lead to the production of an advanced pesticide, which will nevertheless be sold on the pesticide market and used on crops as any other pesticide before it. Only very few technological breakthroughs create an actual new dimension for trade and commerce to expand into. Such was the case with the Write brothers’ invention of the plane, which opened the skies for the exploration of mankind in ways which were unheard of before. The same goes for the invention of the computer and the internet, that created a new sphere for human activity to exist and develop. This new medium allowed for the development of both unique types of goods and services as well as platforms for such goods and services to be traded on.

It is possible to identify a few different types of businesses that utilize (and eventually heavily rely on) the internet and computer networks as their main revenue generators. These industries are discussed in the following sections. An understanding of the basic concepts, terminology and scope of the different industries is an imperative part of the tax analysis to follow in later parts of this dissertation.

3.1. Software

One of the new industries that came into existence as a direct result of the computer and internet revolution was the software industry. The important role that software plays in computer and network operations, combined with the exponential growth of the use of computers worldwide, turned this industry into a phenomenal success (despite several bumps along the road that it had to sustain, such as the Dot Com crisis in the year 2000) and one of the largest revenue generators of the technological era.

The effect of the computer and internet revolution on the software industry was twofold. First, software is an integral part of any modern computer and without it the technological revolution itself could not have materialized. A computer without software is like a book with no words – software is an essential part of what makes computers what they are, and without it computers are little more than oddly-shaped ornaments. The growing demand for computer solutions during the mid-twentieth century was the petri dish for the software industry to develop in, and reciprocally the development of the software industry helped increase the demand for newer and more advanced computer solutions. The software industry was both a source for the computer revolution as well as a beneficiary – a perfect symbiosis.

The term “Software” is defined as “[t]he programs and procedures required to enable a computer to perform a specific task, as opposed to the physical components of the system.” While the use

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46 software, n., OXFORD ENGLISH DICTIONARY ONLINE, http://www.oed.com/view/Entry/183938?redirected From=software (last visited Mar 4, 2017). While the Oxford English Dictionary traces the history of the word back to the year 1960 (id.), it was nevertheless discovered (See Fred R. Shapiro, Origin of the Term Software: Evidence from the JSTOR Electronic Journal Archive, 22 ANNALS 69–70 (2000)). that the term was actually used even before that by mathematician John W. Tukey, who made the following distinction in 1958: “Today the “software” comprising the carefully planned interpretive routines, compilers, and other aspects of automotive programming are at least as important to the modern electronic calculator as its

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of software dates to the nineteenth century and Charles Babbage’s Analytical Engine,\textsuperscript{47} which was programmable using punch cards,\textsuperscript{48} it was not until the 1950s that the software industry was born.\textsuperscript{49} During that time, computers were sold as a single unit – the software was an integral part of the hardware,\textsuperscript{50} and was not considered or treated as a separate product. It was only in 1968 that IBM, which controlled the computer industry uncontested in those days and deeply influenced it with its every move, decided to “unbundle” its hardware and software and to sell each separately.\textsuperscript{51} In retrospect, this act marked the opening shot for two decades of mile-stone achievements for the software industry, during which two of the most important lines of software programs were introduced – personal computer software and enterprise resource planning (ERP) software. Companies such as Microsoft, WordPerfect, and Lotus developed new operating systems (MS-DOS and Windows), application programs (spreadsheets and word processors) and

“hardware” of tubes, transistors, wires, tapes and the like.” (John W. Tukey, \textit{The Teaching of Concrete Mathematics}, 65 \textit{THE AMERICAN MATHEMATICAL MONTHLY} 1, 2 (1958)). Specialized dictionaries provide a more extensive definition for the term software. For example, “[a] generic term for those components of a computer system that are intangible rather than physical. It is most commonly used to refer to the programs executed by a computer system as distinct from the physical hardware of that computer system, and to encompass both symbolic and executable forms for such programs. A distinction can be drawn between systems software, which is an essential accompaniment to the hardware in order to provide an effective overall computer system (and is therefore normally supplied by the manufacturer), and applications software specific to the particular role performed by the computer within a given organization.” (A Dictionary of Computer Science, SOFTWARE (Andrew Butterfield & Gerard Ekembe Ngondi eds., 7 ed. 2016), http://www.oxfordreference.com/view/10.1093/acref/9780199688975.001.0001/acref-9780199688975-e-4896?rskey=X0DFbv&result=1. The U.S. Internal Revenue Code defines the term computer software as a “program designed to cause a computer to perform a desired function” (I.R.C. § 197(e)(3)(B)). Treasury Regulations promulgated under this section include a more extensive definition under which a computer software is “any program or routine (that is, any sequence of machine-readable code) that is designed to cause a computer to perform a desired function or set of functions, and the documentation required to describe and maintain that program or routine” (Treas. Reg. § 1.861-18, which govern the classification of software transactions for federal tax purposes use the expression “computer program” which is defined as “a set of statements or instructions to be used directly or indirectly in a computer in order to bring about a certain result” (Treas. Reg. § 1.861-18(a)(3)).

\textsuperscript{47} See supra note 28.

\textsuperscript{48} A technique that reigned the software world for more than a century and was gradually replaced during the 1960s, yet was in use even until the mid-1980s (Martin Campbell-Kelly, \textit{Punched-Card Machinery, in Computing Before Computers} 122, 151 (William Aspray ed., 1990)).


\textsuperscript{50} \textit{Id.} at 4.

\textsuperscript{51} See Graeme Philipson, \textit{A short History of Software, in Management, Labour Process and Software Development: Reality Bytes}, 9 (Rowena Barrett ed., 2005). The first software program ever to be sold separately was IBM’s Customer Information Control System, used for processing business transactions (\textit{id.} at 10).
development tools for programmers.\(^ {52}\) At the same time, a small German company by the name of SAP AG was developing the first advanced integration software for businesses, which after two decades of phenomenal growth became the largest European software company and the world leader in ERP software.\(^ {53}\)

The second effect of the computer and internet revolution on the software industry was electronic commerce (which will also be separately discussed below). The internet provided software companies (any many other businesses for that sake) with a marketplace through which they could offer their products for sale. At first, the internet was used as a mere showcase. It allowed software developers to present their new products to potential customers, but the actual transactions were still consummated in the real world, either indirectly by purchasing a new hardware with preinstalled software, or through direct purchase of the product at a local brick-and-mortar store (or via a mail or telephone order, followed by a delivery of the product to the customer via various magnetic mediums, some now obsolete, such as floppy discs and compact discs).\(^ {54}\) Later on, as computer networks expanded even further, the speed of data communication increased, and data-security technologies developed, the internet went from being a mere display case to being a more comprehensive electronic platform through which software companies could distribute their products and conduct transactions from start to finish.\(^ {55}\) Being a digital product—easily and cheaply copied without loss of quality and almost instantly delivered to the customer over the internet—has made software a perfect candidate to be sold via online e-commerce platforms, which helped increase sales and distribution volumes even further.

After years of leading the growth-rate charts (with only two years of negative growth following the Dot Com and the 2008 crises), the software industry in the U.S. alone is expected to

\(^ {52}\) Graeme Philipson, supra note 51, at 15.

\(^ {53}\) Peter Buxmann, Heiner Diefenbach, and Thomas Hess, supra note 49, at 4.

\(^ {54}\) Users of personal computers during the 1990s, including the author, will certainly remember having to switch between more than 30 floppy disks in order to install Windows 3.1.

\(^ {55}\) See Peter Buxmann, Heiner Diefenbach, and Thomas Hess, supra note 49, at 15.
generates more than $209 billion in revenue in 2017, and is expected to cross $230 billion by 2021.⁶⁶

3.2. Electronic Commerce

A second line of business affected – or more precisely put, created – by the internet revolution was that of electronic commerce. Though the term “electronic commerce”⁶⁷ has been in use since roughly 1994,⁶⁸ to this day it has no standard universal definition.⁶⁹ Some sources interpret the term widely to encompass business transactions conducted via various electronic mediums such as the World Wide Web, electronic messaging, electronic data interchange systems, electronic mail, facsimile etc.⁷⁰ Other sources use a more narrow definition that limits e-commerce to the buying and selling of goods and services on the internet.⁷¹ The myriad of definitions of e-commerce (including some institutional definitions that have changed over time)⁷² suggests that

⁶⁷ Subhajit Basu, GLOBAL PERSPECTIVES ON E-COMMERCE TAXATION LAW 14 (2007); see also e-commerce, n., OXFORD ENGLISH DICTIONARY ONLINE, http://www.oed.com/view/Entry/251473?redirectedFrom=e-commerce#eid (last visited Mar 4, 2017) (dating the first use of the term back to 1993); but see Rolf T. Wigand, supra note 44, at 1 (stating that the concept of e-commerce has entered the business world as early as the 1970s). As discussed below, the wide variety of definitions of the term and its obscure scope make many of the facts surrounding it ambiguous.
⁶⁸ Dara Pinto, E-COMMERCE AND SOURCE-BASED INCOME TAXATION 1 (2003).
⁷⁰ Australian Taxation Office, TAX AND THE INTERNET: DISCUSSION REPORT OF THE AUSTRALIAN TAXATION OFFICE ELECTRONIC COMMERCE PROJECT TEAM ON THE CHALLENGES OF ELECTRONIC COMMERCE FOR TAX ADMINISTRATION 8 (1997), http://www.cse.buffalo.edu/DBGROUP/mov6_taxinte.pdf; cf. U.S. DEP’T. OF COMMERCE, INT’L. TRADE ADMIN., OFFICE OF TECH. AND ELEC. COMMERCE, 2009 ELECTRONIC COMMERCE INDUSTRY ASSESSMENT 1 (2009), https://goo.gl/nqqYsn (defining e-commerce as the “goods and services sold online whether over open networks, such as the Internet, or over proprietary networks, such as the electric data interchange (EDI)”).
⁷¹ Compare, for example, the OECD definition of e-commerce in the OECD Glossary of Statistical Terms, defining it as “commercial transactions occurring over open networks, such as the Internet” (OECD.Stat
the term is still vague or “dynamic” at best. Still, it is clear that the common denominator in all attempts to define the scope of e-commerce is that of trade in goods and provision of services over the internet (including both business-to-business and business-to-customer transactions).

E-commerce in its traditional form was in use since the 1960s via Electronic Data Interchange (“EDI”) systems. These systems allowed businesses to exchange standardized business information (invoices, inventory, purchase orders etc.) and execute electronic transactions. At first, the information was stored on magnetic tapes and was transferred from one business to another via mail or courier. Since the 1980s, as telecommunication technology advanced, the information is transmitted electronically and securely via private communication networks (VPN). Because using an EDI system required expensive computer equipment, as well as maintaining a private network, this commerce platform was used only by large companies. All other businesses had to conduct commerce the old-fashioned way.

All this changed in 1992, after the gates of the internet were opened to commercial use (until then it was restricted only to academic and scientific research), and a new, low-cost communication platform was now available to all businesses, large and small. And indeed, by the end of 1993 there were already more than 10,000 commercial web sites online. However, the lack of data protection during the early years of the World-Wide-Web impeded the use of the internet as a platform for transmitting secure business information and conducting financial transactions (unlike EDI transactions, which were conducted over private and secure networks).

Extracts, OECD Glossary of Statistical Terms - Electronic Commerce Definition (2003), http://stats.oecd.org/glossary/detail.asp?ID=4721 (last visited Dec 18, 2012), with an updated and much more detailed definition of the term in a later OECD publication — “the sale or purchase of goods or services, conducted over computer networks by methods specifically designed for the purpose of receiving or placing of orders. The goods or services are ordered by those methods, but the payment and the ultimate delivery of the goods or services do not have to be conducted online. An e-commerce transaction can be between enterprises, households, individuals, governments, and other public or private organisations. To be included are orders made over the web, extranet or electronic data interchange. The type is defined by the method of placing the order. To be excluded are orders made by telephone calls, facsimile or manually typed e-mail.” (OECD, OECD Guide to Measuring the Information Society 2011-72 (2011)).

See Subhajit Basu, supra note 58, at 16.
Graeme Philipson, supra note 51, at 24–25.
Id. at 24.
Because the potential of the commercial use of the internet was too great to resist, soon enough secure technologies were developed (secure protocols that ensured safe communication of personal and financial information), which in turn increased users’ confidence and the commercial use of the internet shifted into high gear. It is believed that the first secure e-commerce transaction was conducted on August of 1994, the same year in which Pizza Hut Inc. made history when it became the first company to allow online food orders, and the manifold commerce uses of the internet were starting to unfold.

The next step in the e-commerce evolution took place during the second half of the 1990s, during which the economic magnitude of e-commerce has grown exponentially. In 1995 both Amazon.com (“Amazon”), then an online-only bookstore, and eBay, an online auction website, were launched; in 1996 Dell Inc. was the first computer manufacturer to reach a million dollars per-day in online sales; in 1998 PayPal Inc. launched its e-commerce payment service, and during the same year Chinese investors launched what will later become the largest online business-to-business trading platform (Alibaba.com). Within less than a decade, the number of internet users around the world had increased more than 80-fold, from 3 million in 1991 to 250 million in 1999, with 25% of users (most of them in the U.S.) making electronic purchases online. The incredible influence of e-commerce on the world’s economy in the closing years of the second millennium can be learned by the fact that Jeff Bezos, founder of Amazon, was named man of the year by Time magazine in 1999 despite the fact that at that point in time his company was far from profitable. It was only in 2003 that Amazon finally reported its first

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69 Christos J. P. Moschovitis et al., supra note 28, at 185.
annual net profit with $5 billion in sale. Thirteen years later, Amazon is making annual sales of more than $136 billion.

The exponential growth of the e-commerce economy had persisted into the new millennium, and had even survived the Dot Com crisis of 2000, when the plummeting NASDAQ Composite Index took down with it numerous e-commerce companies. Supported by the increasing internet penetration rate, the expansion of broadband connectivity and Generation X consumers (having been born and grown side by side with personal computers and internet, now turning into credit-card owning, technology-savvy, consuming adults), the path for e-commerce to grow was paved.

The numbers tell the story at its magnitude. Between the years 2000 and 2006, the revenue of the e-commerce industry in the U.S. has more than tripled (from $36.6 billion to $115.6 billion), with a yearly average growth rate of more than 21%. Following the economic recession of 2008, the industry suffered from a decline in growth (to as low as 3.9% in 2009), yet as the dark clouds of recession started to scatter in 2010, the e-commerce industry got back on the horse and has been displaying high growth rates (an average yearly rate of 12% between 2010 and 2016) and is expected to reach $366 billion of revenue in 2021. In addition, the share of e-commerce as a percentage of total retail sales in the U.S. has increased thirteen-fold since the year 2000.

Clearly, the U.S. e-commerce market has a substantial effect on the world-wide growth of this industry, however the true future of this industry lies in the east. According to estimates, by the

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80 While in 1999 e-commerce sales accounted for 0.64% of total U.S. retail sales (U.S. DEPARTMENT OF COMMERCE NEWS, RETAIL E-COMMERCE SALES FOR THE FOURTH QUARTER 1999 REACH $5.3 BILLION, CENSUS BUREAU REPORTS 1 (2000), http://www2.census.gov/retail/releases/historical/ecommerc99q4.pdf), by the end of the third quarter of 2016 it has accounted for 8.4% (U.S. CENSUS BUREAU NEWS, QUARTERLY RETAIL E-COMMERCE SALES: 4RD QUARTER 2016 (2016), http://www2.census.gov/retail/releases/historical/ecommerc16q4.pdf). The data also demonstrates the increasing popularity of e-commerce in the retail sector, the sales of which have increased in the last quarter of 2016 by more than 14% compared to the parallel quarter in 2015, while total retail sales in the U.S. (conventional retail and e-commerce combined) increased by only 4.1% during the same period. Id. at 2.
year 2020 nearly 600 million Chinese will be shopping online, and an average annual growth rate of 30% is estimated to skyrocket e-commerce sales in the Chinese market to an astounding $2.65 trillion, with e-commerce share of total retail sales in China reaching 37.5%. These predictions support the estimates that until the year 2020 the world-wide retail e-commerce sales will maintain a high-teens growth rate and will cross $4 trillion in revenues, with the highest growth rates predicted in the Asia-Pacific, Middle East and Africa, and Latin America regions.

These are not random statistics. They reflect a global phenomenon that has changed both the way people do business with each other as well as the way people consume products and services. In a world where online market places have hundreds of millions of active buyers, and such markets offer more than 45,000 categories of products, it is clear that traditional market places will not dominate the world of commerce for long. The only question left is how long will it take for e-commerce to take the lead.

In summary, e-commerce is gradually becoming a significant factor in the world economy, and turning into a major source of revenue for manufacturers, wholesalers, retailers and service providers all over the world. Secure technologies for protecting personal and financial information on the internet (such as Paypal, Google Wallet, and ApplePay, to name a few) have significantly increased users’ confidence in the online markets, and with the rise in internet

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85 Id. at 19.
87 JUSTIN WATERMAN, supra note 78, at 24.
accessibility around the world,\textsuperscript{88} the market share of e-commerce as well as its contribution to overall economic growth are only expected to rise.\textsuperscript{89}

\section*{3.3. Cloud Computing}

Lexically speaking, cloud computing is part of e-commerce.\textsuperscript{90} As will be clarified below, the term “cloud computing” represents an array of services which are provided solely over the internet. As such, it fits like a glove into the many definitions of e-commerce, even the narrower ones that include the provision of services on the internet as part of e-commerce.\textsuperscript{91} In that case, one may wonder why cloud computing deserves a discussion that is separate from the general discussion on e-commerce. The answer is twofold – first, this new line of economic activity, which is furnished entirely in cyberspace, has some very unique and interesting features, especially with respect to its physical and locational aspects, which have significant importance to the analysis of the tax consequences of such activity; second, this is one of the fastest growing information technology (“IT”) industries today, which is predicted to have a substantial economic impact and significant technological influence on the computer, internet, and e-commerce industries as a whole.\textsuperscript{92}

What exactly is cloud computing? Simply put, cloud computing is a method of providing multiple users with computer resources which are centralized in several locations, and accessed by users via the internet.\textsuperscript{93} In that sense, cloud computing provides users with access to computer resources in the same way power plants and water reservoirs provide access to electricity and water through sockets and faucets on the wall.\textsuperscript{94} The only difference is that cloud computing does not limit the user to a specific physical outlet (a faucet or socket) and can be accessed from

\begin{itemize}
  \item \textsuperscript{88} According to the World Bank’s data, between 2005 and 2015 the number of internet users worldwide has grown by 180%, representing an average yearly growth rate of more than 10%, with developing countries showing the highest growth rates in recent years. The World Bank, \textit{INTERNET USERS (PER 100 PEOPLE)}, http://data.worldbank.org/indicator/IT.NET.USER.P2 (last visited Mar 4, 2017).
  \item \textsuperscript{89} See Neil F. Dorothy & Fiona Ellis-Chadwick, \textit{Internet Retailing: the Past, the Present and the Future}, 38 INT’L J. RETAIL & DISTRIB. MGMT. 943, 955 (2010).
  \item \textsuperscript{90} For the various definitions of e-commerce see \textit{supra} notes 60–62 and the accompanying text.
  \item \textsuperscript{91} \textit{See supra} note 61 and the accompanying text.
  \item \textsuperscript{92} \textit{See infra} notes 125–126 and the accompanying text.
  \item \textsuperscript{93} \textit{See infra} notes 102–103 and the accompanying text.
\end{itemize}
any location with an internet connection. Cloud computing companies provide users with ubiquitous internet-based access to the specific hardware and software resources such users require. The on-demand nature of the service makes it continuously accessible to users from any location with an internet connection, and users pay only for the computing resources they “consume” (based on a pay-per-use billing model).

For example, until not too long ago, the only way to produce a written document on a computer was to use designated word-processing software that had to be purchased and installed on a specific computer. Moreover, accessing that document was possible only from that same computer (or from other computers connected to it via a private network) or by copying it to a magnetic or digital media storage device and transferring it to another computer which also has the same software installed. Cloud computing changed that practice completely. Today, anyone who wishes to create a document can simply go online and access one of the many internet-based word-processing software (such as Google Docs, Microsoft, Zoho Writer and Thinkfree, to name just a few). Using internet-based software, one can create a document, save it online and access it anytime and from anywhere, without being limited to a specific computer or location.

Cloud computing is considered the next evolutionary step in the consumption of computer services. Cloud computing and the internet are doing to computer resources what power stations and electric grids did to the supply of electricity at the beginning of the twentieth century. Before the institutional organization of electric utility, electricity was independently generated and used by factories, each having to purchase its own electric equipment operated by specially qualified personal to supply electricity to the factory. Because none of these factories were in the

99 For a more comprehensive list of online word-processing services see Sean P. Aune, FORGET WORD: 13 ONLINE WORD PROCESSORS (2008), http://mashable.com/2008/02/11/13-word-processors/.
100 Online word-processing represents only one of the possible cloud computing service models. The main models will be discussed below.
business of generating electricity, this mode of operation was far from efficient. Outsourcing
electricity-making to centralized power stations and the provision of electricity via a connecting
grid, allowed on-demand usage and pay-per-use billing, which reduced costs and increased
efficiency. Soon enough no one was generating its own power. There was another reliable and
much cheaper solution. In this sense, there is no difference between electricity and computer
power. Both are resources used by businesses and individuals as means to an end. There is no
intrinsic value in purchasing a computer. It is only used to achieve a goal – whether it is to
generate income by a business or to enjoy leisure time by an individual. From an efficiency
standpoint, if the same goals could be achieved without purchasing a computer or specific
software, no one would buy it. That is exactly the idea behind cloud computing – centralizing
computer resources to reduce the price of using computers, thus providing what has become one
of modern life’s necessary resources (much like water and electricity) in the most efficient way.

As with e-commerce, the novel nature of cloud computing and its continuous development gave
birth to various definitions that attempt to encompass the many facets of this new technology. The
most accepted and cited definition of cloud computing is the one drafted by the U.S.
National Institute of Standards and Technology. According to this definition, “cloud computing
is a model for enabling ubiquitous, convenient, on-demand network access to a shared pool of
configurable computing resources (e.g., networks, servers, storage, applications, and services)
that can be rapidly provisioned and released with minimal management effort or service provider
interaction.” The definition also describes the essential characteristics, service models, and

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102 Andy Isherwood, vice president at Hewlett Packard, was quoted saying that he has “not heard two people
say the same thing about [cloud computing]. There are multiple definitions out there.” (MICHAEL
eecs.berkeley.edu/Pubs/TechRpts/2009/EECS-2009-28.pdf). The OECD defines cloud computing “as a
service model for computing services based on a set of computing resources that can be accessed in a
flexible, elastic, on-demand way with low management effort.” (OECD, OECD INTERNET ECONOMY
easily usable and accessible virtualized resources (such as hardware, development platforms and/or
services). These resources can be dynamically reconfigured to adjust to a variable load (scale), allowing
also for an optimum resource utilization. This pool of resources is typically exploited by a pay-per-use
model in which guarantees are offered by the Infrastructure Provider by means of customized SLAs
[Service-Level Agreements].” (Luis M. Vaquero et al., A Break in the Clouds: Towards a Cloud Definition,
39 SIGCOMM COMPUT. COMMUN. REV. 50, 51 (2009)).

103 Peter Mell & Timothy Grance, The NIST Definition of Cloud Computing, NAT’L INST. OF STANDARDS AND
deployment models of cloud computing. To better understand the unique features of cloud computing it is helpful to briefly review its most common service models.

The first service model, which is also the one that internet users are most familiar with (many times without knowing they are using a cloud computing service), is *Software as a Service* (SaaS). Under this model, a provider of cloud computing services offers users access to the provider’s (or third party’s) software and applications that are installed on the provider’s hardware (without granting access to its operating system, storage or hardware) and that are accessible via the internet or specific client interface.\(^{104}\) Prime examples of this model include web-based e-mail services (such as Gmail, Yahoo!, and Outlook.com), online word-processing and spreadsheet software (as mentioned above),\(^{105}\) data storage services (such as Dropbox and Google Drive), social and professional networking websites (Facebook and LinkedIn), business-designated software for managing sales, inventory, marketing, and bookkeeping (such as Saleforce and Quickbooks), and many more (the list goes on and on and includes web-based services in fields such as photo processing, architecture, design, genealogy and more). These services are used by individuals and by many small businesses, which cannot afford to purchase, customize, operate and service independent locally-installed software for each module or task they require.

The second service model is *Platform as a Service* (PaaS). Mostly used by software developers, this model provides users with a necessary computer environment where they can deploy their own software and applications and develop new ones. The users have no control over the provider’s infrastructure (hardware, operating systems and storage).\(^{106}\) Two of the most commonly used services of this model are Windows Azure and Google App Engine. The third service model is *Infrastructure as a Service* (IaaS). Under this model, users are provided with access to fundamental computing resources (processing power, networks and storage).

\(^{104}\) *Id.* at 2.

\(^{105}\) See supra notes 95–100 and the accompanying text.

\(^{106}\) Peter Mell and Timothy Grance, *supra* note 103, at 2–3.
Customers use this environment to deploy any kind of software, including operating systems. Providers of this kind of service include Amazon EC2, Rackspace, and Google Compute Engine.

This review emphasizes the idea that the expression “cloud computing” does not (and cannot) describe a single application or a single service. Cloud computing is a general name describing an array of services that can be provided on an “as needed” basis, as part of the current fashion of centralizing computer resources and moving more services to the internet (instead of using special locally-installed software). In the technology jargon this is referred to as “moving to the cloud.”

The many benefits of cloud computing can be summarized in a nutshell as increased flexibility, availability, accessibility, and performance of computer resources at reduced costs. In other words, cloud computing increases efficiency in the consumption of computer resources.

The benefits of increased efficiency have not been overlooked by governments worldwide, which have recognized the potential of implementing cloud computing technologies to reduce

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107 Id. at 3.
110 Cloud computing provides greater flexibility by enabling users to add and remove services, computing power and storage in accordance with each user’s needs at any given time.
111 Greater availability is achieved due to the providers’ ability to seamlessly shift resources between servers, allowing for routine maintenance to be conducted without interferences in the service.
112 Accessibility of cloud computing services is significantly higher than that of traditional computer resources due to the ability to access services “on the cloud” from any location or device with an internet connection, thus not being limited to specific computers and networks which in many cases are confined to a certain physical location.
113 The around-the-clock service of the cloud computing infrastructure and the availability of the newest software versions provide for increased performance.
114 On-demand consumption of pay-per-use resources produced by a centralized, highly professional service provider, is by nature less costly than providing the same resource locally and independently. It also replaces high upfront capital expenditures with periodical fees, increasing cashflow flexibility and planning.
their continuously-increasing IT costs. These governmental investments are one of the key growth engines of this industry. Germany, Japan, United Kingdom, and the European Union have all established major cloud computing projects. The U.S. Federal Government has also shown major interest in cloud computing. Its interest and commitment to invest in this industry is demonstrated by the fact that cloud computing has been specifically mentioned in the U.S. Budget Proposal since 2011, the same year in which the U.S. Chief Information Officer in President Obama’s administration published a formal cloud computing strategy that had set cloud computing solutions as top priority in any new government IT investment. When eventually implemented, this strategy has the potential of shifting an estimated $20 billion of the U.S. federal government’s $80 billion IT budget to cloud computing technologies. Such future investments, together with federal projects that already implement cloud technologies, are predicted to save $12 billion annually for the U.S. taxpayer.

What does the future hold for cloud computing? Will it be a passing phenomenon like many other technology trends before it? Or will it change the world of computing all together? In a survey conducted amongst 895 technology stakeholders and critics, 71% said that by the year

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117 See, for example, the “G-Cloud” project in the United Kingdom (http://gcloud.civilservice.gov.uk), the “Kasumigaseki Cloud” in Japan (Tony Chan, JAPAN TO BUILD MASSIVE CLOUD INFRASTRUCTURE FOR E-GOVERNMENT (2009), http://www.greentelecomlive.com/2009/05/13/japan-to-build-massive-cloud-infrastructure-for-e-government), the “EuroCloud” initiative in the European Union (http://www.eurocloud.org) and the “Trust Cloud” in Germany (OECD, supra note 102, at 81).


120 Id. at 2.

121 Although the framework was set in 2011, it was only in 2015 when implementation began. See Barb Darrow, Why the U.S. Government Finally Loves Cloud Computing, Fortune (Sept. 2, 2016) http://fortune.com/2016/09/02/us-government-embraces-cloud.

122 VIVEK KUNDRA, supra note 119, at 1.

123 Existing cloud computer projects include “Nebula” by the National Aeronautics and Space Administration (NASA), the “Magellan” by the U.S. Department of Energy, Office of Advanced Scientific Computing Research (ASCR), and several projects by the Defense Information System Agency (DISA) which is part of the U.S. Department of Defense.

2020 most people will not be using software installed on local PCs, but rather use cloud-based applications on PCs and smartphones. These responses are backed by current estimations according to which cloud computing will enjoy an astounding annual growth rate of 30% in the next few years, reaching $270 billion by the year 2020. It seems, at least for now, that cloud computing is here to stay.

3.4. Online Advertising

The effects of software, e-commerce and cloud computing on the world economy have been substantial, yet there is one other type of internet-based revenue generator that has turned out to be a major player in the digital market, and one that very much affected the growth of the internet as a whole. That is the business of online advertising.

The growth of internet accessibility around the world, the increasing e-commerce activity, and the vast amount of information scattered across the World Wide Web, created an all-in-one medium that a continuously-increasing number of users visiting on a daily basis for a variety of purposes and uses. If to paraphrase on the classic Kevin Costner epigram, open the gates of the

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127 There are professionals from the computer industry who have different views regarding the benefits and future of cloud computing. For example, Craig Partridge, chief scientist at BBN Technologies and adjunct professor of computer science at the University of Michigan believes that cloud computing will hardly be used by 2020 because of privacy issues (JANNA Q. ANDERSON AND LEE RAINIE, supra note 125, at 15); Steve Wozniak, co-founder of Apple, Inc., was quoted saying that “…it’s going to be horrendous. I think there are going to be a lot of horrible problems in the next five years [with cloud computing]” (Brandon Butler, WOZNIK: CLOUD COULD CREATE “HORRENDOUS” PROBLEMS NETWORK WORLD (2012), http://www.networkworld.com/news/2012/080612-wozniak-cloud-261428.html).
128 The World Trade Organization (WTO) is one of the only major institutions that include advertising of products within the ambit of the definition of electronic commerce. According to its definition, electronic commerce is “The production, advertising, sale and distribution of products via telecommunications networks.” WTO.org, GLOSSARY TERM - ELECTRONIC COMMERCE, http://www.wto.org/english/tratop_e/glossary_e/electronic_commerce_e.htm (last visited Mar 4, 2017). For purposes of this dissertation, I will distinguish online advertising from e-commerce based on the criteria and analysis presented herein.
129 The World Bank, supra note 88.
internet and people will come.\footnote{Referring to the iconic phrase “Build it and they will come”, from the 1989 feature film “Field of Dreams,” starring actor Kevin Costner.} And they did, by the hundreds of millions; and when so many people gather in a single place, whether physical or virtual, advertisers will soon follow.

Online advertising, like any other form of advertising, entails a presentation of information about goods, services and ideas, in an attempt to persuade members of the audience to purchase the item or order the service.\footnote{One of the well accepted definition of advertising says that “[a]dvertising is the structured and composed nonpersonal communication of information, usually paid for and usually persuasive in nature, about products (goods, services and ideas) by identified sponsors through various media.” WILLIAM F. ARENS, CONTEMPORARY ADVERTISING 7 (9th ed. 2004).} The physical constraints of traditional advertising mediums, such as radio, newspapers and television, limited the way advertisements could be presented. Each medium had its own predominant type of advertisement form – photo and text advertisements in newspaper, audio spots in radio, and audio-visual commercials in television. The two-way-interaction nature and the sensory versatility of the internet opened a whole new world for the online advertising industry, allowing for a wide variety of advertising formats.

The five main formats of advertisement on the internet are search, display, classified, e-mail, and referral ads.\footnote{OECD, supra note 102, at 185.}\footnote{The word “Ad” is a common abbreviation for the word advertisement, and it is used to describe online advertisements in particular. ALAN CHARLESWORTH, supra note 43, at 3. In this dissertation the words ad and advertisement are used interchangeably.} Search advertising requires advertisers to bid on search keywords (usually in an auction-based bidding process) which, when searched by users, will lead the user to a web page that includes the results alongside the ads that won the bid for such searched words. This type of advertising is the main source of income of companies like Google Inc. and Yahoo! Inc., which rely heavily on income from advertisements in their widely popular search engines. Display ads are graphic advertisements, either in the form of banners or video clips, which appear in websites, online video content, and computer games. Classified ads, very much like the traditional newspaper “classifieds”, are listings of products and services offered for sale which appear on websites. E-mail advertising refers to any advertising which is delivered via electronic mail. Finally, referrals are a method by which advertisers pay a fee to websites for

\footnote{In this dissertation, I will frequently mention leading companies in the online advertising industry, such as Google Inc., Yahoo! Inc., Facebook Inc., and Microsoft Corp., as well as other major companies such as Apple Inc. For the sake of reading convenience, I will refer to these companies using only their commercially-familiar names, while omitting their legal incorporation abbreviation (Inc., Ltd., and Corp.).}
referring potential customers to the advertisers’ website or for providing the customer’s information.\textsuperscript{135}

Out of these five common online advertising formats, search and display ads are by far the most prevalent ones. By the end of 2015, search ads and display ads accounted for 91\% of the U.S. online advertising market’s revenues.\textsuperscript{136} Google is the leading player in search-based advertising. In 2012, nearly 85\% of Google’s advertising revenue originated from its search-based advertising platforms,\textsuperscript{137} and this amount represented nearly three quarters of total U.S. search-based advertising revenue that year.\textsuperscript{138} In recent years display advertising has gained significant popularity (especially due to the widespread use of mobile devices)\textsuperscript{139} and is expected to surpass search advertising in the U.S. and account for 47.9\% of the market’s revenues.\textsuperscript{140} Search and display ads currently dominate the world of online advertising and they are predicted to remain the most popular online advertising formats in the coming years.\textsuperscript{141} The domination of these formats in the online advertising market plays an important role in the analysis to come.

Online advertising was born in 1994, when the online web magazine HotWired posted the first banner advertisement.\textsuperscript{142} It took several more years for the internet to become an attractive medium for advertisers, but eventually it became an integral part of almost every marketing campaign. Practically all consumer-based industries have implemented online advertising as part of their marketing efforts. Retail, telecommunications, financial services, automotive, telecom,
leisure and travel, entertainment, and pharmaceuticals – all advertise online. Consequently, online advertising has become a significant revenue generator in the digital economy, and the numbers clearly show it.

The global internet advertising market in 2016 is estimated at $194 billion (representing 35% of the media advertising market), and it is estimated to reach $335 billion by 2020, by which time it will represent 46% of the media advertising market. When geographically segmented, the U.S. online advertising market is the most dominant. Revenue from online advertising in the U.S. alone has totaled $59.6 billion in the year 2015, and during the first half of 2016 and the third quarter of 2016 it has increased by 19% and 20% (respectively) compared to the figures reported in the same period in 2015. These numbers represent a constant double-digit annual growth in online advertising revenue in the past 13 years (with the exceptions of a 3% negative growth following the 2008 economic crisis). If estimates are correct, revenues from online advertising in the U.S. are expected to reach $105–118 billion by 2020. It is interesting to note that the revenue from online advertising is concentrated in the hands of only a few major companies. In 2015 the 10 market leaders generated 74% of the industry’s revenue, and the top 5 companies (Google, Facebook, Microsoft, Yahoo!, and Twitter) were responsible for nearly two thirds of the total digital ad revenue.

The Asia-Pacific region also experiences massive growth in online advertising revenue. It is estimated to become the largest digital ad market by the end of 2019, with more than 30%

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143 PwC, supra note 136, at 17.
145 PwC, supra note 136, at 4.
148 PwC, supra note 136, at 11.
149 Cindy Liu, supra note 139, at 16.
expected growth rate in India, China and Indonesia.\textsuperscript{151} Latin America and the Middle East & Africa are also expected to enjoy high growth rates.\textsuperscript{152}

These impressive numbers bear witness for the magnitude of this flourishing industry. Yet even without the numbers the ubiquity of online advertising is obvious. Users encounter online advertising wherever and whenever they “surf” the internet – banners in news websites, text advertisements in search results, video commercials during web broadcasting, and even advertisements embedded in online computer games. The internet has become an advertisement-driven market, and it is clear that online advertising will play a key role in the twenty-first century global digital economy.

3.5. What All This Has to Do with Tax?

After reviewing four of the most dominant industries of the digital economy (software, e-commerce, cloud computing, and online advertising), one must wonder how all of this is related to tax. The simple fact is that everything is related to tax. This traditional axiom is especially true in the case at hand, where high-revenue generating industries are involved.

As the numbers clearly show, the influence these industries (as well as other similar technology-based industries) have a considerable influence on the global economy, and aggregately they generate voluminous economic activity that creates taxable income in substantial amounts. Looking into the crystal ball, and relying on previous rapid developments as reasonable predictors, it is also safe to assume that new types of computer-and-internet-based industries and activities will emerge in the near future. Combine the magnitude of these industries (from both present and the foreseeable future) with the fact that they all possess unique tax-related characteristics (as will be elaborated below) that distinguish them from traditional trade and commerce industries, and we got ourselves a tax predicament.

The question at hand is whether the application of traditional tax rules and concepts to these industries will produce tax results that are consistent with sound tax principles and policy, or will it yield incoherent tax outcomes, economic distortions, inequalities or inefficiencies, and if so,

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{151} Cindy Liu, \textit{supra} note 144, at 9, 11.
\item \textsuperscript{152} \textit{Id.} at 9.
\end{itemize}
\end{footnotesize}
what can be done to correct it. Because of the non-physical and ubiquitous nature of these digital industries, these questions are especially and specifically relevant in the cross-jurisdiction context. A responsible tax policy must address and confront these questions, and do it sooner rather than later because the next technological innovation is just around the corner.

While all four industries discussed above have special traits that make them interesting from a tax perspective, this dissertation focuses on online advertising and uses it as a study case to demonstrate the theoretical and practical difficulties with which the current U.S. and international tax systems are confronted when applied to technology-oriented and internet-based activities.

Why online advertising? First, the tax consequences of income from software, e-commerce and cloud-computing activities have been extensively and thoroughly discussed in numerous academic and non-academic publications, including in several reports by the OECD. To the contrary, an in-depth writing and analysis of the tax implications of income from online advertising has been sparse. Second, as will be elaborated in the following chapters, online


For example, prior to the BEPS Project, the OECD discussed income from online advertising only in a minor one-paragraph remark, as part of a discussion regarding characterization of income from e-
advertising has several unique and distinctive characteristics. These special features make the tax analysis of online advertising an interesting topic on the merits. Moreover, these features also distinguish online advertising from the other types of internet-based activities. This distinction calls for (and justifies) an independent discussion on the tax ramifications of income from online advertising.

Finally, the case of online advertising is not a regular case study. The qualities of the technology behind this industry and the way this technology is employed to generate income, serves as an extreme example for the challenges facing domestic and international tax regimes while novel technology-dominated types of business activities develop in an ever-increasing pace. Furthermore, I believe that this extreme case is only the tip of the iceberg. Already today we are experiencing social and economic phenomena which were considered science-fiction until not too long ago (such as mobile commerce, space commerce, and virtual currencies). The monetization of these technological innovations challenges and defies traditional tax rules, concepts and terminology. Since history has proven that technology tends to develop faster than the quickest legislator can (en)act, a serious in-depth discussion about the influence such technology-based activities will have on the domestic and international tax regimes is imperative, and an analysis of the tax ramifications of online advertising can provide a starting point for better understanding of the challenges and difficulties raised by such collision between technology and tax.

In order to have a substantive discussion regarding the application of tax principles and rules in the case of the online advertising industry one must first acquire basic understanding of fundamental principles of online advertising. These are discussed in the following chapter.

4. **Basic Concepts of Online Advertising**

Online advertising has two business aspects which are of specific interest and importance in the context of the taxation of this industry. The first one is the different pricing models used by publisher, and the second is the “personalization” concept (or targeted advertising) which is employed as part of the online advertising business model. Understanding these two basic concepts and learning about the integral part they play in online advertising is crucial for purposes of the discussion on the taxation of this industry.

Online advertising is a complex and intricate business. It has many facets and consequently it involves many players which offer different types of services as part of the advertising placement process. An endless amount of companies worldwide provide performance, monitoring, verification, measurement, analysis, and optimization services for online advertising. However, despite the complexity, when stripping this business down to its essentials, it involves three basic participants – publisher, advertiser, and user. The user is any person who consumes online information, content and services, and who thus has potential exposure to the various forms of online advertising. The advertiser is most commonly a business entity that wishes to present commercial information to users, with the hope of consequently soliciting the users to purchase its products or services. The publisher is the owner of an online platform which provides the setting for users and advertisers to meet (the advertisements are presented to the users who visit the publisher’s online platform).

There are several business models used by online publishers. The first can be referred to as “come in, everything is free.” Under this model the publisher provides users with a free service or free access to information with the hope of attracting a large audience, which will thus make the online platform attractive to advertisers who will be willing to pay for the large exposure potential. Since this type of publisher provides the services free of charge to all users, its only (or at least its major) source of income is advertising. This model is used by all the online advertising giants such as Google, Yahoo!, Facebook and Twitter. They all provide users with a
variety of free services, and take advantage of the high number of users who visit their websites to generate income from advertisements. The business model of these companies revolves almost exclusively around advertising – in 2016 online advertising was responsible for 88% of Google’s revenues,\(^{155}\) 95% of Facebook’s revenues,\(^{156}\) and 88% of Twitter’s revenue.\(^{157}\)

A second type of publisher is one that also provides free services or information to users, accompanied by advertisements, but at the same time also offers users an option to purchase advertisement-free premium services and content. This model is commonly referred to as “freemium” – the user can either get the free and basic level of access (with ads), or pay a fee to remove the ads and have full access to all services.\(^{158}\) The third business model is the “auxiliary publisher.” These are websites for which online advertising is only a secondary line of business. For example, a yoga instructor would have a website the purpose of which is to advertise her yoga classes, but additionally she would also sell advertising space to a yoga equipment company or a healthy food distributor to advertise their products.

### 4.1. Pricing Models

The first interesting aspect of online advertising lies within the various pricing models used by the publishers. The classic model, which has been in use in traditional advertising formats many years before the internet was even created, is the CPM – Cost-Per-Mille (also referred to as cost-per-impression). Under this model, advertisers pay according to the degree of exposure to their advertisement. Measuring the exposure in traditional advertising is performed by rating agencies (the most famous of which is Nielsen), that provide advertisers with estimates as to the number of viewers (for example) who will be watching a certain television show. The cost of the

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155 ALPHABET INC., ANNUAL REPORT (FORM 10-K) FOR THE YEAR ENDED DECEMBER 31, 2016 at 7 (2017), https://abc.xyz/investor/pdf/20161231_alphabet_10K.pdf. In August 2015, Google reorganized its corporate structure by creating a parent company—Alphabet Inc.—that would hold Google and related companies to which Google transferred its non-advertising business. All sources in this dissertation referencing Alphabet Inc. are referring to Google.


158 This model is common amongst developers of applications for mobile devices.
advertisement varies based on this potential exposure. In the online version of CPM, the measuring of exposure is simpler and relatively more accurate. Online, an ad impression (i.e., an exposure to the ad) is defined as the number of times an ad is downloaded during a specified period of time.\textsuperscript{159} The publisher generates income based on the number of times the ad is downloaded by users.\textsuperscript{160} In order to simplify tracking and payment, the count is done by a unit of one thousand. Since online exposure to the ad is based on a measurable criterion, the online version of CPM is more accurate than the offline version used in traditional advertising mediums. Nevertheless, for an online impression to be counted there is no need for the ad to actually be viewed by the user. It only has to be downloaded to the user’s web browser to be counted, and paid for. There is no guarantee that the user paid any attention to the ad, or even saw it (in case the ad appears in lower parts of the webpage, thus leaving it unseen unless the user scrolls down).

Despite this shortcoming, during the early days of the internet CPM was the only pricing model for online advertising – HotWired, the first website to offer online advertising, sold its ad spaces using the CPM model,\textsuperscript{161} and many leading companies (such as AT&T, IBM, and General Motors) made significant investments in online campaigns based on this model. It was in 1996, after two years of CPM dominance, when Procter & Gamble (which refused to pay for online advertising using an “impression” pricing model) insisted on using only a “pay-per-click” model.\textsuperscript{162} This marked the beginning of performance-based online advertising.

Performance-based online advertising is a general name for pricing models according to which the publisher generates income only when the user reacts to the advertisement by means of a measurable action. These pricing models were made available due to the bidirectional nature of the internet.\textsuperscript{163} Unlike traditional mediums of advertising (television, radio, and print), the internet was the first to allow two-way communication between the publisher/advertiser and the

\textsuperscript{159} See Alan Charlesworth, supra note 43, at 4.
\textsuperscript{161} David S. Evans, The Online Advertising Industry: Economics, Evolution, and Privacy, 23 The JOURNAL OF ECONOMIC PERSPECTIVES 37, 38 (2009).
\textsuperscript{162} Barbara K. Kaye and Norman J. Medoff, supra note 142, at 46, 51.
target audience. The publisher and advertiser can receive feedback from the users and obtain better measurements as to the ad’s exposure, thus making it possible to answer one of the most important, yet difficult to resolve, questions in marketing – is the ad effective.

The first performance-based pricing model to be used was Cost-Per-Click (CPC, or Pay-Per-Click). According to this model, the publisher generates income only when the user clicks on the ad (as opposed to simply download it, as in the CPM model). Other performance-based models are various examples of the model referred to as Cost-Per-Action (CPA, or Pay-Per-Action). In the Pay-Per-Action model neither downloading (“viewing”) nor clicking is sufficient – the publisher generates income only when the user takes an action that benefits the advertiser.\footnote{OECD, \textit{supra} note 160, at 275.} Pay-Per-Action, which has been named by leaders of this industry as the “Holy Grail” of online advertising,\footnote{See Marissa Mayer (then Vice President of Search Product and User Experience at Google, and today president and CEO of Yahoo!), as quoted in Cost Per Action: Holy Grail for Targeted Advertising, \textit{YOUTUBE} (2007), http://www.youtube.com/watch?v=d9gvBmiQnvM (last visited Mar 4, 2017). \textit{See also} Stephan Spencer, \textit{GOOGLE DEEMS COST-PER-ACTION AS THE “HOLY GRAIL”}, \textit{CNET NEWS} (2007), http://news.cnet.com/8301-13530_3-9764601-28.html (last visited Mar 4, 2017).} includes such variations as Pay-Per-Sale (the publisher generates income only after a user has purchased an item or service from the advertiser),\footnote{This model is the basis for the Amazon affiliate program (officially named “Amazon Associates”), in which anyone with a website can advertise products sold on Amazon, and if users click on such advertisements and eventually make a purchase, the publisher receives a fee from Amazon of up to 10% of the purchase price. \textit{See Amazon.com}, \textit{AMAZON ASSOCIATES}, https://affiliate-program.amazon.com (last visited Mar 4, 2017).} Pay-Per-Call (a model designed for mobile phones in which the user can click the advertiser’s phone number included in the ad, subsequently placing a call to the advertiser and the call triggers the income to the publisher),\footnote{\textit{See} Google.com, \textit{GOOGLE ADS - MOBILE CLICK-TO-CALL}, https://www.google.com/intl/id_uk/ads/innovations/ctc.html (last visited Mar 4, 2017); Claire Cain Miller, \textit{Advertising Relearned for Mobile}, \textit{NEW YORK TIMES}, October 28, 2012, http://www.nytimes.com/2012/10/29/technology/advertisers-refine-mobile-pitches-for-phones-and-tablets.html?pagewanted=all&_r=0.} Pay-Per-Lead (which requires the user to subscribe to a newsletter, fill in a form, create a new online account, and other means of providing the advertiser with the user’s personal information); Pay-Per-Play (requires the user to watch or listen to a multimedia clip); Pay-Per-Email (the user needs to contact the advertiser via email); Pay-Per-Install or Pay-Per-Download
Performance-based online advertising solves one of the oldest problems of advertising, which was well described by John Wanamaker, considered to be the father of modern advertising, when he said “half the money I spend on advertising is wasted; the trouble is I don’t know which half”. Traditional advertising methods place advertisements in front of a theoretical audience, without having the ability to accurately measure the effectiveness of the advertisements, i.e., whether it was seen by the relevant audience, or if it was seen at all. For example, advertisers cannot tell if viewers were actually watching a certain television advertisement during a commercial break, or if they were even sitting in front of the television screen during that time (as anyone who has ever watched television knows first-hand, during commercial breaks viewers often go to the kitchen to get something to eat or drink, go to the bathroom, take out the dog, or even fall asleep completely). Moreover, advertisers cannot know if the person watching the advertisement was a 20-year-old man or a 70-year-old woman. This was very much a guessing game. Moreover, when recording technology (VCR, Tivo and more) became available, viewers could simply record the show and skip the commercials all together, for which the advertiser nevertheless paid. These traditional efforts of advertising were described as “dropping an atom bomb on a city” (being extremely unfocused with much “collateral damage”), while performance-based online advertising was figuratively and humorously depicted as “[making] lots of spearheads and then get people to impale themselves”. The inaccuracy, inefficiency, and high cost of traditional advertising are gradually being replaced with a cheap, effective and

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168 There is some debate about the inclusion of the Pay-Per-Click model in the performance-based advertising group of pricing models. Some limit this group only to Pay-Per-Action models, claiming that a click without a conversion of some sort (i.e., a sale, a phone call, a “like”) is not a relevant “action”. While this might be true from a business point of view, I do not believe this terminology is applicable in the context of this dissertation. Both Pay-Per-Action and Pay-Per-Click require an active involvement of the user. They both require her to take an action. According to the simple meaning of the word, the user performs an action whether it is merely clicking on the ad or rather performing additional actions following the click, and the publisher’s income is measured according to such actions. Therefore, in this dissertation I include both Pay-Per-Click and Pay-Per-Action models as part of performance-based advertising.

169 John Wanamaker, as quoted in MARILYN ROSS & SUE COLLIER, THE COMPLETE GUIDE TO SELF-PUBLISHING 344 (2010).

precise method. Performance-based advertising allows advertisers to know exactly how many people responded to a given ad, and how many of them were actually influenced by it and made a purchase or acted upon it.\textsuperscript{171} Using performance-based advertising turns John Wanamaker’s half-wasted advertising budget into a fully measurable and efficient expense. Advertisers do not have to chase an obscure audience anymore. It will come to them, with a name tag.

The market’s preference with respect to usage of the different models is clear – performance-based advertising (either CPC or CPA) has been the predominant model since 2006.\textsuperscript{172} In the first six months of 2016 this group of pricing models was responsible for 65\% of the U.S. online advertising industry’s revenue.\textsuperscript{173} Cost-Per-Impression accounted for 34\% of revenues.\textsuperscript{174} A quick look at the industry’s leaders’ financial results indicates the same. Most of Google’s income from AdWords (its auction-based advertising platform) is generated based on a Pay-Per-Click model,\textsuperscript{175} and Yahoo!’s primary source of income is based on Pay-Per-Click advertising on its websites and affiliated sites.\textsuperscript{176} This model is also implemented by Facebook and Microsoft.\textsuperscript{177}

4.2. Personalization and Targeted Advertising

The second aspect of online advertising which deserves attention is the industry’s increased use of personalization technologies and methods, also known as targeted advertising. As the use of the internet grew, and new technologies were developed, it became gradually possible for

\textsuperscript{171} One other advantage of performance-based advertising is that it reduces the risk of click fraud – i.e., when an ad is deliberately clicked, usually numerous times, in the purpose of either generating income to the publisher or generating higher advertising expenses to a competitor. See B. Andrew Cudmore et al., Engaging Online Consumers with an Interactive Cost-Per-Action Advertising Model, 8 J. INTERNET COM. 288, 291 (2009).

\textsuperscript{172} PWC, supra note 146, at 21.

\textsuperscript{173} Id. at 20.

\textsuperscript{174} Id. at 20.

\textsuperscript{175} ALPHABET INC., supra note 155, at 48. (saying that most of Google’ customers pay on a cost-per-click basis).

\textsuperscript{176} YAHOO! INC., ANNUAL REPORT (FORM 10-K) FOR THE YEAR ENDED DECEMBER 31, 2016 at 55 (2017), https://investor.yahoo.net/secfiling.cfm?filingid=1193125-17-65791&CIK=1011006 (in 2016, 52\% of Yahoo!’s revenues were generated from Pay-Per-Click search advertising).

internet publishers and advertisers to track the online behavior of users, their geographic location and even their actual identity, consequently presenting them with tailor-made advertisements based on their interests, likes and dislikes, social affiliation, and other criteria deduced from their behavioral, geographic, and demographic characteristics. In a nutshell, personalization of online advertising is all about “plac[ing] the right ad before the right person at the right time.”

Before targeted advertising, the main method of increasing the ad’s relevancy to the user was contextual advertising. In this method, ads were displayed based solely on content – either the content of the visited website or the user’s search query in search engines. Targeted advertising represented a quantum leap in the ability to personalize advertisements. It matches ads to users not only based on content viewed or searched (a factor which still has an important role in the personalization process) but also, and more importantly, based on the distinctive characteristics (and sometimes even the identity) of the user who is viewing or searching for that content. Presenting an ad which is relevant to the user increases the “click-through rate,” which subsequently increases the chances of “converting” those clicks to an actual sale. For the advertiser, this means a more cost-effective advertising budget.

Because the goal of targeted advertising is to personalize ads to users, one must first answer the key question – who is the user? The practical implication of this underlying question is that online publishers and advertisers effortlessly attempt to collect as much information as possible about users in order to create a unique profile about as many users as possible. The more information they have about users the better they can tailor the ads to each specific user and increase the ads’ effectiveness.

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178 Personalization of online advertising is sometimes referred to as behavioral advertising. This description is not completely accurate because the user’s online behavioral characteristics (i.e., the way she uses the internet, which websites she visits, what types of content she is interested in), is only one piece of the personalization puzzle, which compiles additional non-behavioral information (such as demographic and geographic data, as well as technical information about the user’s computer and web browser).


180 The “Click-through rate” represents the ratio of ad clicks to ad impressions (Interactive Advertising Bureau, CLICK RATE INTERACTIVE ADVERTISING Wiki, http://www.iab.net/wiki/index.php/Click_rate (last visited Mar 14, 2017)), i.e., the number of times an ad was clicked divided by the number of times the ad was downloaded.
Information about users is collected from a variety of sources: (1) the online content the user is searching for or consuming. This includes the keywords the user searches for, the articles she is reading, the videos she is watching, her posts and “likes” on social networks, and even some aspects of the user’s e-mail messages (when he is using a web-based e-mail service such as Gmail or Yahoo! Mail); (2) a long list of signals such as the user’s location, the type of operating system she has installed on her computer, the type of web-browser she uses, and many more; (3) the user’s online history activity, including websites visited, past searches, past online purchases etc.; (4) personal information that the user provides voluntarily, for example when opening an online account with a specific website;\(^{181}\) and (5) third-party commercial databases (this requires the publisher / advertiser to be able to connect between a user’s online information and his real-life identity).\(^ {182}\)

4.2.1. Cookies and Other Tracking Technologies

Personal information of users is harvested by a variety of tracking technologies the use of which is widespread, even though most users are not even aware of their existence.\(^ {183}\) The first and most commonly used tracking technology is the “Cookie”. These not-so-delicious cyber-pastries are “[t]iny pieces of code or data stored in a user’s web browser that contain personally unidentifiable information about the user’s behavior and online activity.”\(^ {184}\) Cookies were originally used to increase convenience and improve customization by identifying returning users and allowing a more expedient web-surfing experience. For example, cookies can remember the user’s location (for delivering local weather), her passwords (allowing easier login

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\(^{181}\) An increasing number of websites encourage (and even require) users to open a personal account or join a customer club (loyalty program) that would provide users with a more personalize online experience; that practice allows the websites to collect more information about the users and ultimately connect between the online and offline identity of the users.


\(^{183}\) See, e.g., Claude Castelluccia, Behavioural Tracking on the Internet: A Technical Perspective, in EUROPEAN DATA PROTECTION: IN GOOD HEALTH?, 26 (Serge Gutwirth et al. eds., 1st ed. 2012) (explaining that most users are not aware of the additional information that is collected about them, such as contextual information collected from photos and videos).

to secure sites) and the items she had left in her online shopping cart. These “first party cookies” (installed on the user’s browser by the visited website, thus called “first party”) had limited benefits with respect to personalization since they provided each website only with the user’s activity in that site.\textsuperscript{185}

The breakthrough in cookie-based personalization occurred when advertising communities, such as ad networks,\textsuperscript{186} were formed and allowed cross-website sharing of user information. Websites which are members of an ad network allow the network to send “third-party cookies” to computers of visitors to those websites. The network then aggregates and cross-references the information it receives from the various member websites and is thus able to build a much more comprehensive user profile.\textsuperscript{187}

Another cookie technology is the Flash Cookie, which is much more durable and intrusive than its predecessor. Based on the Adobe Flash technology (which is used to deliver rich graphics and animation in websites), it has the potential to contain much more information about the user than a regular cookie, it has no expiration, and it is harder for users to erase.\textsuperscript{188}

“Browser fingerprinting” is another tracking process which collects information about the user’s browser type and version, the add-ons and plug-ins installed on the browser, and the operating system and languages installed on the computer.\textsuperscript{189} Aggregating this seemingly harmless and non-intrusive information can help create a unique “fingerprint” of the user’s specific computer and browser, and when combined with information from other tracking technologies, it can allow specific identification of the user.

Additional tracking technologies include Adware (which is a piece of software installed on the user’s computer, usually without the user’s consent, and which collects information about the

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\textsuperscript{185} Omer Tene & Jules Polonetsky, To Track or “Do Not Track”: Advancing Transparency and Individual Control in Online Behavioral Advertising, 13 MINN. J.L. SCI & TECH. 281, 290 (2012).
\textsuperscript{186} Ad networks aggregate websites (usually small ones) to create economies of scale that will be attractive to advertisers by providing them with a large variety of advertising options to choose from. See LAUREN FISHER, EMARKETER, supra note 184, at 6.
\textsuperscript{187} Center for Democracy & Technology, BEHAVIORAL ADVERTISING ACROSS MULTIPLE SITES (2009), https://www.cdt.org/content/behavioral-advertising-across-multiple-sites.
\textsuperscript{188} Omer Tene and Jules Polonetsky, supra note 185, at 293.
\textsuperscript{189} Id. at 294–95.
\end{flushleft}
user’s web usage history and patterns); mobile phones’ GPS and Wi-Fi geo-tracking capabilities (which, unless turned off by the user, enable phones to track the user’s exact geographic location anywhere in the world at any given second); and the less commonly used Deep Packet Inspection (which tracks online activity at the internet service provider level), and History Sniffing (which tracks browsing history based on the different colors that browsers assign to visited and un-visited URLs).

The use of tracking technologies is extremely common. A Wall Street Journal investigation conducted in 2010 revealed that the U.S. top 50 websites on average installed 64 tracking technologies onto users’ computers. Some websites “excelled” with over two hundred “trackers” installed. Tracking has become an integral part of any online activity. The use of tracking is so prevalent it can lead to ironic situations. For example, while reading an online Wall Street Journal article about ways to avoid being tracked by cookies, the Wall Street Journal website itself tried to install at least 10 cookies on the author’s browser (and these are just the ones that an unsophisticated free anti-tracking software managed to detect). Even more ironic, an article published by the Huffington Post criticized the hypocrisy of the NY Times for publishing an editorial supporting online privacy while at the same time using tracking technologies in the NY Times website, yet the Huffington Post website itself attempted to install 9 tracking cookies on the author’s web browser while reading the critique. These examples help emphasize the fact that in today’s modern internet tracking is simply everywhere.

190 ALAN CHARLESWORTH, supra note 43, at 7. This intrusive technology is not used by the market’s big players, but rather by smaller companies which then package the information harvested and sell it to other parties in the ad-serving chain.
191 Deep Packet Inspection and History Sniffing are less common today, mostly as a result of public outcries that motivated the change from within the industry. See Omer Tene and Jules Polonetsky, supra note 185, at 298–300.
The last piece of the information-harvesting puzzle is that of third-party data suppliers. These are companies that collect data about real-life people from various publicly-available and private sources. The information collected includes addresses and phone history, relatives, associates (individuals and corporations), licenses (driver’s, vehicle, professional, recreational etc.), property information, voter information and much more.\(^{197}\) Acxiom Corp., the leader of this industry, is the world’s largest collector and processor of consumer data. As of 2009, the company acknowledged having 1,500 pieces of data\(^{198}\) about approximately 500 million people (each) worldwide, including nearly every U.S. consumer.\(^{199}\) By 2016 that number has risen to 700 million consumers worldwide.\(^{200}\) Simply put, “[t]hey know who you are and they are selling access to it.”\(^{201}\) Indeed, these pieces of data are sold (raw or analyzed) to advertisers who assimilate it into their existing user profiles.\(^{202}\) In many instances this allows the advertiser to correlate between the user’s online identity and her real-life identity, thus maximizing the potential of ad personalization. It doesn’t get any more personal than that.

### 4.2.2. Personalized Ads in a Heartbeat

What do the advertisers and publishers do with the users’ data and personal information? How do they personalize the advertisements? The personalization of the ads is embedded into the ad purchase process. An advertiser can purchase ads either upfront (usually purchased in bulk from an ad network or publisher for a fixed price),\(^ {203}\) or use a real-time automated auction-style mechanism to purchase individual ads (this method is used for advertising in search engines as

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\(^{197}\) ACXIOM CORP., ANNUAL REPORT (FORM 10-K) FOR THE YEAR ENDED MARCH 31, 2016 at 13 (2016), http://investors.acxiom.com/secfiling.cfm?filingID=733269-16-60 (explaining that the company’s our data products contain over 5,000 data elements from thousands of sources).


\(^{200}\) ACXIOM CORP., supra note 197, at 13.

\(^{201}\) Testimony of Jeffrey Chester, Executive Director of the Center for Digital Democracy in BEHAVIORAL ADVERTISING INDUSTRY PRACTICES AND CONSUMERS’ EXPECTATIONS, supra note 182, at 68.


\(^{203}\) LAUREN FISHER, eMARKETER, supra note 184, at 2.
well as for display advertising). In the case of real-time purchase, when a user visits a publisher’s website (or when the user types a query in a search engine), that user’s information is sent to advertisers (either directly or via ad networks), who then analyze the user’s characteristics, compare it to their own database, and based on the specific campaign goals make a bid for the ad. After receiving all the bids, the publisher will conduct the auction, notify the winner, receive the ad and display it to the user. The most remarkable fact is that this entire process happens within less than a second. Only milliseconds pass from the moment the user signals that she wishes to visit the publisher’s website (by either clicking on a link to that website or manually inputting the website’s URL into her browser) and until the requested website, including the personalized ads specifically selected for the user, are downloaded and viewed by the user. This fast and fully-automated process is conducted countless times across the internet at any given moment – it happens each and every time a user visits a website (which offers real-time ad purchase) or uses a search engine, for each available advertisement space within that website and for every search query.

The following is an example of how the personalization process works in real life. Jane is a sports fan, and she spends several hours a week visiting sports news and fans websites. Her online activity is recorded by cookies on her web browser. She recently visited the website of Fred Sporting Goods with an intention of buying a new tennis racket, and she even placed it in the website’s shopping cart, but eventually decided not to buy the racket because it was too expensive for her. This activity was recorded on her computer as well as on the retailer’s database. The day after, when Jane visited one of her favorite sports news websites, which is a member of the same ad network as Fred Sporting Goods website, her user information was sent to the various advertisers, one of which was Fred Sporting Goods. Once Jane was identified as a potential customer, Fred Sporting Goods’ system automatically generated a higher bid for the available ad spot on the sports news website. If Fred Sporting Goods’ bid is the winner of the auction, its ad will be placed on the sports news website. But this will not be just a general ad.

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204 Id. at 4. Real-time buying technologies are increasingly implemented by the various players and platforms conducting the trade of online advertising, and because of its many advantages—diversification, audience targeting and increased cost effectiveness—it is predicted to become the leading technology also in display and video advertising. Id. at 4.

205 LAUREN FISHER, eMARKETER, supra note 184, at 9–10.

206 Id. at 9.
Because the website of Fred Sporting Goods and the sports news website are both members of the same ad network, they cross-reference Jane’s user information from both websites, and consequently personalize the ad specifically for her. Thus, Jane will be presented with an ad for the same racket she almost bought yesterday, but this time with a special discount (which itself could be based on Jane’s personal information acquired from third parties, such as the value of her house and other information which might assist in determining the discount that will be the most appealing to her, while maximizing the retailer’s profit). This last part of the process is known as remarketing or retargeting.\(^{207}\) If Jane eventually buys the racket, then Fred Sporting Goods can sell that information (the fact that she bought a tennis racket) to data companies (such as Acxiom and BlueKai) which in turn can resell it to other retailers or service providers, and soon after Jane will start to see ads for tennis apparel, local tennis clubs, and private tennis classes.\(^{208}\)

### 4.2.3. “Major League” Personalization

The online targeted advertising market is led by two advertising giants – Google and Facebook.\(^{209}\)

#### 4.2.3.1. Google Inc.

Google has two main advertising services. The first is AdWords, which is an auction-based system used by advertisers to place ads on the Google search results page (in Google’s own website or in other websites that are part of the Google Display Network).\(^{210}\) The second is

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\(^{209}\) It is estimated that in 2016 Google and Facebook generated more than 45% of the worldwide online advertising revenues (CINDY LIU, *supra* note 144, at 21). However, many other advertisers also use targeted advertising technologies, such as Twitter (Twitter.com, EXPERIMENTING WITH NEW WAYS TO TAILOR ADS, https://blog.twitter.com/2013/experimenting-with-new-ways-to-tailor-ads (last visited Mar 11, 2017)) and Alibaba (Angela Doland, *How Alibaba Is Pushing to Leverage Its Consumer Data for Brands*, ADVERTISINGAGE.COM, May 19, 2015, http://adage.com/article/digital/alibaba-pushing-leverage-consumer-data-brands/298663), to name just a few.

AdSense, a service designed for website owners, through which they can incorporate targeted Google ads into their websites and receive a percentage of the advertising income from those ads.\textsuperscript{211} Most of Google’s income comes from these two services.\textsuperscript{212}

Since its inception, Google’s search services (both AdWords and AdSense) used content-targeting advertising, i.e., they relied on the keywords being searched (AdWords) or the content of the website in which the ad was presented (AdSense) to match the user with the most relevant advertisements.\textsuperscript{213} However, the personalization of ads using only content targeting had a limited effectiveness. It allowed Google to match between the advertisement and the user based only on the user’s interests at a given moment – the specific keywords she was searching for or the specific website she was visiting. Such an instantaneous and restricted interaction with the user simply did not provide Google with enough information to know who the user really is and what her true interests are. Consequently, the matching of advertisements in this fashion was limited. Knowing more about the user was the key. Therefore, in 2009 Google made two important advancements in its personalization capabilities. First, it introduced its personalized advertising program (formerly known as interest-based advertising), under which Google started collecting information about the users’ online activity from the websites they had visited and to tailor the ads to the users based on such information.\textsuperscript{214} Second, Google announced that it will be presenting personalized search results to all users\textsuperscript{215} (a service which was previously available only to users with Google accounts).\textsuperscript{216} The effect of this new feature was that users were presented with search results which were no longer the ones with the highest relative importance

\textsuperscript{211} See Google.com, GOOGLE ADSENSE, https://www.google.com/adsense (last visited Mar 5, 2017); ALPHABET INC., supra note 155, at 5.

\textsuperscript{212} Testimony of Nicole Wang, Deputy General Counsel, Google Inc. in BEHAVIORAL ADVERTISING INDUSTRY PRACTICES AND CONSUMERS’ EXPECTATIONS, supra note 182, at 51; see also ALPHABET INC., supra note 155, at 32.


(based on the elaborate Google algorithm – PageRank), but rather an edited version of that list, which takes into consideration other personal factors and variables, trying to best match the results to each user.\(^{217}\)

Another important aspect of Google’s continuous personalization efforts is user-created content. Google offers its users a large variety of services, the vast majority of which is completely free of charge. These services include email (Gmail), phone (Google Voice), blog publishing (Google Blogs), multimedia editing and sharing (YouTube and Google Photos), social networking (Google+), documents and office tools (Google Drive, Calendar, and Translator), specialized search (Scholar, Google Shopping, Google Flights, and Patent Search) and the list goes on and on.\(^{218}\) By using these services the users create and consume data and information in enormous volumes, and Google has access to all of it.\(^{219}\) Google then analyzes this information in order to personalize the ads to the relevant user. A prime example of the use of user-created content for purpose of personalizing ads is the case of advertising in Google’s email service (Gmail). Google places ads on its users’ email screen. These ads are based on the content of the user’s emails and her actions with respect to those emails. For example, if the user has been emailing a friend about going on a fishing trip, he could be presented with ads which are related to that subject. If the user receives several emails about photography and marks them all as spam he is not likely to see ads regarding cameras on sale.\(^{220}\)

The developments described above represent a new era in online advertising—the era of personalization\(^ {221}\)—and Google is leading it. From a search engine with content-based advertising, Google has developed into a fine-tuned targeted advertising service, continuously

\(^{217}\) See Google, supra note 215. Personalized search is considered by some to be the beginning of the era of personalization, not just of advertisements, but of content as well. See Eli Pariser, supra note 208, at 3.


\(^{219}\) See Ray Kurzweil, Google’s Director Of Engineering, as quoted in Gregory Ferenstein, GOOGLE’S NEW DIRECTOR OF ENGINEERING, RAY KURZWEIL, IS BUILDING YOUR “CYBERNETIC FRIEND” TECHCRUNCH (2012), http://techcrunch.com/2013/01/06/googles-director-of-engineering-ray-kurzweil-is-building-your-cybernetic-friend/ (last visited Mar 5, 2017) (quoted as saying that Google has access to “the things you read, what you write, in your emails or blog posts, and so on, even your conversations, what you hear, what you say”).


\(^{221}\) Eli Pariser, supra note 208, at 3.
collecting endless amounts of information about its hundreds of millions of users, and consequently presenting those users personalized and tailored online ads.

4.2.3.2. Facebook Inc.

The second major player in the online targeted advertisement market is Facebook. Facebook’s business model is similar to that of Google – it provides users with a free service (a social networking platform for people to interact and share information), this service attracts a mass of users, Facebook collects personal information about these users and uses it to present them with personalized ads.

However, unlike Google, which attempts to obtain information about its users’ interests mostly by way of deduction from their online behavior and characteristics, Facebook found a more straightforward way to get this information – it simply provides users a free service for sharing the sought-after personal information, and they share it by the terabytes. Facebook, the world’s largest social network, has 1.86 billion active monthly users (as of December 31, 2016).

Consequently, Facebook knows about 1.86 billion people (or at least those who are active users) what are their favorite movies, books, and music, their marital status, their political affiliation, their sexual preference, the college or school they went to, who are their best friends, and who

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223 In 2011 it was claimed that Google was collecting 57 signals from its users to personalize the search results (ELI PARISER, supra note 208, at 2). By 2017 that number has risen to 200, by Google’s own account (Google.com, GOOGLE – INSIDE SEARCH – ALGORITHMS, https://www.google.com/insidesearch/howsearchworks/algorithms.html (last visited Mar 5, 2017). Google’s sources of information about its users include the content searched or viewed, websites visited, videos watched, ads clicked on, location, device information, IP address and cookie data, emails sent or received on Gmail, contacts, calendar events, photos and videos uploaded, documents saved on Google Drive, and the personal information provided by the user under her Google account (See Google.com, PRIVACY – YOUR DATA – WE WANT YOU TO UNDERSTAND WHAT DATA WE COLLECT AND USE, https://privacy.google.com/your-data.html (last visited Mar 5, 2017)).

are their not-so-best friends. This abundance of personal information, actively and intentionally shared by the users themselves, is Facebook’s greatest asset. Facebook presents users with targeted ads, which are personalized based on what those 1.86 billion users themselves shared, what they indicated they “liked”, their social milieu and the people with whom they interact.

In 2010 Facebook expanded its social capabilities to the entire web, allowing any website to implement the “like” and “share” buttons, thus enabling Facebook to collect the “likes” and predilections of its users not only from the Facebook.com website, but from virtually and potentially the entire internet. Facebook anticipated over 1 billion “likes” in the first 24 hours of this service. As of February 2012, Facebook recorded 3.2 billion likes and comments each day (from both within and without Facebook.com). This inconceivable figure demonstrates the great potential of the social network advertising market, which is indeed estimated to cross $50 billion by 2018, of which Facebook alone is expected to draw $40 billion.

Facebook is a prime example of personalization at its best – users are simply saying (or clicking) what they like, what they want, and what they think, and Facebook is there to collect that

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225 Another example of Facebook’s knowledge of its users’ personal information is the extraordinary number of photos shared by users and stored in Facebook’s servers. In the fourth quarter of 2012 alone on average more than 150 million photos were uploaded to Facebook per day, accumulating to a total of over 240 billion photos shared on Facebook over time to that date (FACEBOOK, INC., ANNUAL REPORT (FORM 10-K) FOR THE YEAR ENDED DECEMBER 31, 2012 5, http://investor.fb.com/secfiling.cfm?filingID=1326801-13-3&CIK=1326801). Facebook uses face recognition software that identifies people in photos uploaded by its users, adding another layer of personal information that Facebook collects about its users (Facebook.com, HELP CENTER – HOW DOES FACEBOOK SUGGEST TAGS?, https://www.facebook.com/help/122175507864081?helpref=faq_content (last visited Mar 5, 2017).

226 See ELI PARISER, supra note 208, at 114. A research from 2016 discovered that Facebook has 50,000 unique categories in which it places its users, allowing advertisers to target their ads to the relevant and focused audience. Julia Angwin & Terry Parris Jr., FACEBOOK LETS ADVERTISERS EXCLUDE USERS BY RACE PROPUBLICA (2016), https://www.propublica.org/article/facebook-lets-advertisers-exclude-users-by-race.


information and use it to offer targeted advertising. Facebook’s business plan relies heavily on the value it creates for advertisers by allowing them to select relevant and focused audiences for their ads, based on Facebook users’ personal information and specific interests.232 Over one million active advertisers suggest that this business plan is working.233

4.2.4. The Future of Online Personalized Advertisement

Technology and internet experts predict that personalization will have an increasingly important role in years to come.234 These estimations are also supported by academic research, which shows that targeted advertising can increase the click-through rate (i.e., the chance that a user will click the ad) by as much as 670%,235 thus appealing very much to advertisers, which are constantly looking for ways to increase the effectiveness of their advertising budgets. Other researchers say that while the benefit to the publisher is not certain and it is conditioned by several economic factors, targeted advertising nevertheless maximizes the total social welfare for both the publisher and advertiser.236

While this type of advertising technique raises many concerns about users’ privacy237 (and regulatory authorities in the U.S.238 and in Europe239 have already taken steps forward on the

234 See ELI PARISER, supra note 208, at 190.
236 Jianqing Chen & Jan Stallaert, An Economic Analysis of Online Advertising Using Behavioral Targeting, SSRN E LIBRARY, 5 (2010), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1787608 (saying that the publisher will benefit from targeted advertising only when the positive effect of the increased click-through rate is greater than the negative effect of the relaxed competition for the targeted ad slot, which results in lower bids for the ad placement).

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matters) it is nonetheless expected to become a leading trend in the online advertising market. Since this industry “runs” on users’ personal information, collecting and analyzing it will continue to be a fast-growing business, and users’ information will maintain (and strengthen) its position as one of the most sought after commodity of the modern digital economy.


241 See eMARKETER, ONLINE DATA COLLECTION EXPLODES YEAR OVER YEAR IN US (2012), http://totalaccess.emarketer.com (asserting that personal data has become a form of currency, and it is used by the majority of advertisers to enhance ad targeting).
5. **UNDERSTANDING THE BUSINESS IS AN ESSENTIAL STEP IN DESIGNING GOOD TAX LAW**

Until this point the discussion was focused on the business aspects of internet-based industries, and mainly on the online advertising line of business. We gained a better understanding of how online advertising works and reviewed two of the most predominant aspects of this business – pricing models and personalization. This phase of the discussion—learning the business features of a certain unique economic activity and understanding its underlying principles and mechanics—is of crucial importance to the process of determining the proper taxation of such activity. To understand why this phase of the process is so important we must first understand what is it that we strive to achieve – what is “proper” taxation? Once we know what makes a tax adequate we can analyze the manner in which online advertising is taxed under the existing U.S. and international tax regimes and if such manner is found to be inapt we would then be able to use our knowledge of what a proper tax should look like in order to design and propose a better solution.

5.1. **Means to An End**

Tax is defined as “[a] charge, usu. monetary, imposed by the government on persons, entities, transactions, or property to yield public revenue.”[^242] Tax is a tool. It is levied by governments (or any other types of individuals or institutions that govern a collective of people) in order to collect funds to support public expenses.

[^242]: BLACK’S LAW DICTIONARY, supra note 2, at 1594 (emphasis added). See also Oxford English Dictionary’s definition of tax – “A compulsory contribution to the support of government, levied on persons, property, income, commodities, transactions, etc., now at fixed rates, mostly proportional to the amount on which the contribution is levied” (emphasis added) tax, n., OXFORD ENGLISH DICTIONARY ONLINE, http://www.oed.com.proxy.lib.umich.edu/view/Entry/198260?rskey=K1BSBi&result=1#eid (last visited Mar 5, 2017).
Tax has no intrinsic value. Not having tax laws does not make a society less moral and does not render its legal system incompetent or inadequate.²⁴³ One can imagine a situation in which a country has no need for tax law whatsoever. For example, when a country is extraordinarily wealthy as a result of abundance of natural resources it can finance public activities from the proceeds of selling these resources.²⁴⁴ Such a country’s legal system is not in any way deficient or flawed by the mere absence of tax law. This is not the case with other fields of law. Laws that grant and preserve civil rights, as well as criminal laws that prohibit violent and immoral behavior have intrinsic value by their mere inclusion in the book of laws. If to compare to the above example, even when a society has no acts of violence whatsoever, and laws against violence are seemingly redundant, laws that prohibit violent acts have intrinsic value because of the immorality of the acts and the moral stand that such laws represent. Tax laws are not about moral.²⁴⁵ They are merely means to an end. The value and desirability of tax laws is thus determined based on their ability to serve their purpose. If the purpose of taxation is frustrated, there is no justification to continue using the current tax laws and they should be amended or replaced by rules that do achieve such purpose.

As provided by the above definition of ‘tax’, the goal of taxation is first and foremost to raise revenue in order to finance public functioning.²⁴⁶ However, the tax system is also used to carry out other governmental objectives – wealth redistribution (transferring wealth from those who

²⁴³ A possible intrinsic value of taxes can be the public’s collective contribution to the funding of the services provided to that public. Contributing a fair share by way of taxes can theoretically create a sense of mutual support, togetherness, and the feeling of belonging to a group. However, history shows that people’s attitude towards taxes is mostly negative, especially because it is these goals (if one deems them to be desirable) can be achieved by other means, and they are not unique to tax laws. Moreover, the difficulty in creating an equitable tax system, and people’s almost automatic.

²⁴⁴ There are several countries, mostly in the crude-oil-wealthy region of the Persian Gulf, which have no income tax on individuals. These countries finance their public activities by applying a very high corporate tax rate on the multinational corporations that excavate and process oil in their territories. For example, the United Arab Emirates does not impose taxes on income of individuals or companies but for the income of oil and gas exploitation and production companies (which also pay royalties based on production) and branches of foreign banks (DELOITTE, UNITED ARAB EMIRATES: HIGHLIGHTS 2017 (2017), https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-unitedarabemirateshighlig hts-2017.pdf). Taxes could have been eliminated altogether if the pumping, processing and selling of crude oil would have been performed by government agencies instead.

²⁴⁵ There are of course questions of morality with respect to various tax issues (see e.g., Leo P. Martinez, Taxes, Morals, and Legitimacy, BYU L. REV. 521 (1994) (discussing the moral obligation, or lack thereof, to obey tax laws)). For purposes of this paragraph I only refer to the lack of moral value for the mere inclusion of tax law in the legal system.

have to those who have not),\textsuperscript{247} regulation (incentivizing desired activities with tax subsidies and dis-incentivizing unwanted activities with tax “penalties”),\textsuperscript{248} and execution of government spending programs (making government payments via the tax system by providing exemptions, deductions, and credits – also known as tax expenditures).\textsuperscript{249, 250} That being said, redistribution of wealth, regulation, and tax expenditures are not an inherent part of taxation (in its simple and most obvious sense). These purposes can be achieved by other governmental means other than the tax system, and the effectiveness of the use of the tax system for these purposes is widely debated.\textsuperscript{251} Consequently, at least for purposes of this discussion I will consider raising public revenue as the main goal of a tax system.\textsuperscript{252}  

\textsuperscript{247} See id. at 3.  
\textsuperscript{248} See id.  
\textsuperscript{249} Tax expenditures are defined as “those revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability…” (CONGRESSIONAL BUDGET AND IMPOUNDMENT CONTROL ACT OF 1974, (1974)). The concept was introduced by the treasury department in the 1968 annual fiscal report (see infra note 261). It is attributed to Stanley S. Surrey who was then the Assistant Secretary of the Treasury (Tax Policy) (see Rosanne Altshuler & Robert Dietz, Reconsidering Tax Expenditure Estimation, 64 NATIONAL TAX JOURNAL 459, 460 (2011)). Surrey later analyzed and summarized the issue in a series of books and articles (see e.g., STANLEY S. SURREY, PATHWAYS TO TAX REFORM: THE CONCEPT OF TAX EXPENDITURES (1973); STANLEY S. SURREY & PAUL R. MCDANIEL, TAX EXPENDITURES (1985); Stanley S. Surrey, Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures, 83 HARV. L. REV. 705 (1970); Stanley S. Surrey, Federal Income Tax Reform: The Varied Approaches Necessary to Replace Tax Expenditures with Direct Governmental Assistance, 84 HARV. L. REV. 352 (1970)). 

It is possible to include tax expenditures as part of the regulatory category of uses of tax. However, for purpose of this dissertation I refer to the regulatory use of taxes in the sense of command-and-control (as in the case of environmental taxes), and tax expenditures as governmental spending programs used in lieu of federal grants (for example, tax credits for tuition payments, such as the Hope and Lifetime Learning credits in I.R.C. § 25A).  

\textsuperscript{250} See Reuven S. Avi-Yonah, supra note 246 at 3 nn. 12–14. See also Richard M. Bird & Eric M. Zolt, Redistribution via Taxation: The Limited Role of the Personal Income Tax in Developing Countries, 52 UCLA L. REV. 1627 (2004) (arguing against the effectiveness of the distributive role of income taxation); Walter J. Blum, The Effect of Special Provisions in the Income Tax on Taxpayer Morale, in FEDERAL TAX POLICY FOR ECONOMIC GROWTH AND STABILITY: PAPERS SUBMITTED BY PANELISTS APPEARING BEFORE THE SUBCOMMITTEE ON TAX POLICY, JOINT COMMITTEE ON THE ECONOMIC REPORT, 84TH CONG., 1ST SESS. 251, 252 (1955) (criticizing the use of tax preferences as means of providing subsidies for certain activities); Stanley S. Surrey, supra note 249 (arguing that tax expenditures are generally inferior to direct subsidy as a means of achieving social goals); Stanley S. Surrey, The United States Income Tax System--The Need for Full Accounting, in TAX POLICY AND TAX REFORM: 1961-1969 SELECTED SPEECHES AND TESTIMONY OF STANLEY S. SURREY 575 (William F. Hellmuth & Oliver Oldman eds., 1973) (criticizing the fact that expenses incurred by means of tax expenditures are not subject to the same budgetary controls as direct federal expenses, and calling for a higher degree of accounting for tax expenditures); but cf. Reuven S. Avi-Yonah, Taxation as Regulation: Carbon Tax, Health Care Tax, Bank Tax and Other Regulatory Taxes, UNIVERSITY OF MICHIGAN LAW & ECONOMICS, EMPIRICAL LEGAL STUDIES CENTER, PAPER NO. 10-020 (2010), http://papers.ssrn.com/abstract=1664045 (arguing that using taxation for purpose of regulation  

\textit{Continued on the next page...}
Because tax laws are nothing but means to an end, it would be reasonable to say that an adequate tax system is one that achieves its goal, i.e., raises revenue for the government. However, that is not sufficient. Clearly, an arbitrary, discriminatory or excessive tax system is not an apt one, even if it meets its goal. The means of taxation matter as well. An adequate and workable tax system includes tax rules which are designed based on principles of good tax policy. The list of such principles varies from one source to another, yet there is a general consensus that such principles include equity (taxpayers in similar situations should be taxed similarly), neutrality (the effect tax law has on the taxpayer’s decision-making process should be minimized), certainty (taxpayers should be able to anticipate when, where and how much tax is owed), and efficiency (administration and compliance costs should be minimized). These principles and neutrality in particular will play an important role in the discussion to follow.

5.2. The Tax Should Follow the Economics

To determine whether a certain tax achieves its goal we must first find what is the tax base, i.e., the scope and value of economic activity or assets to which the tax will apply. Then, we would need to draft rules that will measure the relevant economic activity and tax it accordingly. When this principle is applied to income tax, one should first determine what is considered income for tax purposes and then determine the rules for measuring that income and taxing it. The same reasoning applies to other types of taxes as well. Both these phases—determining the tax base and drafting the rules to tax it—require an understanding of the economic values and results of the activity that is being taxed. It is thus no surprise that one of the most fundamental premises of

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252 See also Stanley S. Surrey, supra note 251, at 576 (“[A] tax system presumably concerns itself with raising revenue rather than spending funds.”)


254 Black’s Law Dictionary defines “Tax Base” as ”The total property, income, or wealth subject to taxation in a given jurisdiction; the aggregate value of the property being taxed by a particular tax” (BLACK’S LAW DICTIONARY, supra note 2, at 1599.
taxation is that tax should follow the economics. This premise has significantly influenced the way the provisions of the U.S. Internal Revenue Code (the “Code”) were drafted. It resulted in the definition of income for tax purposes being rooted in the Haig-Simons economic definition of income; it required the inclusion of depreciation rules in order for the tax calculation to take into account the economic loss of value of property which is used for generating income; it necessitated the allowance of deductions and taxation of net income instead of revenue received; and many more provisions the purpose of which is to determine and measure the economic benefits and burdens incurred by the taxpayer in order to accurately levy tax on these economic results.


1 IRC. § 61.

See HENRY C. SIMONS, PERSONAL INCOME TAXATION: THE DEFINITION OF INCOME AS A PROBLEM OF FISCAL POLICY 50 (1938) (refining Robert M. Haig’s concept of personal income and defining it as “the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in value of the store of property rights between the beginning and end of the period in question”).

See United States v. Gotcher, 401 F.2d 118, 121 (5th Cir. 1968); Alice G. Abreu and Richard K. Greenstein, supra note 255, at 343–44. There are, however, differences between the definition of income under Section 61 of the Code and the Haig-Simons definition. For example, imputed income (see infra note 268) is not included in the Code’s definition of income, but it is included in the Haig-Simons definition (see MICHAEL J. GRAETZ & DEBORAH H. SCHENK, FEDERAL INCOME TAXATION: PRINCIPLES AND POLICIES 130–31 (6th ed. 2009)). Professor Simons himself said that his definition required some modification in order to provide an adequate tax base (see UNITED STATES DEPT. OF THE TREASURY, BLUEPRINTS FOR BASIC TAX REFORM 22 (1977)); also see Professor Bittker’s succinct note, saying that “[a] truly “comprehensive” base, in short, would be a disaster” (Boris I. Bittker, A Comprehensive Tax Base As a Goal of Income Tax Reform, 80 HARV. L. REV. 925, 982 (1966)).

The concept of taxing net income rather than gross revenue dates back to the early days of the income tax, before the Haig-Simons definition was formulated. See EDWIN R. A. SELIGMAN, THE INCOME TAX: A STUDY OF THE HISTORY, THEORY, AND PRACTICE OF INCOME TAXATION AT HOME AND ABROAD 19 (1911).
5.2.1. The Gap between Economics and Tax

Tax law’s attempts to follow the economic consequences of the taxpayer’s actions are not always successful. In many instances, the taxation of a given activity is incoherent with its economic results, creating a disparity between the real-life financial outcomes and the values used for tax purposes. In other words, in such instances there is a gap between what happens in reality and the way tax law defines the limits of, measures the values of, and taxes such economic reality. This gap is created because of several factors.

The first factor to considerably contribute to the gap between economics and tax (the “Gap”) is the use of the tax system for purposes other than raising revenue for government activities. As discussed above, the tax system is commonly used to carry out other governmental objectives such as redistribution of wealth, regulation and execution of government spending programs (tax expenditures). The use of the tax system to achieve these objectives is accomplished by the implementation of various tax mechanisms such as exemptions, deductions, credits, and preferential tax rates. The inclusion of these mechanisms in the tax system results in a significant deviation of the tax base from the “widely accepted definitions of net income.”

In other words, the net income upon which the tax is levied is not the same as the economic net income the taxpayer generated. A good example is included in section 179 of the Code, which allows small businesses to treat the cost of certain assets as an expense which is fully deductible in the tax year in which the asset was placed in service. This is an exception to the general rule which states that when an asset is expected to produce economic benefits that would last beyond the current tax year, the cost of the asset is to be capitalized and depreciation is deducted over the economic useful life of the asset. This exception (as well as the bonus depreciation provision in Code section 168(k)) is a tax expenditure which could have been achieved using a federal grant spending program. Its purpose is to provide a subsidy to incentivize investments in certain

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260 See supra notes 247–249 and the accompanying text.
262 I.R.C. § 179.
263 I.R.C. § 167.
Utilizing this provision creates a gap between the economic and tax results of the activity. From an economic standpoint, the taxpayer did not suffer any diminution of his wealth upon purchase of the asset. She had merely exchanged money for an asset of identical value. However, tax-wise, she immediately recognizes 100% deduction in the amount equal to the cost of the asset, consequently reducing her net income, which is thus different (lower) from her economic income. Her economic position is different from her tax position regarding the purchase of the asset.

It is important not to confuse the use of these mechanisms as part of the tax system’s attempt to follow the true economics and tax only the net income (for example, by allowing deductions of business expenses) with the use of these mechanisms for achieving one of the other objectives mentioned above. While the latter widens the gap between the economic and tax results, the former acts to equate the two and minimize the gap.

The second element contributing to the broadening of the Gap is the fact that defining and measuring the economic values of any activity and translating it into a workable tax terminology is a difficult and non-scientific task. For example, the definition of income for tax purposes provided a fertile ground for an abundance of scholarly discussions and its scope has been refined and redefined again and again by the courts. The vague boundaries of the term create a

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265 See STANLEY S. SURREY AND PAUL R. MCDANIEL, supra note 249, at 187 (noting that the basic task of the tax expenditure definition is to distinguish between the exclusions and deduction which are an essential part of the tax system and those that are tax expenditures).


267 The first attempt by the U.S. Supreme Court to define income was in Eisner v. Macomber, 252 U.S. 189, 207 (1920). That definition was abandoned and later replaced with a new one in C.I.R. v. Glenshaw Glass Co., 348 U.S. 426, 431 (1955). The scope of the definition of income was addressed numerous times by the courts both before and after the Glenshaw Glass case. See, e.g., Old Colony Trust Co. v. Comm’r of
grey-area in which it is sometimes unclear whether certain accessions to one’s wealth are considered taxable income or not. In other cases, the definition of income for tax purposes excludes certain economic additions to the taxpayer’s wealth (usually due to political or administrative constraints). Thus, the difficulty defining income for tax purposes and the variations between it and the economic definition of income, contribute to the widening of the gap between the tax and economic results.

An example of the inherent difficulties of valuing and measuring economic results can be found in the rules of depreciation. Depreciation deductions have an essential role in an economic-based income tax. It is used as a matching mechanism which attempts to measure the economic loss of value of capital assets during their useful life, and take this loss into account when calculating taxable income. Ideally, the depreciation deduction for tax purpose should be exactly equal to the economic loss of value of the asset. However, depreciation rules are far from exact science. Administrative constraints require the use of general presumptions regarding the useful life of assets, the use of conventions and grouping of assets. Consequently, the depreciation deduction is not always equal to the true economic loss of value (which in itself is extremely difficult to measure), thus expanding the gap between the economic and tax results.


A prime example is the case of imputed income (defined as the value of goods and services a taxpayer produces for personal consumption, and the value of the use of durable goods) (BORIS I. BITTNER & LAWRENCE LOKEN, I FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS 5–22 (3rd ed. 1999)). While it is not explicitly excluded from the definition of income under the Code, the difficulties associated with valuing and collecting tax from this type of income has practically excluded it from the tax base (see MICHAEL J. GRAETZ AND DEBORAH H. SCHENK, supra note 258, at 131; Thomas Chancellor, Imputed Income and the Ideal Income Tax, 67 OR. L. REV. 561 (1988) (supporting the exclusion of imputed income from the tax base). Cf. HENRY C. SIMONS, supra note 257, at 110–24 (discussing the inequities arising from both inclusion and exclusion of imputed income in the tax base). That being said, some courts have held that imputed income is taxable (see MICHAEL J. GRAETZ AND DEBORAH H. SCHENK, supra note 258, at 132 and the cases cited therein).


See I.R.C § 168(d) (specifying the half-year, mid-month, and mid-quarter conventions that are applied to the calculation of the allowable depreciation deduction for the year during which the relevant asset was placed in service or disposed of).

I.R.C § 168(c) provides the recovery period for different types of assets (3-year property, 5-year property, etc.). Each asset is classified into one of these categories based on its class life. The criteria for such classification is relatively broad, leading to grouping of assets with different class life yet with the same recovery period (e.g., assets with class life of more than 10 years and less than 16 years will all be classified as 7-year-property, and their cost is recovered in the same manner) (I.R.C § 168(e)).
The third element contributing to expansion of the Gap is the rule-based (rather than standard-based) nature of tax laws. The use of rules is presumed to be simpler than standards. Rules provide certainty and they are easier to apply. Rules are best suited to deal with frequent events that share similar characteristics. Consequently, the Code provides general rules for calculating taxable income which are meant to apply to the vast majority of taxable activities. These general rules are applied with the presumption that most income-generating activities operate under similar economic principles, and thus the calculation of the taxable income derived from them can be done by applying the same set of rules. These rules are designed to determine tax liability in accordance with the economic principles which underlie most transactions in most industries. However, rules have a one-way relationship with the reality they are meant to govern. They do not interact with it. They lack the ability to adjust and the flexibility to adapt to uncommon or unique circumstances. Rules are best used when the uncommon situations are indeed uncommon. But once the “uncommon becomes common” the rules are not useful any more since they produce results that do not coincide with the economic outcome of the activity. The fact that the Code is mostly based on bright-line rules limits its ability to adequately encompass new types of income. The application of current rules to such types of income produces distorted results that widen the Gap.

5.2.2. Under-Taxation and Over-Taxation

A gap between the tax and economic results of a certain activity will create either under-taxation or over-taxation. Under-taxation is created when the taxable income from a given activity is lower than the economic income from that activity. Consequently, the taxpayer ends up paying

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274 David A. Weisbach, Formalism in the Tax Law, 66 U. CHI. L. REV. 860, 865, 862 n.5 (1999) (describing the position of major scholars who support the claim that rules are simpler than standards. This article later provides a different opinion, suggesting that tax rules are more complex than tax standards, thus adopting a similar claim made several decades earlier by Stanley Surrey (see Stanley S. Surrey, Complexity and the Internal Revenue Code: The Problem of the Management of Tax Detail, 34 LAW & CONTEMP. PROBS. 673, 707 n. 31 (1969)). Cf. Louis Kaplow, Rules Versus Standards: An Economic Analysis, 42 DUKE L J 557 (1992) (rejecting the claim that rules are simple and standards are complex).

275 Louis Kaplow, supra note 274, at 622.

276 Id. at 622.

277 See David A. Weisbach, supra note 274, at 871.
less tax than she would have paid had there been an accurate match between the tax and the economics. This disparity between the economic and tax results, leading to reduced tax liability, is commonly referred to as a “loophole”. The binary nature of tax rules (creating a bright-line that taxpayers can choose to stand on whichever side of the line is favorable to them) makes it possible for taxpayers to take advantage of loopholes and plan their business to reduce their tax liability. Taxpayers use loopholes to design tax shelters. Tax shelters attempt to place the taxpayer inside the Gap, where the Code does not accurately measure the economic income. Consequently, the taxpayer receives tax benefits to which she would not have been entitled to had she not used the tax shelter. One of the most predominant tax shelters used by many U.S. multinational corporations is the deferral of taxes on active foreign-source income. According to the Code’s provisions, a Controlled Foreign Corporation is not subject to U.S. tax on active income which is received in a foreign jurisdiction as long as that income is not repatriated back to the U.S. This shelter is a good example of a structural flaw in the Code that lead to substantial under-taxation. According to current estimates, U.S. multinational corporations have approximately $2.6 trillion in deferred foreign earnings. Between the years 2011 and 2012, Apple had $35 billion of foreign base company sales income, which should have been taxed

278 A loophole is defined as “[a]n ambiguity, omission, or exception (as in a law or other legal document) that provides a way to avoid a rule without violating its literal requirements; esp., a tax-code provision that allows a taxpayer to legally avoid or reduce income taxes” (BLACK’S LAW DICTIONARY, supra note 2, at 1028). In the context of tax law, loopholes have been described as gaps in the law which were not foreseen by Congress (unlike tax expenditures, which premeditatedly create such a gap) (see STANLEY S. SURREY AND PAUL R. MCDANIEL, supra note 249, at 25).


280 See MICHAEL J. GRAETZ AND DEBORAH H. SCHENK, supra note 258, at 394 (describing tax shelters as “any investment or transaction that produces a tax savings greater than that which would be appropriate given its economic income or loss”).

281 As defined in I.R.C. § 957(a).

282 Subpart F of the Code (I.R.C. §§ 951–65) provides an anti-deferral regime which taxes foreign source income of Controlled Foreign Corporations in the same year the income was earned (i.e., even if it was not repatriated). However, this regime applies only to “Subpart F income”, which mainly includes passive income (royalties, interest and dividend) and certain types of income from related parties, but not active business income (I.R.C. § 952).

immediately under Subpart F.284 However, by using the Check-The-Box regulations (considered to be one of the biggest loopholes of the Code285), combined with the rule of deferral, Apple managed to reduce its U.S. tax liability for this income to zero, thus avoiding U.S. taxes of approximately $12.5 billion.286 While in economic terms Apple had additional $35 billion in its bank account, for U.S. tax purpose that income was completely ignored. This is under-taxation at its “best.”

But tax shelters are not enjoyed only by multinationals with multi-billion earnings. An example of a loophole that was used by many small business owners is the sports utility vehicle (SUV) expensing loophole. As a result of the coming together of certain circumstances and the combination of several Code provisions, it was possible for business owners to purchase SUVs (which could easily be used for personal purposes as well) and immediately deduct up to $100,000 of the cost of the vehicle.287 From an economic point of view it is clear that the taxpayer did not suffer a loss in the amount of the cost of the car (she merely exchanged cash for an asset which to her is worth the same amount, and suffered a partial decrease in value as a result of depreciation). However, from a tax point of view she was allowed to reduce her taxable income by the cost of the SUV (up to $100,000, which is far more than the cost of most SUVs in

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284 I.R.C. § 954(d). Foreign base company sales income is an income received from the sale of goods by an entity in one country to a related entity for use in a different country. This income is subject to Subpart F taxation in order to prevent companies from setting up intermediary entities in low-tax jurisdictions which would then buy finished goods and resell them for use in other jurisdictions while shifting most of the profit to the low-tax jurisdiction.


286 US SENATE – PERMANENT SUBCOMMITTEE ON INVESTIGATIONS, OFFSHORE PROFIT SHIFTING AND THE U.S. TAX CODE—PART 2 (APPLE INC.) 34 (2013), https://www.gpo.gov/fdsys/pkg/CHRG-113shrg81657/pdf/CHRG-113shrg81657.pdf. Apple made use of other loopholes as well, such as the same country exception (I.R.C. § 954(d)(1)(A); Treas. Reg. § 1.954-3(a)(2)) and the manufacturing exception (I.R.C. § 954(d)(1)(A); US SENATE – PERMANENT SUBCOMMITTEE ON INVESTIGATIONS, supra at 36–37). By the use of all these loopholes Apple managed to completely avoid U.S. taxes on a total income of $44 billion (between the years 2009-2012) (id. at 32).

the market, even the most luxurious ones), thus obtaining tax benefits which do not reflect her true economic situation.

On the other hand, when the taxpayer has taxable income which is higher than the actual economic income she derives from a given activity, she suffers from over-taxation. For example, if the Code limits the amount of a certain deductible expense that is extremely significant in a specific industry, this will create a substantial gap between the taxable income and the economic profit earned, causing over-taxation. Such a limitation can be found in section 280E of the Code, which disallows deduction of expenses paid or incurred in connection with the illegal sale of drugs altogether.

Both under- and over-taxation influence taxpayers’ decision-making process, consequently creating inefficiencies and loss of social wealth. When the Code levies taxes on a given activity, and that tax is not compatible with the economic results of the activity, it changes the relative prices of the different activities and incentivizes taxpayers to alter their behavior in order to avoid the more burdensome tax outcomes or enjoy the more beneficial ones. Consequently, instead of making decisions based solely on economic criteria and personal preferences, the inaccurate tax introduces additional considerations into the decision-making process and influences the taxpayer to make less-efficient choices that she otherwise would not have made. The result is a decrease in total social welfare, also known as deadweight loss or excess burden. This outcome undermines an important tax policy principle – neutrality. A neutral tax system does not change relative prices, thus has no, or only little, effect on taxpayers’ decision-making process. In an economy with free markets, rational actors and no externalities, such a system leads to an efficient allocation of resources and maximizes social wealth. It is thus clear that both under- and over-taxation have negative effects that are best if avoided.

5.2.3. Can We Close the Gap?

What can be done to close the Gap and remedy its negative effects? An illustration of the situation could help realize the possible solutions to the problem. Imagine the economic

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290 See Ethan Yale, supra note 270, at 551.
consequences of one’s actions as a square frame and the rules of tax law as round blocks. For tax law to capture and tax as much of the economic results of the activity as possible, these blocks must be placed inside the frame and cover the maximum possible area. This is of course a futile attempt. The geometric features of the round blocks (analogous to the restricted nature of rules) make it impossible to ever completely cover the entire area of the frame. If placed next to each other, the round blocks will leave gaps, that represent the economic benefits which will remain un-taxed. What can be done to solve this problem? How do we get maximum coverage of the frame, thus maximizing the correlation between the tax and the economic results? Two possible solutions come to mind.

5.2.3.1. Get More Blocks = Add More Rules

The first solution to this problem is to get more blocks. These new blocks should be smaller, so they could fit into the gaps between the original blocks, thus allowing for better coverage of the frame. When going back to the real world the analogy is clear – add more rules. However, these additional rules are not similar to the general rules of the Code (represented by the round blocks). They are uniquely tailored to the situation at hand in order to fit into the gaps created by the Code’s general rules.

In many cases, the general rules of the Code cannot adequately encompass the economic consequences of certain activities. As mentioned above, the inflexible nature of rules significantly limits their ability to produce satisfactory results when applied to unique and out-of-the-ordinary types of income-generating activities. If a certain line of business has special characteristics which are not part of the “ordinary business scheme” that all general tax provisions are aimed at, a gap will be created between the economic and tax results of that line of business. The Code’s solution to this problem is to provide adjustments to the general rules in an attempt to modify them to the specific circumstances which exist in certain situations or specific lines of business. This is accomplished by either adding exceptions to the general rules,291 or by

291 For example, I.R.C. § 451(a) provides the general rule for determining the taxable year in which amounts shall be included in gross income. Then, in section § 451(f), the Code provides a special rule which applies to the utility services industry (electricity, water, gas, telephone, etc.). This exception is tailored to this specific industry, in which payment for the services is almost always made after the services are provided (the company bills the customer after the fact, based on usage). To prevent utility companies from deferring income for services already provided but for which payment was not yet collected (which is a built-in

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offering complete sets of tailor-made rules for specific industries. If a unified set of rules would have been used to determine the taxable income of all these businesses, it would have yielded an economically-distorted result because of each business’s unique characteristics. To have a truly neutral tax system all taxpayers must pay their taxes based on the actual economic results of their actions. Thus, when the general rules are too general to encompass the special features of certain economic activities, specific rules are required in order to mitigate the differences and accurately measure the economic results. It is important to note that these special rules are to be distinguished from industry-targeted tax expenditure provisions. Such provisions are not aimed at gaining more accurate taxation, but rather provide tax benefits to certain industries (which will usually be the ones with a strong lobby in Capitol Hill). Not only such provisions do not contribute to the closing of the Gap, they expand it even further.

That being said, adding more rules has its disadvantages. It could be described as fighting fire with fire. Because the primary purpose was to close the gaps originally created by the inflexible nature of rules, adding more rules, albeit more targeted and business-specific, may indeed close some gaps, but at the same time also create others. The new rules will suffer from the same

feature of this industry for almost any utility provided in the last month of the company’s tax year), the Code requires that these companies include such amounts in their gross income in the year the services are provided to the customer. Another example can be found in § 863(e), which provides a special rule for determining the source of income generated by international communications. Because of the unique features of this line of business (involving, by definition, at least two jurisdictions, both of which are essential players in the income-generating process), the general source rules in §§ 861–862 could not provide an adequate tax treatment, thus requiring an exception for this specific line of business.

For example, I.R.C. Subchapters H (§§ 581–601), L (§§ 801–848) and M (§§ 851–860G) provide each a specific set of rules for the taxation of a specific industry (banking institutes, insurance companies, and regulated invested companies and real estate investment trusts, respectively).

For example, the oil and gas industry enjoys several preferential tax provisions such as the Enhanced Oil Recovery Credit (I.R.C. § 43), the ability to immediately expense and recover intangible drilling and development costs (id. § 263(c)), and the use of the favorable depletion deduction method (which can result in allowance of a deduction in excess of the actual cost) (id. §§ 611–617). See also Roberta F. Mann, supra note 287, at 650–51. It is estimated that the total tax expenditure cost associated with the oil and gas industry in the years 2016–2020 will be nearly $12.3 billion (THE JOINT COMMITTEE ON TAXATION, ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2016–2020 32 (2017), https://www.jct.gov/publications.html?func=download&id=4971&chk=4971&no_html=1. On the Gap-expanding quality of tax expenditures see the text accompanying supra notes 260–264.

See, e.g., testimony of Prof. Reuven S. Avi-Yonah in US SENATE – PERMANENT SUBCOMMITTEE ON INVESTIGATIONS, supra note 285, at 22 (when asked whether some of the existing loopholes in the Code that enable U.S. multinational corporations to shift profits outside the U.S. and obtain deferral should be closed, Avi-Yonah answered “[y]es. I mean, you can always say about every loophole, well, if you close this, there will be another loophole, let us wait until we have an overall reform of the system. That is no reason not to close loopholes. I think these loopholes need to be closed” (emphasis added)).
rigidness and lack of adaptability which characterizes any rule. Additionally, there is no way of knowing beforehand whether the gaps closed by the new rules will be of higher or lower fiscal value than the gaps created by the addition of new rules. In the words of Prof. Surrey, “[l]oopholes are gaps in the tax law which were not foreseen by Congress.”

It is, by the mere definition of loopholes, impossible to predetermine the value of the additional loopholes created by the addition of more rules. If it were possible, such loopholes would have been averted in the first place. This quality makes the practice of adding more rules in an attempt to close loopholes a guessing game – you win some, and you lose some. Some rules will indeed close the loophole and either will not create any subsequent loopholes at all, or at the most will create additional loopholes with fiscal value which is lower than that of the original loophole which was closed. Other rules may close the loophole but create additional loopholes with higher fiscal value than the original loophole they were meant to close, thus only aggravating the problem. Undoubtedly, this is not a perfect tool in the quest for a better tax system.

5.2.3.2. Filling in the Gaps Between the Blocks = Add Standards

Another solution to the frame-and-blocks problem is pouring a liquid substance in between the blocks which will spread and cover the gaps. In the world of legal norms, the equivalent instrument which has sufficient flexibility and adjustability qualities that will allow it to perform such a task is that of the legal standard. The use of standards provides the courts the flexibility required to fill in the gaps created by the non-continuous nature of rules. And indeed, tax law includes standards as part of its efforts to prevent taxpayers from taking advantage of the Gap in order to procure tax benefits which are not in correlation with the economic results of their actions. In order to limit the ability of taxpayers to abuse the Code’s predictability by applying its provisions in a literal fashion, the courts have developed general standards for prevention of tax avoidance, such as the “economic substance doctrine.” This doctrine “denies tax

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295 See STANLEY S. SURREY AND PAUL R. McDALE, supra note 249, at 25.
296 David A. Weisbach, supra note 274, at 872.
297 See Stanley S. Surrey, supra note 274, at 694.
298 To put things into context, tax avoidance is basically an attempt by the taxpayer to manipulate tax laws in her favor in order to take advantage of certain provisions that create a disparity between the economic and tax results of her actions, consequently leading to under-taxation.
299 Most scholars agree that the economic substance doctrine originated in the opinion of Judge Learned Hand in Helvering v. Gregory, 69 F.2d 809, 810 (2d Cir. 1934) aff’d, 293 U.S. 465 (1935) (see Daniel J. Continued on the next page...
benefits arising from transactions that do not result in a meaningful change to the taxpayer’s economic position other than a purported reduction in Federal income tax.”

In other words, the doctrine is used to prevent taxpayers from conducting solely tax-motivated transactions in order to enjoy the tax benefits created as a result of the asymmetry between economics and tax.

The economic substance doctrine consists of a two-prong test. The first, a subjective prong, focuses on the taxpayer’s motives and examines whether she had a substantial business purpose, other than reducing her tax liability, for conducting the transaction in the way that she did. The second prong, an objective one, examines whether the transaction has economic substance. This part of the test focuses on the change in the taxpayer’s economic position after the transaction, compared to her position before the transaction. Courts have applied this test by looking for a meaningful change in the taxpayer’s economic position, and narrower applications of this test looked for a reasonable possibility of creating a profit from the transaction. This prong is intended to deny taxpayers tax benefits when there is no change in their economic position. I.e., it aims to prevent taxpayers from taking advantage of the gap between the economic and tax results of a given activity or transaction in an attempt to obtain tax benefits which do not correspond with the economic reality.

This doctrine, and its ability to use its standard-based nature to prevent abuse of the Code, is nevertheless limited. It does not provide a general prohibition on minimizing one’s tax liability and avoiding tax. The contrary is true. It is a well-known premise (at least under U.S. tax law)


The two-part test was established by the U.S. Supreme Court in Frank Lyon Co. v. U. S., 435 U.S. 561 (1978); see also Sochin v. C.I.R., 843 F.2d 351, 354 (9th Cir. 1988) (describing the business purpose test as the subjective prong and the economic substance requirement as the objective prong).


See id.; see also Black & Decker Corp. v. United States, 436 F.3d 431, 441 (4th Cir. 2006) (describing the two-prong test).

Id. at 395–96.
that taxpayers have no legal or moral obligation to maximize their tax liability beyond what the Code requires. It was famously noted by Judge Learned Hand that “[a]ny one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one’s taxes.”

While this freedom to pay as little taxes as legally possible is confined by the economic substance doctrine, the doctrine itself, by nature, is limited to cases that fit into its two-prong test. Consequently, any transaction which has a business purpose and economic substance will pass the scrutiny of the doctrine. If such a transaction happens to fall into the Gap, i.e., if the taxation of the transaction does not adequately encompass the actual change in the taxpayer’s economic position, it will provide the taxpayer with tax benefits which will not be limited by the economic substance doctrine.

One must also consider the fact that courts have been divided in their application of the two-prong test. Some require that both parts of the test (subjective and objective) will be met in order to validate a transaction. Other courts require that only one of the prongs will be satisfied, and some even focus entirely on one prong, completely disregarding the other. To that we must add the lenient interpretation given by some courts to the business purpose requirement, finding a business purpose even when the transaction was predominantly motivated by tax considerations. Based on this lax interpretation, a transaction will lack business purpose only if it was motivated solely by tax avoidance purposes. Combining this permissive interpretation with the fact that some courts treat the two-prong test as disjunctive, requiring satisfaction of only one of the prongs, leads to a conclusion that transactions which provide substantial tax benefits can fly below the radar of the economic substance doctrine. David Hariton eloquently described taxpayers’ ability to bypass the doctrine by saying that “[it] permits taxpayers to retain

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305 Helvering v. Gregory, supra note 299, at 810; see also Commissioner v. Newman, 159 F.2d 848, 850–51 (2d Cir.), cert. denied, 331 U.S. 859 (1947) (“[T]here is nothing sinister in so arranging one’s affairs as to keep taxes as low as possible. Everybody does so, rich or poor, and all do right, for nobody owes any public duty to pay more than the law demands: taxes are enforced exactions, not voluntary contributions. To demand more in the name of morals is mere cant”).

306 See, e.g., Procter & Gamble Co. v. C.I.R., 961 F.2d 1255, 1259 (6th Cir. 1992) (“A taxpayer need not arrange its affairs so as to maximize taxes as long as the transaction has a legitimate business purpose.”)

307 Yoram Keiman, supra note 302, at 393 & nn.108–12.

308 Id.

309 Id. at 391 & n.101.

310 Id. at 391 & n.102.
even the most egregious tax benefits if they arise from transactions with meaningful economic consequences.»

To conclude, when the economic substance doctrine applies to a given transaction it will remedy the under-taxation by denying the tax benefits and equalizing the tax with the economics. However, if the taxpayer passes the scrutiny of the economic substance doctrine, she will be able to enjoy the tax benefits and in some cases there will be a disparity between the tax and economic consequences of her actions. In these instances, the application of standards is not able to assist in closing the Gap, resulting in under-taxation and loss of social wealth, as discussed before.

5.2.4. What About Over Taxation?

Over taxation is created when the taxpayer’s financial results, for purpose of calculating her tax liability, are higher than her actual economic results. This can happen in a variety of ways – disallowing the deduction of a substantial expense,\textsuperscript{312} ignoring or capping losses incurred,\textsuperscript{313} etc. The social consequences of over-taxation are similar to those of under-taxation. While the latter creates incentives for the taxpayer to engage in certain activities and transactions because of their favorable tax treatment, the former creates an opposite vector – incentivizing taxpayers to refrain from engaging in certain transactions and activities because of their disadvantageous tax treatment. In both cases the Code creates incentives which interfere with the taxpayer’s economic and preference-based decision making process, thus creating deadweight loss. However, unlike the case of under-taxation, in which the government has tools (anti-avoidance rules\textsuperscript{314} and standards) to try and levy a tax which is appropriate to the taxpayer’s economic

\textsuperscript{311} David P. Hariton, Sorting Out the Tangle of Economic Substance, 52 BULL. SEC. TAX’N 235, 235 (1998). See also Yoram Keinan, supra note 302, at 388 (“A more complex, tax-advantaged way of executing a transaction should not lack economic substance if the transaction itself has economic substance”).

\textsuperscript{312} This is the case with the limit imposed by I.R.C. § 280E, which disallows deduction of expenses paid or incurred in connection with the illegal sale of drugs. The same problem arises from the use of conventions in the calculation of depreciation. For example, when a taxpayer buys a depreciable asset on January 1st and the asset is placed in service the same day, the taxpayer will nevertheless be entitled only to half of the first-year depreciation allowance during that year because of the half-year convention (I.R.C. § 168(d)(1)).

\textsuperscript{313} Such as with the limit set by I.R.C. § 165(d), which allows losses incurred from gambling activity only to the extent of the gains from gambling winnings.

\textsuperscript{314} Examples of anti-avoidance rules (as opposed to anti-avoidance standards, such as the economic substance doctrine) include (1) the rules under Treas. Reg. § 1.304-4, intended to close a loophole through which taxpayers were able to avoid taxation under I.R.C. § 304 (applying to stock redemption) by using controlled

Continued on the next page...
results, the same is not true for over-taxation. Anti-avoidance rules are one-sided. The Code does not provide the taxpayer with any tools or procedures with which she may demonstrate to the government that she is over-taxed and request a special application of the law to her case. In the case of over-taxation the taxpayer has no option but to pay the higher tax. David Weisbach provides an argument in favor of the seemingly-unfair one-way nature of tax-avoidance rules. He argues that these rules create a level playing field which reduces the taxpayer’s ability to take advantage of the fact that she can plan her actions in advance and in accordance with the law, while the government has no such ability, but can only guess the taxpayer’s actions *ex-ante* when it determines the content of the law. However, this argument does not provide a satisfying justification for the difference between over- and under-taxation in cases where the over-taxation is not a result of premeditated planning or a personal choice made by the taxpayer, but rather an inadequate application of the rules to a new situation that the rules were not designed to apply to when originally drafted. If the rules are applied to a novel type of income-generating activity, their application (being limited and inflexible by nature) may yield unfitting results that cause over-taxation compared to the taxpayer’s actual economic position. Weisbach’s argument does not provide a reasonable justification for these types of over-taxation cases.

5.3. **Conclusion**

From the above discussion we can conclude that good tax laws should be drafted from the bottom up. To adequately tax a certain activity one must first understand it and levy the tax in accordance with the economic consequences of that activity. Understanding the business being taxed, and especially any unique and uncommon characteristic it possesses, is an imperative part of the process. Tax laws that fail to encompass the business’s full scope of economic consequences will eventually create under (or over-) taxation, which in turn will incentivize taxpayers to change their decisions and behaviors in a manner which diminishes total welfare. How do we close the gap between the tax and the economic results in such cases? Should we add more specific rules? Should we use standards instead? Maybe apply a combination of the two?

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315 See David A. Weisbach, *supra* note 274, at 877.
316 *Id.* at 878.
At this point of the discussion we must leave these questions unanswered. By the time we finish analyzing the problems and challenges posed by the taxation of income from online advertising we would hopefully be able to provide some answers, or at the very least some general recommendations. The conclusions of the discussion regarding the optimal taxation of income from online advertising will also serve as foundation and guidance for determining the proper taxation of other cross-jurisdiction digitally-produced income, which will become more and more prevalent in years to come.

This chapter brings us to an inevitable conclusion that a close examination of the nature of online advertising and its economic components is an imperative part in the process of determining the proper taxation of this activity. The first step of this inquiry was presented in the previous chapters, which introduced the basic mechanics of online advertising and two of its most material and unique features – action-based pricing models and personalization. These chapters dealt with the business side of online advertising. In the next step, we need to make the transition from the business terminology to that of the world of tax. This will be discussed in the next chapter.

317 See supra chapters 3.4 and 4.
6. **DISTINGUISHING ONLINE ADVERTISING**

This chapter serves two purposes. First, it will serve as a bridge between the previous chapters that discussed the business aspects of online advertising (and other digital industries), and the following chapters, in which we will discuss and analyze the taxation of income from online advertising. The second purpose of this chapter is to explain why online advertising, rather than any other type of digital business, is the best study case for discussing the challenges raised by the digital economy with respect to the applicability of the existing international tax regime. Both these purposes will be achieved by discussing the unique characteristics involved in generating income from online advertising. This will not be a business-oriented discussion. Rather, we will focus on those characteristics that are most relevant and significant for the tax analysis that will follow in the next several chapters.

Online advertising has some unique characteristics which set it apart from the other major digital-based industries—software, e-commerce, and cloud computing—at least in the context of the taxation of these activities. More specifically, we can identify three distinguishing factors that arise from the comparison between the above digital industries: (1) the effect of the income-generating activity on the physical world, which I call the “physical fingerprint”; (2) the parties involved in the transaction; and (3) the revenue-generating factor. Each of these factors is discussed below.

**6.1. Physical Fingerprint**

Traditional means of trade and commerce generally had a common denominator – they were all bound by the physicality of our world. Trading in property or providing services, especially in the international context, traditionally required overcoming geographical borders and obstacles, as well as political and man-made barriers and jurisdictional lines. Internet-based activities defy this ancient axiom. In the modern software business, though the parties to a transaction often sit on opposite sides of the planet, the order, payment, and delivery of the product can all be
processed over the internet. A transaction for the sale of software that is conducted online leaves no physical fingerprint whatsoever.

The same applies to the online advertising business model – text ads and banners are nothing but a combination of data bits, usually automatically generated by complex algorithms that match an ad to the specific characteristics of a given user. Income is generated by the click of a button, and in some cases even without a click (the CPM pricing model), by a user that can be located anywhere on the globe. The physical location of the publisher, the advertiser and the users do not constrain the ability of the publisher to generate income. It is true that location plays a crucial role in the personalization of ads to the users, however identifying and relying upon the location of users for that purpose only leaves a digital fingerprint (in the sense that the ad is tailored to the user based on his location), but it does not leave a physical fingerprint in the real world. The physical location of none of the parties in the online advertising process influences the realization of the income and no physical evidence of such transaction is left in the real world.

The lack of physical fingerprint and location independence is also shared by cloud computing. Out of the five essential characteristics enumerated in the NIST definition of cloud computing, it is interesting, in this context, to mention two in particular which emphasize the non-physical aspect of cloud computing. First, cloud computing provides “on demand self-service” access to computer resources. This allows the customer to unilaterally obtain computing capabilities from any location with an internet connection “without requiring human interaction” from the service provider. Second, the service provider’s resources are pooled amongst its customers, allowing for assignment according to customers’ demand. The definition specifically mentions that “[t]here is a sense of location independence in that the customer generally has no control or knowledge over the exact location of the provided resources but may be able to specify location at a higher level of abstraction (e.g., country, state, or data center).” This means that cloud computing services can be provided in a fully automated manner and it is independent of location (which can be changed seamlessly and inconspicuously). Beside the location of the

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318 See supra note 103 and the accompanying text.
319 Peter Mell and Timothy Grance, supra note 103, at 2.
320 Id. at 2.
servers from which the service is provided, cloud computing leaves no physical fingerprint as well.\footnote{Other qualities of cloud computing that demonstrate its physical independence are server virtualization (where one physical server can perform the tasks of several different servers, while sharing resources (processing power, memory, storage) with other virtualized servers, that could be located anywhere on the globe) and multi-tenancy (the ability to share a single server’s resources between multiple customers and provide them with cloud services using the same resources/servers. The service is provided from the same physical server but is separate for each user) \textit{(see Janine Anthony Bowen, Overview of Cloud Computing, in Cloud Computing 2011: Cut Through the Fluff & Tackle the Critical Stuff 45, 61 (Peter Brown & Leonard T. Nuara eds., 2011))}.}

E-commerce, in contrast, is by nature often required to overcome physical barriers and constraints, even though most parts of the transaction are performed online. When it comes to trade in tangible property, for example, even if purchase and payment are processed online, the seller will eventually have to physically deliver the goods to the customer. The same applies to many types of services offered for purchase online, which are ultimately also performed in a specific physical location. There are types of services that can be provided from a distant location, especially ones of advisory nature, such as legal and medical advice, business consulting and the like. However, these services usually also leave a physical fingerprint since they are not (yet) provided by automated machines but rather by persons performing the service in a distant, yet very physical, location. There are certain intangibles (such as a copyrighted digital photography) that might not leave any physical impression, yet the trade in such goods constitutes a relatively minor portion of overall e-commerce activity.

One possible critique of the concept of physical fingerprint may state that all forms of online activity require the physical use of computers by end-users as well as the physical presence of computer servers all over the world. The response to such a claim will be that the physical fingerprint characteristic is not meant to identify meta-physical activities, but rather point out those cross-jurisdictional transactions that are less burdened by the physical aspects involved in the process of generating the income. Further, the lack of a physical fingerprint is but one of several factors (described below) which, when combined, are used as a litmus test to identify those internet-based revenue-generating activities that have the most mobility, flexibility, speed and automation, and thus have the most potential to ultimately be free of, and unaffected by,
physical borders and jurisdictional confines altogether (and thus raise tax-related challenges), even if their underlying mechanics (servers and computers) remain physical in nature.

6.2. The Parties to the Transaction

When conducting an e-commerce transaction, be it the sale of a software program, the sale of tangibles or intangibles, or the provision of services, the transaction in its classic form will include two parties – the seller/provider of goods/services and the buyer/recipient of the goods/services. Although there are also transactions that involve multiple parties, in most cases such transactions are comprised of a series of two-sided transactions. For example, a three-corner exchange transaction includes a sale of asset X from party A to party B, and a subsequent exchange of asset X for asset Y between parties B and C. In these classic cases, revenue is generated when one party to the transaction pays (or has a duty to pay) the other party for goods or services provided by that other party. The same analysis applies to sale of software or provision of cloud computing services. The former is a transaction between a seller and a buyer, and the latter is a transaction for the provision of services that includes the service provider on one side and the customer on the other. All these cases are different examples of a two-sided transaction.

That is not the case with online advertising. In the business of online advertising revenue is generated based on a triangular scheme that involves the publisher, the advertiser, and the user. Such multi-party transactions cannot be broken down into two separate two-sided revenue-generating transactions because the third party (the user) cannot be seen as a party to a transaction with either the publisher or the advertising client. Going from two to three participants in any transaction will, by nature, create complexities that do not exist in a two-party interaction. Specifically, the fact that three parties are involved in the income-generating process,

322 Not surprisingly, an arm’s-length transaction is defined as “[a] transaction between two unrelated and unaffiliated parties; A transaction between two parties, however closely related…” (BLACK’S LAW DICTIONARY, supra note 2, at 1635) (emphasis added).

323 Online advertising is a prime example of a two-sided market. Jean Tirole, Nobel Prize winner in economics, defined two-sided markets as: “markets in which one or several platforms enable interactions between end-users, and try to get the two (or multiple) sides “on board” by appropriately charging each side. That is, platforms court each side while attempting to make, or at least not lose, money overall” (Jean-Charles Rochet & Jean Tirole, Two-sided Markets: A Progress Report, 37 THE RAND JOURNAL OF ECONOMICS 645, 645 (2006)). Tirole explained that “[p]ortal[s], TV Networks and newspapers compete for advertisers as well as “eyeballs.”” Id. at 645.
each of whom can be located in a different tax jurisdiction, adds complexity to an already-complex tax analysis. When combining this feature with the previous characteristic of lack of a physical fingerprint, we start to get some sense of the tax difficulties and challenges this type of activity might create.

### 6.3. The Revenue-Generating Factor

In the case of the software, e-commerce and cloud computing industries, revenue is generated as a result of the sale of goods, the provision of a service, or the use of property (in the case of royalties), and it is owed by the party that either received the property/service or made use of the asset. In other words, generally speaking, the acts of the party providing the goods/services are those that generate the revenue, which is then owed to the providing party by the receiving party. This is not the case in the three-party transaction model of online advertising. Under this model, one party (the publisher) provides users with (usually free) access to a virtual platform, which meets a certain need of the users (searching the internet, sending emails, creating social or professional connections, etc.). The more popular that platform is, the more it attracts clients wishing to advertise, who constitute the third flank of this triangular transaction. Unlike the software, e-commerce and cloud computing industries, the event which triggers the right to receive revenue from online advertising is not the sale of a product or provision of a service between the payee (publisher) and the payor (advertiser). The revenue is only created if and when the user, who is neither earning the revenue nor paying for it, has acted in a way that triggers the recognition of income (i.e. viewed a certain web-page, clicked on a sponsored ad, or otherwise acted upon an ad).

The financial reports of the major online publishers support this argument. For example, Facebook includes in its annual report an analysis of revenue by user geography, which is based Facebook’s estimate of the geography in which ad impressions are delivered or virtual and digital goods are purchased. Facebook notes that the revenue by user geography charts presented in the report is geographically apportioned based on Facebook’s estimation of the

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geographic location of the users when “they perform a revenue-generating activity.” The importance of the users for the realization of the income is further established by the fact that Facebook recognizes revenues from click-based ads in the period in which a user clicks on the content, and from action-based ads in the period in which a user takes the action the advertiser contracted for. Google applies the same method and recognizes revenues “each time a user engages with ads that appears next to the search results or content” on Google’s online platforms or those of Google Display Network members, and Google recognizes revenues from cost-per-impression pricing each time ads are displayed. This means that Facebook and Google do not recognize revenues until the users click or act upon the ads.

The essential role of the user in the revenue-generating process from online advertising is emphasized even further due to the intensive personalization efforts involved in online advertising. As discussed in chapter 4.2 above, online publishers (as well as other parties in the online advertising market) continuously develop new technologies and marketing strategies with the goal of improving the personalization process and tailoring the ads to the users based on their personal characteristics and interests. The users are no longer anonymous consumers of online ads (like in the case of traditional mediums of advertising). The online ad placing process is designed to treat each user individually (as much as possible, based on the available information on that specific user). Placing the user in the focus of this process accentuates the unique position of the user as the revenue-generating factor. Online publishers are aware to the fact that without the users’ clicks (or other online actions) they cannot generate revenue, and thus invest in personalization in order to increase ad effectiveness and the chances that the users will click/act upon the ads and generate that income to the publishers.

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325 Id. at 37 (emphasis added).
326 Id. at 40.
327 ALPHABET INC., supra note 155, at 48.
328 It is worth noting that when Facebook determines the locations from which revenues arise for accounting purposes, Facebook does not rely on the location of the users but rather on the billing address of the advertiser or developer (FACEBOOK, INC., supra note 324, at 80). The same method is used by Google (ALPHABET INC., supra note 155, at 27). As will be discussed in chapter 9.1.2 below, the tax structure used by these advertising giants is designed such that all their advertising revenues (from outside the U.S.) is sourced to a jurisdiction that is neither the jurisdiction of the users nor that of the advertisers, thereby resulting in significant tax savings.
One could argue that the audience of traditional mediums of advertising, such as television, billboard, magazine or radio, also takes part in the revenue-generating process, albeit indirectly, by consuming (or refraining from consuming) the advertised products / services. This argument is based on the notion that advertising is dependent on the existence of an audience, and in the absence of such audience, or if the advertising is inefficient (i.e., the audience is not persuaded to buy the product or service), the advertisers will cease to advertise, and this will affect the publisher’s income.

The response to this position can be summed in three words – dependency, immediacy, and measurability. Indeed, there would be no advertising whatsoever if there was no audience to advertise to, no matter what the chosen format is. It is also true that the response (or lack of response) of the audience to traditional forms of advertisement could have an indirect effect on the revenue of the publisher (if the advertising campaign fails to reach its goals, the client might stop using the publisher in future campaigns). However, the dependency, immediacy, and measurability of an online publisher’s income distinguishes it from traditional advertising formats. Unlike traditional advertising formats, the income of an online publisher is directly dependent on the users’ response. The income at stake is not a future theoretical income, which the publisher may or may not receive from the advertising client depending on the success of the current campaign, but rather the current campaign’s advertising budget, which the publisher will earn solely depending on the users’ actions. The online publisher will generate revenue only if users surf the online publisher’s website, click the ad, or act upon it; and that income will be generated immediately upon such actions taken by the users.\(^\text{329}\) Compare this to any traditional format of advertising, where the publisher is paid (sometimes even before the advertisement is published) unconditionally and wholly independently from the audience viewing it (for example, a billboard advertisement may be paid for, in advance, even if in fact it was not seen by a single driver). In addition, online advertising is measurable to a very high degree of accuracy – down to a single click. This quality allows publishers to place the users in the center of the advertising process and provide advertisers appealing pricing models that are directly dependent on the active actions of the users. By doing so, the publishers turn the users into the revenue-generating factor in this equation. This quality of measurability does not exist in any other form of

\(^{329}\) See supra notes 326–327 and the accompanying text.
traditional advertising. The significant differences between traditional and online advertising is exactly what makes advertisers flock to online advertising, where they can get a better return for their advertising budget.

To conclude this chapter, the above discussion and comparison demonstrates that the process of generating revenues from online advertising entails very unique features. Online advertising shares some of these special features with other internet-based industries (such as the lack of physical fingerprint in cloud computing services and in downloadable software transactions), but none of these industries present such an extreme case as online advertising. Online advertising transactions leave no physical fingerprint, they are conducted in a three-party model where all parties can be located in different tax jurisdictions, and where the third party in the transaction, who is neither the payee nor the payor, is the one whose active participation is the only trigger for generating the revenue. This is undoubtedly a complex combination of circumstances which makes online advertising an extreme example and an interesting study case for the tax consequences of digital types of income, especially in the cross-jurisdiction context.
7. INTERIM SUMMARY

By this point it is clear that online advertising presents a new and unique revenue-generating model. The growing accessibility to the internet around the world, the double-digit growth rate of online advertising’s share of the global advertising market, and the increasingly strong financial reports of the major players in this market, together suggest that online advertising is not a passing phenomenon. The unique characteristics of this type of economic activity undermine the traditional boundaries imposed on cross-border income-generating transactions, which for centuries have served to define and limit the world of commerce. Online advertising is completely unbound by any such physical or jurisdictional borders and is further generated in a multi-party transaction in which the active revenue-generating party is neither the payee nor the payor. When this type of activity takes place in a multi-jurisdictional context (be it at the international or domestic level), it gives rise to complicated challenges regarding the applicability of the current international tax regime to income generated from such type of activity. The source of such income, its character, and the ability of countries to tax such income under domestic tax law and under bilateral tax treaties, are some of the issues that should be discussed with respect to income of this sort. In the following chapters, we will make the transition from the business analysis of online advertising and the other digital-based industries, to the tax analysis of these activities, and online advertising in particular. This analysis will hopefully yield a comprehensive understanding of the challenges that such borderless activities create for the current domestic and international tax regimes, and especially for the concepts of source, character and taxable presence.
8. **Taxation of Income from Online Advertising Under the Existing U.S. and International Tax Regimes**

The purpose of this chapter is to explore the manner in which income from online advertising is taxed under the existing U.S. and international tax regimes when such income is derived in a cross-jurisdiction setting. Seeking an answer to this question will involve six inquiries, each discussed in one of the six parts of this chapter. The first part includes an introduction to the basic concepts of international taxation, including a review of the two pillars of modern cross-border taxation – source and residency. The second part includes an important historical background of the development of the concept of taxation at source. The third part discusses the importance and relevance of determining the source of income. The fourth reviews the source rules under U.S. federal income tax law (including a discussion about the character of income and a review of the analogy method, which is used by courts to determine the source of income when an applicable statutory source rule does not exist). The fourth part also includes a review of source rules under bilateral tax treaties. By that point of the discussion we will have the necessary background to approach the first part of the main analysis – what is the source of income from online advertising under existing U.S. and international tax law. This topic will be discussed in this fifth part of this chapter. Based on the conclusions reached in the fifth part, with respect to character and source of income from online advertising, we will then attempt to determine the tax liability of online publishers under the U.S. and international tax rules. This last part of the analysis, as included in the sixth and final part of this chapter, will cover a scenario where no tax treaty is in place and another scenario where such a treaty does exist.

As this chapter will eventually show, the results of the inquiry regarding the source and character of income realized from online advertising, as well as the manner in which online publishers are taxed under existing rules, are economically distorted, because such rules fail to encompass the special and distinguishing features of income from online advertising. The existing rules are
entirely oblivious to the fact that the users are the ones generating the income (by viewing, clicking or acting upon an ad), resulting in a characterization and sourcing of the income that are entirely disconnected from the economic foundations on which online advertising is based. The reasons for such unfitting results are discussed in the next chapter, but first thing is first.

8.1. Source vs. Residence

One of the basic foundations of international taxation is the notion of “jurisdiction to tax.” According to this principle, a country has a right, as a matter of customary international law, to tax income that is economically related to it. The traditional criteria for creating an economic connection between a jurisdiction and a person receiving a certain item of income are nationality and territoriality.

Nationality: Although an individual’s nationality is usually determined based on that individual’s citizenship, almost all countries have adopted a different definition of nationality for tax purposes – one that is based on residency. The definition of residency for tax purposes varies between countries, although most countries use one of three common tests: (i) a subjective test that attempts to locate an individual’s center of vital economic and social interests, (ii) an objective test that is usually based on the number of days an individual is physically present within the country’s borders, and (iii) a mixed test that combines the subjective and objective tests. Defining the jurisdictional connection between a country and an individual based on

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331 Unless stated otherwise, the term “person” refers to individuals and entities alike.


333 REUVEN S. AVI-YONAH, supra note 330, at 23.

334 See, e.g., the definition of the term “Israel Resident” under the Israeli Income Tax Ordinance (New Version) 5721-1961, § 1. The term is defined based on a subjective test—“the center of life” test—which takes into account an individual’s familial, economic and social ties, including the location of his permanent home, the location of the residence of the individual and his family, his regular or permanent place of employment or business, the place of his active and substantive economic interests, and the place of his activity in organizations, societies and other institutions. However, in addition to the subjective test, the definition includes a rebuttable presumption based on an objective test, under which an individual who is present in Israel at least 183 days during the tax year, or is present in Israel at least 30 days during the tax year and at least 425 days during the tax year and the two preceding tax years, is presumed to be a resident of Israel during the tax year.
residency, rather than citizenship, has a two-sided effect. On the one hand, it will broaden the scope of individuals that will be treated as having a connection with the jurisdiction, as it will include such individuals that reside in the jurisdiction even though they are not citizens of the jurisdiction. On the other hand, a residency-based criterion will also limit the scope of individuals being considered residents, as it may exclude citizens of the jurisdiction that do not reside within the jurisdiction. This double-sided effect leads to what is considered by most as a justified result – the country has jurisdiction to tax those individuals that reside in it, whether they are citizens or nor, and has no jurisdiction to tax those who do not reside within its borders, whether such nonresidents are citizens of the country or not, because they do not benefit from the services and protections provided by the country.\textsuperscript{335} The U.S. is currently the only country in the world that includes citizenship within the definition of residency for tax purposes.\textsuperscript{336}\textsuperscript{337} Meaning that under U.S. federal income tax law, an individual who is a citizen of the United States is subject to U.S. federal income tax without regard to where that person resides around the globe, and even if that person was not born in the U.S. and never visited the U.S.\textsuperscript{338} In addition, the U.S. applies an objective residency test—the substantial presence test—with respect to non-citizens.\textsuperscript{339} This unique residency definition has only a broadening effect, as it does not exclude citizens of the U.S. that reside outside its borders, but does include non-citizens who reside in the U.S.

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\textsuperscript{335} The justification of taxation based on the benefits conferred, also called the benefits principle, is further discussed in chapter 10.1.1 below.

\textsuperscript{336} The definition of the term “United States Person” includes (i) a citizen or resident of the United States, (ii) a domestic partnership, (iii) a domestic corporation, (iv) any non-foreign estate, and (v) certain trusts (collectively, a “U.S. Person”). I.R.C. § 7701(b)(30). A domestic partnership and a domestic corporation mean a partnership or corporation that were created or organized in the U.S. or under the law of the U.S. or of any of the States (id. § 7701(a)(4)). A foreign partnership or corporation means a partnership or corporation which is not domestic (id. § 7701(a)(5)).

\textsuperscript{337} Eritrea is often cited as another country that taxes its citizens regardless of their residence, but the Eritrean tax on nonresident citizens is different from the one applied by the U.S. Eritrea applies a flat 2\% tax on nonresident citizens whereas nonresident U.S. citizens are subject to the same tax imposed on residents (graduated tax rates). See Ruth Mason, Citizenship Taxation, 89 S. CAL. L. REV. 169, 172 n. 12 (2015).


\textsuperscript{339} I.R.C. § 7701(b)(1)(A)(ii). Individuals who are lawful permanent resident of the U.S. (Green Card holders), individuals that meet the substantial presence test, and individuals that make a certain election to be treated as resident aliens are collectively defined as “Resident Aliens” (id. § 7701(b)(1)(A)).
The residency of corporate entities is commonly determined based on one of two tests (or the combination of the two): (i) place of incorporation (i.e., the jurisdiction within which the corporation was registered and established), and/or (ii) the place of central management and control. Under the latter test, a corporation may be a resident of a jurisdiction, even though it is not incorporated in such jurisdiction, if the corporations’ highest level of decision-making (i.e., decisions taken by the board of directors) takes place within that jurisdiction. Many countries adopt both tests in determining corporate residency (that is the case, for example, in the United Kingdom, Israel and Canada). In the U.S., though, a corporation’s residence is based solely on its place of incorporation.\textsuperscript{340}

Territoriality: the second element in determining a country’s jurisdiction to tax is based on geographic borders. According to this criterion, a person has an economic connection with a jurisdiction if that person derives income from sources within the territorial borders of that jurisdiction, whether or not that person is a resident of the jurisdiction. The other side of the coin of this criterion is that a person does not have an economic connection with any jurisdiction from within which that person does not derive income, even if that person is a resident or a citizen of such jurisdiction.

These two basic criteria—residence and territory—were the basis for the development of two types of national tax regimes: territory-based and residency-based. Under a purely territory-based taxation system (also commonly known as source-based system), a country imposes taxes on all economic activity that originates from within its borders,\textsuperscript{341} regardless of whether it is generated by residents of such country or by nonresidents. It is obvious why a key question in such a tax regime is how to determine the source of income (i.e., whether income was generated within or without the geographical borders of the jurisdiction). Under a purely residency-based taxation

\textsuperscript{340} Id. § 7701(a)(30)(C) (including “domestic corporation” within the definition of a United States Person). Residency of corporations raises many issues and criticism. For an in-depth discussion of the problems and possible solutions of corporate residency see Omri Y. Marian, Jurisdiction to Tax Corporations, 54 B.C.L. REV. 1613 (2013) (suggesting a two-pronged test for corporate residency, based on the location where the corporation’s securities are publicly traded, or the place of the corporation’s central management and control).

\textsuperscript{341} These jurisdictional borders will generally include a country’s land territory as well as its territorial waters. For a more precise definition of the geographical borders of the Unites States for U.S. federal tax income purposes, see infra notes 432–440 and the accompanying text.
system, a country only imposes taxes on income derived by its residents, without regard to the geographical location of where the income was generated.

Many countries adopt a tax system that incorporates both territory and residence components. For example, the United States’ federal income tax system applies a residency-based principle with respect to income derived by U.S. Persons\(^\text{342}\) and a territory-based principle with respect to income derived by persons who are not U.S. Persons.\(^\text{343}\) Accordingly, U.S. Persons and Resident Aliens are subject to United States federal income tax on their world-wide income (no matter where such income was derived), while Foreign Persons are subject to U.S. federal income tax only on income derived from sources within the United States.\(^\text{344}\)

Other countries (including Canada, Japan, and the United Kingdom) have adopted a different mix of territory and residence based systems with respect to their residents. Under such tax systems, certain types of income, usually active, generated by a resident from foreign sources will be exempt (based on the territorial principle), while other types of income, usually passive income, will be taxed based on the residency principle.\(^\text{345}\) In recent years, multiple proposals to adopt some type of territoriality into the U.S. federal income tax system (in the form of foreign-source active income exemption) have been suggested by the Obama administration as well as by Republican members of Congress.\(^\text{346}\) Given the dramatic effects such proposals would have on

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\(^{342}\) Resident Aliens are treated as U.S. residents under I.R.C. § 7701(b)(1)(A) and therefore come within the definition of U.S. Persons.

\(^{343}\) Individuals and entities that are not U.S. Persons are hereinafter defined as “Foreign Persons”. Individuals who are neither U.S. citizens nor Resident Aliens are separately defined as nonresident aliens (“Nonresident Aliens”). Id. § 7701(b)(1)(B).

\(^{344}\) This general rule is subject to certain exceptions. For example, Nonresident Aliens and foreign corporations are not subject to U.S. federal income tax with respect to interest income on bank deposits (id. §§ 871(i)(2)(A) and 881(d)), portfolio interest (id. §§ 871(h) and 881(c)), original issue discount on short-term debt instruments (id. §§ 871(g)(1)(B)(i)), and certain dividends (id. §§ 871(i)(2)(D) and 881(d)), despite all these items of income being from sources within the U.S. In addition, in limited circumstances, Nonresident Aliens and foreign corporations may be subject to U.S. federal income tax with respect to certain items of income from sources outside the U.S., if such income is effectively connected with a U.S. trade or business of the Nonresident Aliens or foreign corporation (the term U.S. trade or business is discussed in section 88.6.1 below).


Continued on the next page...
the U.S. tax system (especially given that such changes were part of a proposed overall update to
the U.S. federal income tax system), it is no surprise that such proposals remained on the
drawing board. The most recent proposal of adopting territoriality in the U.S. was introduced in
June of 2016 by the Tax Reform Task Force, a Congress task force lead by the Ways and Means
Committee Chairman Kevin Brady.\footnote{\textbf{Participation Exemption System for the Taxation of Foreign Income 3 (Oct. 26, 2011),}
\texttt{http://waysandmeans.house.gov/uploadedfiles/final_te--_
Committee (1923) (\textquote{1923 Double Taxation Report}).\footnote{Id. at 20.}}}}}}

### 8.2. Where it All Began: The Early Days of International Taxation

The next stop in our journey of exploring the concept of source requires us to go back in time, nearly a hundred years ago, to the days when the basic principles of international taxation were being formed. The purpose of this historical detour is twofold: it will provide a helpful background as to the development of the concept of taxation at source and the division of taxing rights between source and residence countries, and it will also provide the historical context that will have an important role of the analysis to come.

In 1921 the financial committee of the League of Nations requested four renowned economists to prepare a report regarding the problem of double taxation. On April 5, 1923, the four economists submitted their report, titled \textquote{Report on Double Taxation.}\footnote{\textbf{League of Nations, Econ. & Fiscal. Comm. Report on Double Taxation Submitted to the Financial Committee (1923) (\textquote{1923 Double Taxation Report}).\footnote{Id. at 20.}}}

The main conclusion of the report is that the problem of double taxation should be resolved by dividing the right to tax a taxpayer’s income based on the taxpayer’s relative economic interest in each jurisdiction to whom he or she owes \textquote{economic allegiance}.\footnote{Id. at 20.}

The report enumerates four main questions that should be considered when determining the jurisdictions to which a taxpayer owes \textquote{economic allegiance}: (1) where is the yield physically or economically produced? (2) where are the final results of the process as a complete production of wealth actually to be found? (3) where can the rights to the handing over of these results be
enforced? and (4) where is the wealth spent or consumed or otherwise disposed of?\textsuperscript{350} The report considers question number 1 as seeking to find the origin of the wealth, question number 4 as seeking to find the place where the wealth is disposed of (which the report considered to be the place of residence or domicile of the taxpayer), and questions number 2 and 3 as seeking to find the place of possession of the wealth (the place where the wealth is found between its production at origin and its disposition at residence).\textsuperscript{351}

The report states that the most important factors with respect to the question of economic allegiance are questions number 1 and 4, that is, “the origin of the wealth and the residence or domicile of the owner who consumes the wealth” (stating further that the other two factors are usually of significance only for purpose of supporting the claim of origin or residence jurisdiction).\textsuperscript{352} This conclusion of the report was the basis of what will become one of the most fundamental principles in international taxation – the distinction (and some would say rivalry) between source and residence jurisdictions.

Even when limiting the analysis to two main questions (origin/source and residence), the report acknowledges that applying the concept of economic allegiance to the taxation of income (as opposed to taxation of capital) raises significant difficulties, on both the practical and theoretical level.\textsuperscript{353}

First, the place where the wealth is produced (i.e., the origin or source of the income) may involve more than one jurisdiction. The report considers the production of the wealth as “all the stages which are involved up to the point of the wealth coming to fruition, that is, all the stages up to the point when the physical production has reached a complete economic destination and can be acquired as wealth.”\textsuperscript{354} The report gives an example of oranges that are not considered acquired/produced wealth until they are picked, packed and delivered to the place where demand

\textsuperscript{350} Id. at 25.
\textsuperscript{351} Id. at 23–25.
\textsuperscript{352} Id. at 25.
\textsuperscript{353} Id. at 26.
\textsuperscript{354} Id. at 23.
exists so that consumers can buy them. All of these stages, according to the report, can involve different jurisdictions.\textsuperscript{355}

Second, when determining the origin of wealth one does not limit the analysis solely to the physical location, but rather must look for the true economic location where the wealth is produced.\textsuperscript{356} The report clearly distinguishes between the physical location (sometimes referred to as \textit{situs}) and the economic location.\textsuperscript{357} In this context the report provided the following definition of place of origin:

\begin{quote}
"When we are speaking of the origin of the wealth, we refer naturally to the place where the wealth is produced, that is, to \textbf{the community the economic life of which makes possible the yield or the acquisition of the wealth}. The yield or acquisition is due, however, not only to the particular thing, but to the human relations which may help in creating the yield."\textsuperscript{358}
\end{quote}

The report further says that although frequently the physical location and the economic location overlap, "[p]hysical situs is one thing; origin or economic location is quite another thing; they do not necessarily coincide."\textsuperscript{359} Furthermore, the report takes the position that the economic location should be the main consideration when determining economic allegiance, and the "[p]hysical situs is of importance in economic allegiance only to the extent that it reinforces economic location."\textsuperscript{360}

Finally, the report states that "modern income is such a composite product and such a complex conception that even theoretically it is not easy to assign in a quantitative sense the proportions of allegiance of the different countries interested."\textsuperscript{361} The difficulties discussed above will become apparent in the following parts of this chapter, when we review the source rules and apply them to the case of income from online advertising.

\textsuperscript{355} Id.
\textsuperscript{356} Id. at 24.
\textsuperscript{357} Id.
\textsuperscript{358} Id. at 23 (emphasis added).
\textsuperscript{359} Id. at 24–25.
\textsuperscript{360} Id. at 25.
\textsuperscript{361} Id. at 27.
After considering four different methods for solving the problem of double taxation, the economists ultimately recommended the “method of exemption for income going abroad” as the most practical method of avoiding double taxation.\(^\text{362}\) Under this method, the country of origin (i.e., source) is required to give nonresidents an exemption from tax on income derived within its borders.\(^\text{363}\) The economists noted that this exemption at source would be easier to implement and administer when applied between countries in which similar conditions exist. The reason for this is that when the scope of investments between two countries is relatively equal, the amount of “income at source” generated by nonresidents of each country is relatively equal as well and therefore the amount exempted by each country is approximately the same as the amount of foreign-source income generated by each country’s residents, which is income that each country can tax in full. Therefore, although both countries forgo taxing nonresidents at source, each country has the exclusive right to tax an approximately equal amount of foreign-source income generated by its own residents. On the other hand, the economists acknowledged that the method of exemption at source may be more difficult to implement between countries that do not have such an equilibrium, but rather have a more distinct debtor-creditor relationship (i.e., when residents of country A invest more in country B than the residents of country B invest in country A, which results in more income generated at source in country B).\(^\text{364}\) Therefore, for these types of situations the 1923 Double Taxation Report recommended adopting the classification and assignment method,\(^\text{365}\) under which different types of income would be classified to categories, and the primary right to tax each category would be granted to either the origin or residence country based on the location where the primary economic activity generating the income takes place.\(^\text{366}\)

The 1923 Double Taxation Report considered two other methods for avoiding double taxation, both of which the economists rejected. First was the “method of deduction of income from abroad.” Under this method the residence country would allow its residents a deduction for taxes paid in the source country, which in practice means that the country of residence concedes all

\(^{362}\) *Id.* at 51.  
\(^{363}\) *Id.* at 42.  
\(^{364}\) *Id.* at 48–49.  
\(^{365}\) *Id.* at 42.  
\(^{366}\) *Id.* at 51.
taxing rights to the source country (the opposite of the exemption method discussed above).\textsuperscript{367} The economists rejected this method because unless properly restricted it would place the tax revenue of the country of residence at risk for unexpected tax increases by the source country.\textsuperscript{368} The second method that the economists rejected was the “method of division of the tax.” Under this method the right to tax is divided between the countries of source and residence based on the economic contribution carried in each. This is the earliest suggestion of what is referred today as formulary apportionment. The economists rejected this method because they believed that “[t]o allocate the exact proportion of economic allegiance to origin or domicile in each particular category is well-nigh impossible. Such an attempt would savour too much of the arbitrary.”\textsuperscript{369}

In 1922, even before the submission of the final 1923 Double Taxation Report, the League of Nations decided to appoint a group of technical experts to examine the problems of double taxation and tax evasion from a practical and administrative point of view. The technical experts submitted their report in 1925.\textsuperscript{370} Interestingly, the 1925 Technical Experts Report did not follow the recommendation of the 1923 Double Taxation Report. Rather, the technical experts adopted a mixed approach. For personal income tax the 1925 Technical Experts Report adopted the method of exemption, which essentially means taxation only in the country of residence (because the country of origin exempts all nonresidents from taxes on income derived from domestic sources). For impersonal taxes (which are referred by the 1925 Technical Experts Report as “impots reels”) the technical experts adopted the method of classification and assignment, which essentially meant (when applied to impersonal taxes) taxation by the country of origin.\textsuperscript{371} This concept was later incorporated by the technical experts committee (which by that time had

\textsuperscript{367} Id. at 41–42.
\textsuperscript{368} Id. at 42; see also Edwin R. A. Seligman, Double Taxation and International Fiscal Cooperation, at 138 (1928).
\textsuperscript{369} 1923 Double Taxation Report, supra note 348, at 39. See also EDWIN R. A. SELIGMAN, DOUBLE TAXATION AND INTERNATIONAL FISCAL COOPERATION (1928). In his book, Seligman acknowledges the fact that the “division of tax” method was already an existing practice when the 1923 Double Taxation Report was drafted, as it was applied by Great Britain with respect to its colonies. This fact was also noted by the 1925 Technical Experts Report (infra note 370), which nonetheless reached a similar conclusion and rejected the “division of tax method” by saying that it would not be possible to “adopt generally such a very complicated system in the international sphere” (id. at 14).
\textsuperscript{371} Id. at 15. See also EDWIN R. A. SELIGMAN, supra note 369, at 145.
expanded to include representatives of additional countries, including the United States) into the tax convention model presented to the League of Nations in 1927. This bifurcated approach was quickly abandoned, though, in subsequent drafts of the tax convention model. The main reason was that most states that were requested by the League of Nations to review the 1925 Technical Experts Report did not have impersonal taxes on specific domestic sources of income and thus, under the original draft, would have been giving away much of their taxation rights to the country of residence without gaining much in return. Therefore, subsequent drafts of the tax convention model adopted the classification and assignment method (with no distinction between personal and impersonal taxes), under which income was classified to different categories and the primary right to tax each category was assigned to either the source or residence country. This method has since been included in all major tax treaty models—the OECD, U.S. and U.N. models—and was incorporated in thousands of bilateral tax treaties around the world.

The center role that source and residence taxation had in the development of international taxation was also noted by Professor Edwin Seligman (who was one of the four economists who drafted the 1923 Double Taxation Report) in his final remarks in his book about double taxation (in which he reviews the 1923 Double Taxation Report and the 1925 Technical Experts Report), as follows:

“When we observe all these considerations it is clear that we shall continue to be influenced primarily by the two fundamental ideas of location of the property or the origin of the income on the one hand, and on the other hand the residence of the taxpayer who owns the property or receives the income.”

From a perspective of nearly a century later, this prediction turned out to be extremely accurate. In fact, it is obvious today that the work of the four economists, as presented in the 1923 Double Taxation Report (as well as the following work of the technical experts), laid out the foundation

375 EDWIN R. A. SELIGMAN, supra note 369, at 167–68.
of modern international taxation. Therefore, it is clear why the definition of origin/source that was coined by the 1923 Double Taxation Report ought to be meaningfully considered in the analysis to come – not because the definition is necessarily the most accurate or comprehensive one, but rather because of the magnitude of the influence that the 1923 Double Taxation Report had on the tax systems of so many countries around the world and on thousands of tax treaties. As a reminder, the 1923 Double Taxation Report defined the “origin” of income as “the place where the wealth is produced, that is, to the community the economic life of which makes possible the yield or the acquisition of the wealth.” We shall return to this definition later in this dissertation.

8.3. The Importance of Determining the Source of Income

No country has a tax system that is based solely on the residency criterion. All countries have implemented some form of territoriality (i.e., taxation at source) in their tax rules. Consequently, determining territorial borders and whether income is derived from within or without such borders are critical issues for the revenue of any jurisdiction. Once a country applies some territorial aspects in its tax system with respect to either its residents or nonresidents, or both, such country must establish rules to determine when income is considered generated (or “sourced”) within or without its territorial borders. As discussed further below, determining the source of income also has significant effect when a tax treaty is in place between two or more jurisdictions, in an attempt to prevent double taxation and double non-taxation of income.

Theoretically speaking, if all countries in the world would have adopted a pure residency-based taxation system that applied to residents and nonresidents alike, the question of source of income would have been superfluous. In such a theoretical world, every country would tax the income of its own residents, regardless of the location where such income was derived, and would not tax the income of nonresidents, even if such income was derived from within such country’s geographical borders. This position is advocated by some economists, who claim that

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377. 1923 Double Taxation Report, supra note 348, at 23.
378. Such a theoretical world would require a different set of rules for determining residency in order to prevent double taxation in the event that more than one country considers a person to be a resident according to the

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pinpointing the exact source of income is impossible because there is no universal definition that can locate the source of any given income.\(^{379}\) According to such a position, most types of income have more than one source, and therefore attempting to attribute income to a single origin is both economically inappropriate and distorting.\(^{380}\) Proponents of this position instead support the view presented above, stating that as a matter of international tax law, only residency-based taxation should be used. However, the practical implementation of such a fundamental change in international tax policy is effectively impossible. First, it would require rare and unlikely global coordination (there is no motivation for one country to move to a pure residency-based taxation system if its own residents are still taxed by other countries that choose not to make the transition).\(^{381}\) Second, such a change would mostly benefit the wealthy developed countries and significantly weaken the already-struggling tax systems of developing countries that rely primarily on taxation at source. Third, as phrased so aptly by former Louisiana Senator Russell B. Long, a basic tenet of tax politics is, “[d]on’t tax you, don’t tax me, tax that fellow behind the tree!”\(^{382}\) Governments like to tax nonresidents because they are easy prey – they do not vote locally, and therefore they can easily be taxed without risking loss of electoral power.\(^{383}\) For these reasons, it seems highly unlikely that a pure residency-based tax system would be adopted.

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\(^{379}\) The first economists to make this argument were Professors Hugh J. Ault and David F. Bradford. See, e.g., David F. Bradford, *The X Tax in the World Economy*, PRINCETON UNIV. CTR. OF ECON. POLICY STUDIES, WORKING PAPER NO. 93, p. 22 (August 2003) (saying that the “the ambiguity of the idea [of source] at the most fundamental level is a reason that sourcing rules are so controversial and arcane”); Hugh J. Ault and David F. Bradford, *Taxing International Income: An Analysis of the U.S. System and Its Economic Premises*, NATIONAL BUREAU OF ECONOMIC RESEARCH WORKING PAPER SERIES, WORKING PAPER NO. 3056, p. 26 (1989) (arguing that “[t]he idea that income has a locatable source seems to be taken for granted, but the source of income is not a well-defined economic idea”); cf. Mitchell A. Kane, *A Defense of Source Rules in International Taxation*, 32 YALE JOURNAL ON REGULATION 311, 319 (2015) (disagreeing with Ault and Bradford and arguing that “[t]here is a coherent way to understand source rules as legal rules designed to reflect factual predicates about the geographic location of income).

\(^{380}\) This is a classic example of a game-theory coordination conundrum, in which all players can increase their benefit with a coordinated decision (assuming that a world-wide implementation of pure residency-based tax systems is indeed more beneficial than the existing array of tax systems), but if such coordination is or seems impossible, each player will be reluctant to act alone, because the result of her action would do her more harm than good.


\(^{382}\) See REUVEN S. AVI-YONAH, supra note 330, at 39; see also 1923 Double Taxation Report, supra note 348, at 38 (stating that, as of the time the report was published, “…[g]overnments are dominated by the desire to tax the foreigner”).
by all countries in a coordinated matter. Until that happens, territoriality, source and origin of income will remain essential components in every tax system around the globe.

Delving into the Internal Revenue Code of 1986, as amended (the “Code”), one can identify several key aspects in the U.S. federal income tax system that highlight the importance of determining the source of income for purposes of the U.S. federal tax regime, as it applies to certain types of taxpayers:

1. **Foreign Persons**: determining the source of income plays an important role in the process of applying the U.S. federal income tax system to the income of Foreign Persons. Foreign Persons are generally subject to U.S. federal income tax on the income they derive from sources within the United States and generally are not subject to tax in the U.S. for income derived from sources outside the United States. Thus, the rules for sourcing income under the Code play a significant role in determining how much income generated by Foreign Persons will be subject to U.S. federal income tax. Foreign Persons’ U.S.-sourced “fixed or determinable, annual or periodical” (“FDAP”) income, which is not effectively connected with a U.S. trade or business, is subject (on a gross-basis) to a 30% withholding at source. This tax rate also applies to certain capital gains generated by Nonresident Aliens from sources within the United States (but only if not effectively connected with a U.S. trade or business). Additionally, Foreign Persons’ income that is effectively connected with a U.S. trade or business is subject (on a net basis) to U.S. federal income tax at the same graduated rates that apply to U.S. Persons. Such tax applies to U.S.-source income, but also to certain types of foreign-source income that are attributable to such Foreign Person’s office or fixed place of business within the U.S. Finally, Nonresident Aliens and foreign corporations are subject to a 4% tax on any gross transportation income derived from U.S. sources. All of the above demonstrates that

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384 As a reminder, the term Foreign Persons include Nonresident Aliens, foreign corporations and partnerships, and certain types of trusts and estates. See supra notes 336 and 343.
385 I.R.C. §§ 871(a) and 881, subject to certain exceptions (see supra note 344).
386 Id. § 871(a)(2).
387 Determining the source of income is relevant also for the branch profits tax, which may apply to foreign corporations that are engaged in business in the U.S. Id. § 884.
388 Id. § 864(c).
389 Id. § 887.
ascertaining the source of income is a crucial part of determining the amount of a Foreign Person’s taxable income in the United States.

2. **U.S. Persons:** Because the income of U.S. Persons is subject to tax on a global basis, one would imagine that determining the source of income would have no relevance to such taxpayers. Not only is this conclusion incorrect, but the contrary is true – finding the source of income is vital in determining some of the most important items on a U.S. Person’s tax return. Because the U.S. taxes the global income of its citizens and residents, double taxation is inevitable. The non-U.S. income of a U.S. Person will likely be taxed by other jurisdictions as well, either because such income originates from these jurisdictions or because the income is earned by a U.S. citizen who is also a resident of another jurisdiction. In order to mitigate double taxation, the United States has adopted a foreign tax credit system. To put it simply (because the subject is considered to be one of the more complex ones in the Code), the United States allows certain foreign taxes paid to be credited against U.S. tax liability. However, this credit is not without its limitations. Defining it broadly, the foreign tax credit amount is limited to the amount of U.S. taxes that would have been owed on the foreign-sourced income. Because the foreign tax credit is used to offset U.S. tax liability, taxpayers have an incentive to classify their income as being from sources outside the United States, thus increasing the foreign tax credit allowance and reducing such taxpayers’ U.S. tax liability. The source of the income is thus a major consideration in determining the tax liability of U.S. Persons. The sourcing of deductions shares the same importance, and U.S. taxpayers often make it their goal to have as

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390. Another common method for resolving the double taxation problem is the exemption method. For a short description of both the credit and the exemption methods, see article 23 in the OECD Model Tax Convention and the accompanying commentary notes. OECD, MODEL TAX CONVENTION ON INCOME AND ON CAPITAL 2014: FULL VERSION (AS IT READ ON 15 JULY 2014) at C(23)-1 (2014), available at OECD iLibrary, doi: 10.1787/20745419 (the “OECD Treaty Model” and “OECD Commentaries”). Both the exemption method and credit method can be applied either by local law or by a tax treaty, when such treaty is in place between the two relevant jurisdictions.

391. I.R.C. § 901. See also REUVEN S. AVI-YONAH, DIANE M. RING, AND YARIV BRAUNER, supra note 376, at 360 (providing a detailed explanation of the mechanics of the foreign tax credit system).

392. I.R.C. § 904.


394. Nonresident Aliens and foreign corporations can also make use of the foreign tax credit (with some necessary adjustments), but the allowed credit amount is also limited under Section 904 of the Code. I.R.C. § 906.
many of their deductions sourced within the United States as possible in order not to reduce their foreign source credit allowance.

The second important aspect of determining the source of income for U.S. Persons has to do with the anti-deferral regime of Subpart F of the Code, under which certain U.S. shareholders of a controlled foreign corporation (“CFC”) are required to include in their gross income their prorata share of the corporation’s Subpart F income. Subpart F income is a term of art, which, inter alia, specifically excludes income from sources within the United States that is effectively connected to the corporation’s U.S. trade or business (with exceptions). Accordingly, the source of income is an important aspect in determining the Subpart F income of a CFC, and thus the income of the CFC’s U.S. shareholders.

Third, certain individual U.S. Persons who live outside the United States are allowed to exclude from their gross income “foreign earned income” from personal services. This exclusion is, however, limited to income from sources within the foreign country where the U.S. Person resides.

Fourth, because the source of the income affects the amount of a Foreign Person’s income that is subject to U.S. federal income tax, determining the source of income of a Foreign Person subsequently creates a corresponding duty to the U.S. payors of such income to withhold U.S. taxes owed by such Foreign Persons. Sections 1441 and 1442 of the Code require the payor to withhold tax on income paid to Nonresident Aliens and foreign corporations. However, this duty only applies with respect to payment of income from sources within the United States. A similar rule applies to partnerships, requiring withholding of taxes (at various rates) from a partnership’s effectively connected income that is allocable to partners who are Foreign Persons. Because withholding agents are held liable for any tax they did not properly withhold (including interest

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395. Id. § 957(a).
396. Id. § 951(a).
397. Id. § 952(b) and Treas. Reg. § 1.952-1(b)(2).
398. I.R.C. § 911(b). This exclusion is also limited to an amount of $100,800 for taxable years beginning in 2015. Rev. Proc. 2014-61, at section 3.32.
399. I.R.C. § 1446.
and penalties), it becomes clear why the determining the source of income has a significant role in this respect as well.

3. **U.S. Possessions:** The Code provides several tax breaks in connection with U.S. possessions. For example, a bona fide resident of Guam, American Samoa, or the Northern Mariana Islands can exclude from gross income any income derived from sources within any of these U.S. possessions, including any income that is effectively connected to a trade or business conducted within any of these possessions. The Code provides similar rules for taxing income that is derived from sources within the Virgin Islands.

The preceding discussion clarifies (in a nutshell) that despite the criticism about the difficulty in ascertaining the economic source of income, such a determination plays a crucial role in the overall tax considerations of U.S. Persons and Foreign Persons alike. Furthermore, various proposals to reform the U.S. federal income tax system have included provisions that, if adopted, will significantly change the way the U.S. tax system treats foreign active income of U.S. corporations. These proposals call for certain types of foreign-source income, which thus far has been “trapped” outside the United States, to be either tax-exempt and thus repatriated tax free, or subject to a special minimum tax. These proposed reform provisions further highlight the importance of determining the source of income.

Finally, the importance of determining the source of income is apparent also when we expand the discussion beyond the context of the Code and to the international “playground” of foreign jurisdictions and tax treaties. Determining of source of income under domestic law can differ from one country to another, resulting in either double taxation (when two jurisdictions consider the same income of the same taxpayer to be taxable, each according to its own domestic laws) or double non-taxation (when none of the relevant jurisdictions tax the income). Countries attempt to mitigate the double taxation problem through the use of bilateral tax treaties, under which the

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400. Id. § 1461.
401. Id. §§ 931–937.
402. Id. § 931.
403. Id. § 932.
404. *See* the proposal by the Committee on Ways and Means, *supra* note 346; *see also* BETTER.GOP (TAX REFORM TASK FORCE), *supra* note 347.
405. *See* the proposal by the Obama administration, *supra* note 346.
source (and character) of the income has critical importance in allocating the right to tax between the two contracting states. The issue of determining source in the context of tax treaties will be discussed further in section 8.48.4.2 below. In addition, the issue of double non-taxation has been in the public spotlight in recent years due to tax schemes and structures, usually employed by multinational corporations, that allow companies to avoid paying taxes in multiple jurisdictions (or divert income to jurisdictions with low income tax rates). Double non-taxation has been one of the main drivers of the OECD’s Base Erosion and Profit Shifting Project (the “BEPS Project”) that was launched in 2012. 406 The BEPS Project final reports (issued in October 2015) that are relevant to the topic at hand are discussed later in this dissertation. 407

8.4. Source Rules

By this point it is clear that determining the source of income is an essential step under the tax system of any jurisdiction. This determination is accomplished by a designated set of rules, commonly referred to as the “Source Rules.” The sole purpose of source rules is to determine the source of various types of income. Source rules do not include operative tax language – they do not determine what types of income are taxed, who is taxed, how taxes are applied or calculated, or what the tax rate is. Determining tax liability is achieved by the operation of a separate set of rules. The source rules are a preliminary step in that process. As was well described by David Rosenbloom:

“The source rules throw down a marker, a parameter within which the rules of taxation can be applied. The latter rules spell out the extent to which the United States asserts jurisdiction on tax within the area thus defined.” 408

The following sections of this chapter describe the source rules under the U.S. federal income tax law and source rules under tax treaties. Reviewing these rules will serve as a stepping-stone for the analysis of how income from online advertising is (and ought to be) sourced and taxed.

406 See OECD, ACTION PLAN ON BASE EROSION AND PROFIT SHIFTING 13 (2013), https://www.oecd.org/ctp/BEPSActionPlan.pdf (stating that “[f]undamental changes are needed to effectively prevent double non-taxation, as well as cases of no or low taxation associated with practices that artificially segregate taxable income from the activities that generate it”).

407 See chapter 10.2.2.2.3 below.


8.4.1.1. Existing Source Rules

U.S. federal income tax law includes a variety of source rules that can be found in different chapters of the Code. There are several ways to group and categorize the source rules. For the purpose of this dissertation, the following categorization is most helpful.

The source rules in the Code can be divided into two main groups, based on the operative language of the rules. The first group includes the source rules that categorize the entire income as being either from sources within or without the U.S. (the “Binary Source Rules”). This first group can be further divided into two sub-groups, based on the location of the rules within the Code: (a) source rules that are included within Part I of Subchapter N of the Code. This part (which includes Sections 861 through 865 of the Code) is titled “Source Rules and Other General Rules Relating to Foreign Income,” and (b) source rules located in other parts of the Code, outside sections 861 through 865. The second group includes source rules that apply to income that by its inherent nature is generated both within and without the U.S. and therefore the rules apportion part of the income to be from sources within the U.S. and part of it to be from sources outside the U.S. (the “Apportioning Source Rules”). The following paragraphs will review the various source rules that are included in each of these groups.

The first sub-group of the Binary Source Rules includes rules that are in Sections 861 through 865 of the Code, and that determine the source of income to be wholly within or without the U.S. The list of rules within this category includes rules that apply to general types of income (such as dividends and interest) and special rules that apply to income received from specific types of activities (such as income from ocean or space activities). Below are a few examples of the source rules included in this group:

- **Interest** income is generally sourced in accordance with the residence or place of incorporation of the obligor;\(^{409}\)

\(^{409}\) Most of the source rules described below are subject to exceptions.

\(^{410}\) *Id.* §§ 861(a)(1) and 862(a)(1).
• **Dividends** income is generally sourced in accordance with the place of incorporation of the company paying the dividends;\(^{411}\)

• **Rents and royalties** income is generally sourced based on the location of the property yielding the income, or the place of use of the property;\(^{412}\)

• **Personal services** income is generally sourced based on the place of performance or delivery of the services;\(^{413}\)

• Capital gains from the *sale of personal property* are generally sourced based on the residence of the seller;\(^{414}\)

• Capital gains from *sale of real property* are sourced according to the location of the property;\(^{415}\)

• Income from the *sale of inventory* is generally sourced based on the place of sale;\(^{416}\)

• Income received from *transportation* that begins and ends within the same country is sourced to that country;\(^{417}\)

• Income received from *space or ocean activities* is sourced based on the residency of the person receiving the income;\(^{418}\) and

• **Social Security** benefits are sourced within the U.S.\(^{419}\)

The second sub-group of Binary Source Rules consists of rules that are not included within the part of the Code that specifically discusses source rules (sections 861–865), but are rather scattered across various other parts of the Code. These rules include, for example:

• The source rule for amounts realized from the sale of certain preferred stock;\(^{420}\)

• The source rule for distributions received by a U.S.-owned foreign corporation;\(^{421}\)

\(^{411}\) *Id.* §§ 861(a)(2) and 862(a)(2).

\(^{412}\) *Id.* §§ 861(a)(4) and 862(a)(4).

\(^{413}\) *Id.* §§ 861(a)(3) and 862(a)(3).

\(^{414}\) *Id.* § 865(a).

\(^{415}\) *Id.* §§ 861(a)(5) and 862(a)(5).

\(^{416}\) *Id.* §§ 861(a)(6) and 862(a)(6).

\(^{417}\) *Id.* § 863(c)(1).

\(^{418}\) *Id.* § 863(d).

\(^{419}\) *Id.* § 861(a)(8). The term “Social Security Benefit” includes any amount received by reason of entitlement to a monthly benefit under title II of the Social Security Act, or a tier 1 railroad retirement benefit.

\(^{420}\) *Id.* § 306(f).

\(^{421}\) *Id.* § 535(d).
• Special source rules applicable to certain expatriates;\textsuperscript{422}
• Special source rules for purpose of applying (and preventing abuse of) the foreign tax credit rules;\textsuperscript{423} and
• Rules for re-sourcing expenses and income of members of an affiliated group.\textsuperscript{424}

While the rules included the first sub-group of the Binary Source Rules apply to specific types of income or activities (interest, rent, ocean and space etc.), the rules included in the second sub-group are intended to support rules that apply to certain transactions and tax structures. This explains why the rules within the former sub-group (of “core” source rules) are included in a designated part of the Code devoted predominantly to issues of source, while the rules from the latter sub-group appear in other parts of the Code and are intended to serve other tax provisions.

The second group of source rules—the Apportioning Source Rules—includes rules that apportion certain types of income as being partly from sources within the U.S. and partly from sources without the U.S. There are only a handful of such rules, as follows:

• Income from services rendered partly within and partly without the U.S.;\textsuperscript{425}
• Income from sale of inventory produced within the U.S. but sold outside the U.S. (and \textit{vice versa});\textsuperscript{426}
• Income from the sale of inventory in the U.S. that was previously purchased in a U.S. possession;\textsuperscript{427}
• Income from transportation that either starts or ends in the U.S. (but not both);\textsuperscript{428} and
• International communication income derived by a U.S. person.\textsuperscript{429}

\textsuperscript{422} Id. § 877(d).
\textsuperscript{423} Id. §§ 904(f)(1), 904(g) and 904(h); also, Sections 901(j)(4) and 952(d) of the Code allow the Treasury Department to issue re-sourcing rules to disallow foreign tax credits on taxes paid to countries that support international terrorism and countries with which the U.S. has severed diplomatic relations.
\textsuperscript{424} Id. § 864(e)(7) and Treas. Reg. § 1.861-11T.
\textsuperscript{425} I.R.C. § 863(b)(1)
\textsuperscript{426} Id. § 863(b)(2)
\textsuperscript{427} Id. § 863(b)(3)
\textsuperscript{428} Id. § 863(c)(2)
\textsuperscript{429} Id. § 863(e)(1)(A). Income from international communication received by a Foreign Person is sourced entirely outside the U.S. (unless such person maintains an office or other fixed place of business in the U.S.). Id. § 863(e)(1)(B).
The first three rules in the above list are substantive, as they attempt to apportion the income based on what the 1923 Double Taxation Report referred to as “economic allegiance.” I.e., the income is apportioned based on the proportional share of the U.S. and the foreign country in the value creation process that ultimately results in the generation of the income. The last two rules on the list (the rules for income from transportation and international communication) also apportion the source of the income, but do so in an arbitrary way – allocating 50% of the income to sources within the U.S. and 50% of the income to sources outside the U.S. Although this method is more convenient to administer, it does not allow for an apportionment that is based on the actual economic activity that contributed to the generation of the income, and thus what it gains in administrative convenience it lacks in accuracy.

As can be learned from above review, there is no single concept of source that underlies all source rules. The rules are inconsistent in their economic approach as they incorporate two opposing principles. Certain types of income are dealt with under a substantive approach, which attempts to follow the economic source of the income.\textsuperscript{430} This approach is applied to income from royalties (generally sourced according to the location of the use of the property), gains from disposition of real property interests (sourced according to the location of the property), and income from personal services (generally sourced according to the location where the services are performed). In these instances, the source rule attempts to identify and follow the location where the economic benefits are generated – i.e., the place where the economic activity giving rise to the income takes place.

On the other hand, other types of income are governed by a set of formal source rules that disregard the location of the economic activity generating the income. For example, the source of income from dividends is determined according to the payor’s place of incorporation. Such a rule can render arbitrary results because the income producing activity, from which the company was able to generate revenue and distribute dividends, may not necessarily correspond with the place of incorporation of the company. Although an argument could be made that the corporation derives its legal capacity from the jurisdiction in which it is incorporated, which makes that

\textsuperscript{430} \textit{Reuven S. Avi-Yonah}, \textit{supra} note 330, at 43.
jurisdiction the economic source of any income generated by the corporation, it would still seem arbitrary to assign the entire economic source to the country of incorporation and completely ignore the jurisdiction(s) from which the corporation derived its income. Other formal source rules include the rules for interest income (generally sourced according to the residency of the payor), and capital gains (generally sourced according to the residency of the seller). These formal rules are applied to specific types of income, the economic sources of which are either so difficult to locate that doing so would create an unreasonable administrative burden, or easily manipulated by the taxpayer, such that attempts to locate the true economic source of the income would be a futile effort. In addition, formal source rules are also applied to certain types of income based on political agendas or, in some cases, based on attempts by Congress to increase tax revenues. That was the case with respect to income from space or ocean activities which is sourced in accordance with the residency of the payee. This rule does not attempt to find the economic origin of the income, but was rather drafted in this fashion because most businesses engaged in space activities (at the time when the rule was enacted) were U.S. corporations. Therefore, sourcing the income from space activities based on the payee’s place of residence necessarily captures more of this type of income under the umbrella of the U.S. tax system, and increases the U.S. federal government’s tax revenue. This rule also prevents foreign tax credit manipulation and improper inflation of the foreign tax credit limitation.

In summary, there is no single coherent principle of source that serves as the bedrock on which all source rules stand. The two approaches based on which source rules were drafted—substantive and formal—yield results that are inconsistent and are difficult to justify under a single concept of source.

Before continuing our exploration of the source rules under U.S. federal income tax law, a small detour is in order. As is clear from the above review of the rules, many of the source rules require making a geographical observation in order to determine how the source rules will apply. For example, in order to determine what is the source of income from the provision of personal services, one must first determine where the service was provided – within or without the U.S. In order to determine if a certain activity takes place within the U.S., or if property is located

See KUNTZ & PERONI, supra note 393, at A2-42.
without the U.S., one must first know where the “United States” starts and where it ends, for purposes of the source rules.

The term “United States,” when used in a geographical sense, is defined to include only the States and the District of Columbia.**432 Under Treasury Regulations, this definition further includes the “territorial waters of the United States and the seabed and subsoil of those submarine areas which are adjacent to the territorial waters of the United States and over which the United States has exclusive rights, in accordance with international law, with respect to the exploration and exploitation of natural resources.”**433 Treasury Regulations specifically say that the term “United States” does not include the U.S. possessions and territories or the air space over the United States.434

Historically, the territorial waters of the United States extended three nautical miles from the coast. In 1988, President Ronald Reagan, by way of Presidential Proclamation, extended the territorial limit of the United States from three to 12 nautical miles,435 which was the international standard by that time.436 However, the Presidential proclamation expressly stated that it would not extend or alter “existing Federal or State law or any jurisdiction, rights, legal interests, or obligations derived therefrom.”**437 It is therefore not clear whether the territorial waters of the United States extend to 3 or 12 miles from the coast, for U.S. federal income tax purposes.438

The seabed and subsoil adjacent to the territorial waters (also referred to as the continental shelf) was added to the definition of the United States for U.S. income tax purposes in 1968, by the

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432 I.R.C. § 7701(a)(9).
433 Treas. Reg. § 301.7701(b)-1(c)(2)(ii).
434 Id. § 301.7701(b)-1(c)(2)(ii). U.S. possessions and territories are included in the definition of United States for purpose of the foreign earned income exclusion under Section 911(a). Id. § 1.911-2(g).
437 Presidential Proclamation, supra note 435.
enactment of Section 638 of the Code. However, the continental shelf is considered part of the United States, for U.S. federal income tax purposes, only with respect to activities that involve the exploitation of natural resources. The continental shelf extends up to 200 miles beyond the territorial waters.

8.4.1.2. Determining the Character of Income

Generally speaking, the operative language of the source rules described in the preceding section is simple and does not require interpretation or a complicated application process. The source rules are rather straightforward – various types of income are sourced within the U.S. or without the U.S. (or partly within and partly without the U.S.) based on mostly discernable criteria. Be it the location of the payor, the location of an asset, the location where services are provided or a sale is made, applying these criteria is mostly an uncomplicated task as long as the geographical borders of the jurisdiction are known and well defined. However, a prerequisite to the application of the source rules is the classification of each item of income to the various categories to which the source rules apply. One must first know what kind of income is at hand, so the proper source rule could be applied. Under most circumstances, the preliminary phase of characterizing the income would not be complicated as well. When a creditor is paid income with respect to a loan, it is clear that the income should be characterized as interest. When the owner of real property receives lease payments from the lessee, it is clear that the income should be characterized as rents. These clear-cut cases do not pose any challenge to the source rules, and are thus not very interesting. But what happens when it is not so clear how to categorize an item of income? This question has reached the courts multiple times. Below are a few notable examples.

439 I.R.C. § 638(1).
440 The United Nations Convention on the Law of the Sea recognizes an exclusive economic zone that extends up to 200 nautical miles (supra note 436, at Part V Article 57). Although the U.S. never ratified the aforementioned convention, it did ratify, in 1961, the United Nations Convention on the Continental Shelf (1958), that grants states the right to exercise sovereignty over the continental shelf (defined as the seabed and subsoil of the submarine areas adjacent to the coast but outside the area of the territorial sea, to a depth of 200 meters) for purpose of exploring and exploiting its natural resources (see United Nations Convention on the Continental Shelf, Article 1, 499 United Nations Treaty Series p. 311 (1965) http://treaties.un.org/doc/Publication/UNTS/Volume%20499/v499.pdf).
441 Some complexity is involved with respect to the application of some of the substantive source rules such as the rules for royalties (determining where an intangible was used) or services (determining where a multinational corporation provides its services). See REUVEN S. AVI-YONAH, supra note 330, at 44–45.
The first example is the case of *C.I.R. v. Wodehouse*. Sir Pelham Grenville Wodehouse (also known as P. G. Wodehouse) was a one of the most renowned humorists of the early twentieth century. At the relevant times, Wodehouse, a British citizen, was residing in France. Wodehouse was a Nonresident Alien for U.S. income tax purposes and did not have a place of business in the U.S. Wodehouse entered into an agreement with a U.S. publisher for the writing of a future series of stories. Under the agreement, the U.S. publisher would have the exclusive copyrights in the stories in the U.S., Canada and South America, and in return the publisher paid Wodehouse an upfront lump-sum. In this case, both Wodehouse and the Internal Revenue Service ("IRS") agreed that the income was from sources within the U.S. The parties were in dispute, however, as to the character of the income. Wodehouse argued that he had sold his entire rights in the stories, and therefore the income should be characterized as gain from the sale of personal property. Under the relevant source rule, the income is sourced in accordance with the residence of the seller, and with Wodehouse being a resident of France, the gain would not be subject to tax in the U.S. On the other hand, the IRS argued that the payment was royalty income for the use of or for the privilege of using the copyrights in the United States. If the income is royalties it is sourced in accordance with the place of use of the property and thus, in this case, would be sourced within the U.S. and the income would be subject to U.S. tax.

The majority opinion of the Supreme Court held that the payment represents royalties and that Congress did not intend to relieve of taxation lump sum advance payments of royalties while at the same time tax small repeated royalty payments. The dissent, written by Justice Frankfurter and adopted by two other justices, supported Wodehouse’s position and held that the income should be characterized as gains from the sale of personal property, mainly because Wodehouse had relinquished all control over the copyrights, which is a distinct characteristic of an absolute

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443 The royalties would be considered FDAP income and thus subject to tax when paid to a Nonresident Alien. See I.R.C. § 871(a), which, at the relevant times for *Wodehouse*, was included in Section 211(a) of the Code. Another issue that was discussed in *Wodehouse* was whether the fact that the royalties were paid in a lump sum meant that it was not FDAP income, because it was not an annual and periodical payment. The Supreme Court held that the income does not have to be annual or periodical in order to qualify as FDAP, because a lump sum payment represents the present value of future periodical FDAP payments. See *Wodehouse*, supra note 442, at 393.
444 Interestingly, much of the majority’s opinion discusses the question of whether Wodehouse’s income is of a type that Congress intended to relieve of taxation, and finally concludes that Congress did not intend to relieve such income from “readily collectible” taxes. See *Wodehouse*, supra note 442, at 390–391.
sale.\textsuperscript{445} Today, many scholars believe that Frankfurter’s dissenting argument was more persuasive and, had it been supported by the majority, would have resulted in a more appropriate characterization of the income.\textsuperscript{446}

\textit{Wodehouse} is a good example of how different commercial aspects of a transaction that divert, even so slightly, from the paradigmatic example of a certain type of income, can create significant difficulties in ascertaining the proper characterization of the income. In \textit{Wodehouse} it was the lump sum upfront payment and the relinquishment of control over the intangible property that challenged the classic definition of royalties and required the court to decide whether this special kind of income is more like royalties or rather more like gains from the sale of property. The characterization dilemma could have been even more complicated had Wodehouse argued, as suggested by Avi-Yonah, that the income was upfront payment for personal services (for writing the stories that, at the time the payment was made, were not yet written).\textsuperscript{447}

Another example of the difficulties involved in characterizing income can be found in a series of seminal cases discussing artistic creations and performances by Nonresident Aliens, where the courts had to determine whether the income should be characterized as royalties or as income from the provision of personal services. In these cases, the courts held that when a taxpayer’s personal efforts lead to the creation of personal property, in which the taxpayer does not maintain any interest, the income received by the taxpayer is from personal services, even when the amounts received by the taxpayer are contingent upon to the proceeds generated from the sale (or licensing) of the property by its owner.

In \textit{Ingram v. Bowers},\textsuperscript{448} Mr. Enrico Caruso, one of the world’s famous Italian opera singers of the early twentieth century, entered into a contract with a U.S. record company. Under the contract, Mr. Caruso recorded his singing and in return received payments that were based on the amount of records sold, with a minimum payment paid to him regardless of sales volume. Mr. Caruso had no legal rights in the recordings. The New York District Court was faced with the

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{445} \textit{Id.} at 402–403.
\item \textsuperscript{446} \textit{See} REUVEN S. AVI-YONAH, \textit{supra} note 330, at 48.
\item \textsuperscript{447} \textit{Id.} at 48.
\item \textsuperscript{448} \textit{Ingram v. Bowers}, 47 F.2d 925 (S.D.N.Y. 1931) \textit{aff’d}, 57 F.2d 65 (2d Cir. 1932).
\end{itemize}
\end{footnotesize}
question of whether Mr. Caruso’s income that was received on account of record sales outside the U.S. constitutes income from sources within or without the U.S. In order to make a decision, the court first needed to conclude whether the income was from royalties or personal services. The court held that the contract between Mr. Caruso and the record company was not a licensing contract, as Mr. Caruso had no proprietary right, title or interest in the recordings. The court further noted that although the compensation was contingent upon sales (with a minimum compensation paid in any event), the arrangement was for the provision of services. Therefore, because Mr. Caruso’s services (which the court considered as being the decisive feature in the generation of income from the foreign sales of records) were rendered in the U.S., the income received for such services was subject to U.S. tax.

In *Karrer v. United States,* Paul Karrer, a Swiss chemistry professor (who received the Nobel Prize for his discovery of vitamins B2 and E), entered into a contract with a Swiss pharmaceutical company. Under the contract, the company would sponsor Karrer’s research, the company would have the sole right to exploit any commercial product that may result from the research, and Karrer would receive a percentage of the net proceeds from the sale of such commercial products. The research was successful and the Swiss company conveyed these rights to a U.S. subsidiary that sold the products in the U.S. The U.S. subsidiary was the one that made the payments to Karrer directly. The IRS argued these were U.S.-source royalty payments subject to federal income tax, however the U.S. Court of Claims ruled in favor of Mr. Karrer. The court held that despite the fact that the payments were based on U.S. sales such payments were compensation for Karrer’s service rendered in Switzerland and therefore are foreign source income that is not subject to U.S. tax.

In *Boulez v. Comm’r of Internal Revenue,* Mr. Boulez, a renowned German orchestra conductor, had entered into a contract with a record company for the recording of his work. Under the contract, the record company had all the property rights over the recordings, even though Mr. Boulez’s compensation was based on the sale of the records. Mr. Boulez claimed that

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449 *Id.* at 926.

450 *Id.*


the payments he received were royalties, and thus not subject to U.S. tax in accordance with the tax treaty between the U.S. and Germany that was in force at the relevant time. The Tax Court held that Mr. Boulez “had no licensable or transferable property rights in the recordings”453 and therefore the compensation he was paid under the contract was not royalties but rather compensation for personal services. Because Mr. Boulez performed such services in the U.S., his income for rendering the services was from U.S. sources and subject to tax in the U.S.

As noted previously with respect to Wodehouse, the courts in the above three cases were faced with the question of the character of the income because the commercial agreement included an element that did not fit to the traditional service agreement model – the compensation being contingent upon sales. This deviation from the classic service agreement model, and the introduction of a royalty-related concept into the contract, meant that the commercial reality did not fit the existing legal constructs of the source rules, at least not prima facie, which thus required the courts to conduct an inquiry and determine the character of income. As will be further discussed below, the rapidly-evolving world of commerce and business, and especially the growth of the digital economy, only continues to create new business models and commercial agreements that by their very nature (as being innovative and avant-garde) do not squarely fit into the classic types of income for which source rules exist. This brings us to the second major problem with source rules – they are few and very specific.

8.4.1.3. No Source Rule? No Problem: The Analogy Method

The previous section discussed several examples in which a certain item of income could have been characterized, at least prima facie, as more than one type of income, where the possible candidates were the “classic” categories of income for which source rules exists (royalties, services, sale, etc.). Once the courts determined the nature of the income (based on the facts and circumstances), determining the source of the income was simply a matter of applying the relevant source rule. But what happens if the character of the income is clear but the Code simply does not include a source rule for that type of income?

453 Id. at 595.
As is clearly observable, the list of source rules in the Code is far from comprehensive. There are many types of income for which there is no specific source rule, such as income from gambling, cancellation of indebtedness, gifts and many others. How should one determine the source of income in the absence of a specific statutory rule? One solution would be for Congress to add new source rules to the list whenever a new type of income emerges. Although Congress has done so in the past (for example, when the source rule for income from space and ocean activities was added to the Code in 1986), this is clearly not a satisfactory solution because of the slow pace of legislation, especially when it is tax-related. Given that a statutory-based solution is not likely to come from Congress, courts needed to find an alternative way to resolve the problem of lack of specific source rules. Courts have dealt with this problem by using the analogy method, which has been well explained as follows:

“When an item of income is not classified within the confines of the statutory scheme nor by regulation, courts have sourced the item by comparison and analogy with classes of income specified within the statutes.”

And –

“The sourcing rules are not comprehensive. If a category of FDAP is not listed, case law tells us to proceed by analogy. In other words, if the guaranty fees were neither interest nor payment for services rendered, we would still have to figure out whether they were more like interest or more like payment for services rendered (or, possibly, some other category of FDAP that has a specific sourcing rule).”

In other words, applying the analogy method means that the courts would (1) compare the income in question to other categories of income for which statutory source rules exist; (2) choose the category of income the characteristics of which most resemble the income in question; and (3) apply the source rule for the category that was chosen to the income at hand.

There are several examples of case law where the courts applied the analogy method. The first example considered the appropriate source of amounts received as consideration for an

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obligation not to compete. In *Korfund Co. v. C.I.R.*, a German company entered into an agreement with a U.S. competitor under which the German company agreed not to compete with the U.S. corporation in the United States. A portion of the amounts paid under the contract was in consideration for this undertaking. The petitioner (the U.S. corporation) contended that this amount was paid for performing a service by refraining from doing an act (negative performance). The petitioner claimed that the act of refraining from competing was continuously performed in Germany, where the company resided. The Tax Court did not agree, and held that the source of the income should be determined based on the location of the right that was relinquished, i.e., the market where the competition would have taken place in the event of a breach of the covenant. In this case, absent the non-compete covenant the German company could have earned business income in the U.S. which would have been U.S.-source income and therefore, according to the court, the amount paid for the non-compete obligation is U.S.-source income.

In *Howkins v. Comm’r of Internal Revenue*, the petitioner claimed that alimony payments he had made to his Nonresident Alien former wife, from a bank account that he maintained in England, were from sources outside the U.S. The Tax Court reasoned that while alimony is not one of the types of payments included in the list of statutory source rules, it can be learned, from the existing statutory rules, that Congress was looking for the place where the income was produced, and not the payor’s sources of income or the origin of the physical means of payment. The court analogized alimony with payment of interest which, like alimony, is an obligation to make a periodical payment over a period of time, and which is not incurred in exchange for property or services. Consequently, the court determined the source of alimony income in analogy to that of interest income (i.e., the residence of the payor/obligor) and concluded by saying that the court is “not, in any event, holding that section 861 is literally applicable to the case at bar, but merely noting that, in the absence of a specific statutory source-

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458 *Id.* at 693–94.
459 *Id.* at 694.
of-income rule for alimony, the statutory rules of general application, and especially the general rule for interest payments, present a persuasive analogy.”

In the case of Bank of America v. United States, the issue was the sourcing of acceptance, confirmation and negotiation commissions paid to Bank of America by foreign banks with respect to commercial letters of credit that were issued by the foreign banks. Bank of America contended that the payments should be sourced in analogy to interest because they represented the use of the bank’s credit. The IRS claimed that these commissions were income from the provision of personal services. The court applied the analogy method and determined that the acceptance and confirmation commissions are sourced by analogy to interest “because it furnishes the closest analogy in the statutory sourcing provisions.” The negotiation commissions were sourced by analogy to personal services.

The final example of the application of the analogy method is a recent one, where the court had to determine the source of guarantee fees. In Container Corp. v. C.I.R., a Mexican parent corporation guaranteed a debt of one of its U.S. subsidiaries. In return, the parent corporation received a guarantee fee from the U.S. subsidiary. The court first determined that the guarantee fees were neither interest income nor income from personal services. Then, in accordance with the analogy method, the court inquired whether guarantee payments are more like interest or more like services. The court reached a conclusion that guarantee fees are more analogous to service payments than to interest payments. First, the court noted that a guarantee “lacks a principal characteristic of a loan” because the parent company did not extend any funds to its subsidiary. Second, the court held that guarantee fees are produced by the guarantor because they are paid in return for the guarantor’s promise to incur a contingent future obligation to repay the debt – a promise that is supported by the guarantor’s sufficient assets. The court thus concluded that because guarantee fees, like services, are produced by the obligee, they should,

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460 Id. at 695.
462 Id. at 149.
463 Container Corp. v. C.I.R., supra note 455.
464 Id. at 139.
465 Id. at 140.
like services, be sourced to the location of the obligee.\textsuperscript{466} Applying the source rule for services, the court concluded that the guarantee fees were sourced in Mexico, the place where the parent performed the “services” that generated the fees, and thus the income was not subject to U.S. tax.\textsuperscript{467}

The above examples demonstrate the difficulties involved in implementing the analogy method with respect to types of income that do not have a statutory source rule. Employing the analogy method necessarily requires the courts to exercise discretion with respect to the similarities and distinctions between the type of income at hand and the types of income for which source rules exist. In the absence of a single comprehensive concept of source to guide the courts, such exercise of discretion can result in a variety of outcomes, not of all which will necessarily conform with the economic reality of the income that the court is reviewing.\textsuperscript{468} In addition, similar types of income could theoretically be sourced differently by different courts, which would create inconsistencies across jurisdictions. This is not surprising, though, because an imprecise method, such as the analogy method, is bound to create imperfect (and possibly contradictory) results in some cases, especially given the absence of a single unified concept of source that courts could use as a guidepost when confronted with new types of income for which the Code does not provide a source rule.\textsuperscript{469}

This problem is likely to be exacerbated when courts will have to confront the sourcing of new types of income that are generated in non-traditional mediums, such as the internet, or which are based on digital business models that simply did not exist when the traditional source rules were

\textsuperscript{466} Id. at 140–41.

\textsuperscript{467} The lack of certainty as to the appropriate source rule that should be applied in the case of guarantee fees was resolved by the Small Business Jobs Act of 2010 that added section 861(a)(9) to the Code (see P.L. 111-250, § 2122). Under that section, guarantee fees received from a U.S. Person (as well as guarantee fees received from any Foreign Person if such fees are effectively connected with such Foreign Persons’ U.S. trade or business) are treated as income from sources within the U.S. This is a unique example of a type of income that did not have a specific source rule, and for which Congress created such a dedicated rule.


\textsuperscript{469} The lack of a unified concept of source is further explained and discussed in chapter 9.2.3 below.
first drafted and enacted, nearly a century ago. Applying the analogy method to these new
types of income, with their unique features, will be like forcing a square peg into a round hole.

Despite its weaknesses and limitations, the analogy method is still the law of the land. As such, it
should be applied also when analyzing the source of income from online advertising, as will be
described in subchapter 8.5 below.

8.4.2. Source Rules in Tax Treaties

Tax treaties are intended to resolve an allocation problem that arises when more than one
jurisdiction (usually two, but not necessarily) claim to have a right to tax the same item of
income of a certain taxpayer. These overlapping claims create a risk that taxpayers will be
subject to tax more than once for the same income. It is clear why double taxation of income
would create a negative incentive for cross-border investments, which is something that most
countries would like to eliminate, or at the very least minimize, by entering into tax treaties with
as many countries as possible.

It will almost always be the country of source and country of residence that will be claiming
overlapping rights to tax the income. This is a scenario where a resident of one country receives
income from another country, of which he is usually not a resident (the source country), and both
the source and residence countries wish to tax the income. This is the underlying conflict that
double taxation treaties are intended to address (i.e., source vs. residence), as was identified by

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470 The list of statutory source rules, which today is included in Sections 861 and 862 of the Code, was first
introduced to the federal income tax laws by the Revenue Act of 1924, 43 Stat. 253 (see Section 217,
enumerating the source rules for interest, dividends, personal services, rents and royalties, and gains from
the sale of property). Prior revenue acts (from 1918 and 1916) included only a limited version of two
source rules—for interest and dividends—which were not stand-alone rules, but were rather integrated with
the substantive provisions asserting the tax liability of Nonresident Aliens and foreign corporations (see
sections 213(c) and 233(b) of the Revenue Act of 1918, 40 Stat. 1057, and sections 1 and 10 of the

471 Although less common, it is also possible for two countries to assert overlapping rights to tax income based
on a claim of residency (i.e., residence vs. residence). Such a case could arise, for example, when a U.S.
citizen, who is a resident of France, derives income from a third jurisdiction, and such income is subject to
tax in both the U.S. and France. In this case, the income does not arise from any of the contracting states,
and therefore the relevant article in the U.S.-France treaty will likely not apply. This is because the
assignment rules in tax treaties for the various types of income usually apply only when the income arises
from one of the contracting states. In the case when the source of the income is from a non-contracting state,
the income will usually be subject to the provisions of the article discussing “Other Income,” which will be
further discussed below. See United States Model Technical Explanation Accompanying the United States
Continued on the next page...
the 1923 Double Taxation Report. As noted by the four economists in 1923, there are several methods of resolving double taxation, but the method that eventually prevailed, and is included in thousands of tax treaties around the world, is the method of classification and assignment. Under this method, income is classified to different categories, and the primary right to tax each category is assigned to either the source or residence country (and the residual right is granted to the other country, usually subject to restrictions and limitations).

Accordingly, most tax treaties, as well as the three most-used tax treaty models—those of the U.S., the OECD, and the U.N.—include a list of various types of income (and gain) such as interest, dividends, royalties, business profits, and other types of income received by certain taxpayers like students, government employees and more. For each type of income, the treaty includes a rule of assignment that determines which country—source or residence—has the first bite at taxing the income, and whether there are any limitations on the other jurisdiction’s ability to have a second bite at taxing the income.

The source rules are usually embedded into the substantive assignment provisions, and at the same time set the boundaries of such rules. For example, Article 11 of the OECD Treaty Model, that governs interest income, states that “[i]nterest arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State.” This language achieves two purposes. First, it limits the application of the rule only to cases where the source of the income is from within one of the contracting states (“arising in a contracting state”), and second, it assigns the initial right to tax the income to the country of residence. The following subsections of Article 11 include additional provisions that allow the source country to tax the income, subject to certain limitations. One question remains – when is interest income

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473 See chapter 8.2 above.
475 OECD Treaty Model, supra note 390.
476 OECD Treaty Model, supra note 390, at Article 11(1) (emphasis added).
considered as “arising in a contracting state”? I.e., how is the source of the income determined under the treaty? This question is answered by Article 11(5), which states that “[i]nterest shall be deemed to arise in a Contracting State when the payer is a resident of that State.”477 This source rule is essentially identical to the source rule for interest income under the Code – the income is sourced in accordance with the residency of the obligor.

Some older tax treaties include source rules that were formulated in the same manner as in the Code – a separate list of specific source rules for various types of income.478 This formulation was abandoned in later treaties that were negotiated after the issuance of the revised U.S. Treaty Model in 1996, and also when older treaties were renegotiated.479

Very much like in the case of domestic U.S. source rules, there are two main issues that can arise in determining the source of income for purpose of applying the provisions of tax treaties. First is the question of proper characterization of the income. As with the Code, the source rules in most tax treaties are character-specific, and will apply only to the type of income they are intended for. Thus, for example, dividend income will be analyzed under the dividends article of the treaty (that includes the source rule for that type of income), royalty income will be reviewed under the royalties article of the treaty, and so forth. Some of the major articles in tax treaties include a definition of the type of income they apply to (and other relevant definitions may be found in the definitions sections of the treaty), in order to assist in determining under which article should a given item of income be taxed.480 Although helpful, such definitions do not encompass all possibilities, especially when new types of income are involved, or when special features are added to “classic” types of income (as was the case in Wodehouse).481 Because the various treaty articles assign tax rights differently and have different thresholds and limitations, determining

477 Id. at Article 11(5).
478 See, e.g., the tax conventions between the United States and Japan (Article XIII) (1955, now terminated), Cyprus (Article 6) (1984), Morocco (Article 5) (1977), and Iceland (Article 6) (1975, now terminated).
479 For example, the list of source rules that was included in the first U.S.-Iceland tax treaty from 1975 was replaced with the format of the U.S. Treaty Model when the treaty was renegotiated in 2007.
480 For example, Article 12(2) of the OECD Treaty Model, which deals with royalties, includes the following definition of the term “royalties”: “… payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience.”
481 See supra note 442 and the accompanying text.
the characterization of the income is a critical phase of the analysis that could have significant implications on the final taxation of the income.

A good example of the difficulty and importance of characterization of income can be found in complex financial products. Many banks issue securities that have unique features that create uncertainties regarding the tax characterization of such instruments. For example, a bank may issue securities that are linked to the performance of an index that tracks the performance of publicly traded stock, the securities pay a monthly coupon that is based on the cash dividend distributions of the index constituents, and at maturity the holder of the security receives an amount based on the overall performance of the index and may lose a certain amount of his investment, possibly all of it. Because this financial product has both debt and equity characteristics, the tax treatment of the securities may be uncertain and the character of the coupons paid on the securities may not be clear as well. When a bank from one country issues similar securities to residents of another country (which is a common practice in the global investment market), the characterization of the periodical coupons may have significant effect on the tax that would apply to such income, if any. If the income is characterized as interest, the bank will be allowed to withhold tax at source up to the limitation set forth in the applicable treaty. If, on the other hand, the income does not fit the character of any of the types of income discussed in the treaty, the income will be treated under the “Other Income” Article, and depending on the specific treaty, may be completely free from taxation at source. In this scenario, not only the security holder’s interest is at stake. In many countries, the issuing bank is required to withhold taxes at source from the payments made to the holders at a rate set by domestic law, and the bank is allowed to withhold at a lower rate (or refrain from withholding altogether) if the recipient of the income provides proper documentation asserting the recipient is eligible for the benefits of a tax treaty. If such documentation requirement is not met, the bank itself will be liable for any tax not properly withheld. Therefore, in many cases involving complex financial products, where the character of the income is uncertain, the issuing bank is


\[483\] See, e.g., I.R.C. § 1461 of (any person required to deduct and withhold any tax under chapter 3—regarding withholding from payments made to Nonresident Aliens and foreign corporations—is liable for such tax).
reluctant to take a risk with respect to withholding taxes and will thus withhold income from all nonresidents in accordance with domestic law. The bank may allow such holders to show that the income is eligible for a reduced withholding tax rate under an applicable treaty, but the bank will agree to withhold at the lower rate only if the holders show that they are eligible for such reduced rate under any possible characterization of the income (i.e., that the terms of all possibly relevant articles of the treaty, such as interest, dividends and “other income,” are met). Given the difficulty in determining the character of income in this scenario, it is likely that holders will not be able to meet this requirement, and will end up being subject to withholding at the rate set under the domestic law of the source country. This result is obviously detrimental to both the bank and the security holders – the bank will find it more difficult to market these types of financial products because they provide a lower return due to the tax withheld at source, and the holders will receive a return that is incompatible with the risk associated with the securities, especially when compared to securities issued by banks located within the holders’ jurisdiction or within other jurisdiction that have lower or zero withholding tax rate.

The complexities involved with characterization of income for purpose of applying tax treaties is further emphasized when the income is generated in a non-traditional medium like the internet. These issues were explored by a special committee of the OECD (a Technical Advisory Group, or TAG) around the time of the Dot.com Bubble, when e-commerce and online business were rapidly expanding and creating new challenges for cross-border taxation and tax treaties. In its report, the TAG discussed various characterization issues arising in the context of electronic commerce. For example, one of the main issues examined in the report was whether software payments and payment for know-how, especially when paid for the use of or the right to use a copyright, should be characterized as income from royalties (and thus subject to Article 12 of the OECD Treaty Model), or rather as business profits (and thus subject to Article 7 thereof). The TAG also discussed the distinctions between payments for the provision of services and other payments and also considered the implications for mixed payments. Finally, the TAG report

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485 OECD, supra note 154.
identified 28 common categories of transactions that are conducted via e-commerce or online.\textsuperscript{486} applied the conclusions of its prior analysis to these transactions, and determined the proper character of income derived in each of the listed categories.\textsuperscript{487}

Because the issue of character of income derived from online transactions will be dealt with in length in part 8.5 of this chapter, it is sufficient, for purposes of the current discussion, to note that the magnitude of the list of various e-commerce and online transactions that the TAG was able to identify (28 in total) is by itself evidence to the abundance of possible types of transactions arising from online activity, and the corresponding abundance of characterization issues that may arise in the context of tax treaties. More than 15 years have passed since the TAG identified these 28 common online transactions. As with dog years, 15 years in “technology years” could equal a lifetime of advances and innovation. One can only imagine how many categories would the TAG have identified had it drafted its report today.

The second source-related issue with respect to tax treaties is the ability (or lack thereof) of treaties to determine the taxation (and prevent double taxation) of a new type of income, which is not covered under any specific article. To address this scenario, most treaties include an article titled “Other Income.”\textsuperscript{488} Under this article, any income that is not dealt with in the other treaty articles would be taxed only in the country of residence of the taxpayer. The source country is entirely prohibited from taxing the income. This is the language used in the “Other Income” article in the U.S. and OECD Treaty Models. This version of the provision essentially assumes that all types of income that have a strong “economic allegiance” to the country of source have already been identified and dealt with in the other articles of the treaty, and that any other type of income either has insignificant economic allegiance to the source country, or should be taxed by the country of residence by default, merely as a matter of simplifying the administration of the treaty.

\textsuperscript{486} The list of typical categories includes, for example, electronic order processing of tangible products, electronic ordering and downloading of digital products, application hosting, provision of application services, website hosting and more. See id. at 164–175.
\textsuperscript{487} The OECD Committee on Fiscal Affairs, through its Working Party No. 1 adopted the TAG report and recommendations for changes to the commentaries accompanying Article 12 of the OECD Treaty Model. See OECD Treaty Model, \textit{supra} note 390, Treaty Characterisation Issues Arising from E-Commerce, at R(18)-1.
\textsuperscript{488} See Article 21 in the U.S., OECD and U.N. Treaty Models.
With respect to treaties between developed and developing countries, this version of the “Other Income” article significantly benefits the developed country because that country is usually the “creditor” (i.e., residents of developed countries invest more in developing countries than residents of developing countries invest in developed countries), and thus will likely be the country of residence to which income is exclusively assigned under this article. As noted, this one-sided language exists in both the U.S. and OECD Treaty Models. The U.N. Treaty Model, however, includes a caveat to this provision. Being a model that is more attuned with the taxation rights to developing countries (source/debtor countries), the U.N. Treaty Model also allows the source country to tax the income, notwithstanding the main provision of the article that gives exclusive taxing rights to the country of residence.\footnote{See U.N. Treaty Model, supra note 475, at Article 21(3).}

One final source-related observation in the treaty context is with respect to the taxation at source of business income. Under most tax treaties and all three Treaty Models, the right to tax business income (or, to be exact, business profits) is assigned to the country of residence. The country of source, from which the profits are generated, may tax the business profits only if such business is carried through a permanent establishment (“PE”) in the contracting state. There are differences between the definition of a PE in the three Treaty Models, but generally speaking the term is defined as a fixed place of business through which the business of an enterprise is wholly or partly carried on. The definition in all Treaty Models also includes several examples that are considered a PE, several exclusions of activities that do not give rise to a PE, and rules regarding the creation of a PE based on agency and ownership of subsidiaries. The PE concept is in fact a threshold for the taxation at source of business profits. Such threshold does not exist with respect to any other type of income covered by the Treaty Models. As will be discussed further below, this threshold for source taxation has a significant impact on the taxation of income from online advertising and other types of digital-based income.

As previously noted, most of the source rules included in U.S. tax treaties are consistent with the source rules in the Code. What happens, though, when a source rule in a treaty contradicts the rule in the Code?\footnote{See, e.g., Article 11(5) of the U.S.-New Zealand tax treaty (1983), which contradicts the source rule for interest income included in I.R.C. § 861(a)(1).} The answer, unfortunately, is not straightforward. There is no clear test that
determines which of the two—treaty or Code—prevails. The Code provides only the following principle:

“For purposes of determining the relationship between a provision of a treaty and any law of the United States affecting revenue, neither the treaty nor the law shall have preferential status by reason of its being a treaty or law.”491

As the Code does not provide an answer to this question, one is required to seek resolution under general interpretation principles. When there is a discrepancy between the provisions in a tax treaty and the Code, the generally acceptable rules of interpretation tell us that the later in time shall prevail.492 This approach has been adopted by the IRS, when it was required to resolve a contradiction between a source rule included in a treaty and the source rules in the Code.493

After reviewing the source rules in the Code, the method of sourcing income for which the Code does not have a specific source rule (the analogy method), and the major issues involving source and characterization when tax treaties are in effect, we can now move the application phase, and attempt to determine the source of income derived from online advertising.

8.5. Determining the Source of Income from Online Advertising Under Existing U.S. Federal Income Tax Law

The first step in determining the source of income that is derived from online advertising is to find the proper character of the income. If the process of characterization will result in a finding that the income is characterized as one of the types of income for which the Code has a specific source rule, then determining the source of the income would simply require applying the appropriate source rule. However, if the attempt to characterize the income would not be fruitful

491 I.R.C. § 7852(d)(1).
492 See Whitney v. Robertson, 124 U.S. 190, 194 (1888) (setting forth the basic rule of interpretation with respect to contradicting statute and treaty, as follows: “By the constitution, a treaty is placed on the same footing, and made of like obligation, with an act of legislation. Both are declared by that instrument to be the supreme law of the land, and no superior efficacy is given to either over the other. When the two relate to the same subject, the courts will always endeavor to construe them so as to give effect to both, if that can be done without violating the language of either; but, if the two are inconsistent, the one last in date will control the other”).
493 See Private Letter Ruling 9523006 (June 9, 1995) (the source rule for interest under the 1983 U.S.-New Zealand tax treaty, which contradicts the general source rule under Section 861(a)(1), controls, because the later changes to the Code (in the Tax Reform Act of 1986) were non-substantive and thus do not constitute an “override” of the treaty source rule under the later-in-time rule).
(i.e., it will yield a conclusion that income from online advertising cannot be characterized as one of the types of income for which the Code provides a source rule), the next step would be to apply the analogy method to find the most resembling type of income for which a source rule exists, and apply that rule to income from online advertising. These steps are discussed in the following sections.

8.5.1. Character of the Income Derived from Online Advertising

There are two prime candidates for characterizing income that is derived from online advertising – income from the provision of personal services or income from royalties. These two types of income seem, at least on the surface, to be adequate approximations for the characterization of income from online advertising. It is appealing to think of online advertising as a service provided by the online publisher, very much like in other advertising channels, or, if looking at this issue through a more technological lens, as royalty income generated from the use of the publisher’s technology by the advertisers. The following sections consider these two possible characterizations.

8.5.1.1. Income from the Provision of Personal Services

Can income from online advertising be characterized as income from the provision of personal services?

Because all major online publishers are corporations, the first hurdle to jump over in answering the above question is to determine whether a corporation can be considered as having income from personal services. The answer is yes. A corporation (and other entities) may be considered as earning income from personal services rendered by its employees or agents.\textsuperscript{494} Such income is sourced, under the regular rules in Sections 861(a)(3) and 862(a)(3), based on the location where the services are performed. In addition, and very relevant to the case at hand, a corporation may

\textsuperscript{494} See, e.g., Bank of Am. v. U.S., supra note 454 (negotiation commission received by Bank of America from foreign banks in connection with commercial letters of credit was considered income from personal services); Le Beau Tours Inter-Am., Inc. v. United States, 547 F.2d 9, 11 (2d Cir. 1976) (the source of the income of a service corporation is determined by the place its compensable services are performed); Comm’r of Internal Revenue v. Hawaiian Philippine Co., 100 F.2d 988, 991 (9th Cir. 1939) (concluding that “no reason has been advanced why Sec. §119(c)(3) [predecessor to section 861(a)(3)] was not intended to apply to corporations. Clearly the section, in general, is applicable to corporations”).
be considered as providing personal services even if such services are performed through the use of machinery.\textsuperscript{495}

When personal services are performed by a corporation (or other entity) partly within and partly without the U.S., the income from such services that is attributed to the personal services performed in the U.S. (and would thus be considered from U.S. sources) is determined by allocating the income on the basis that “most correctly reflects the proper source of the income under the facts and circumstances of the particular case.”\textsuperscript{496} That being said, Treasury Regulations take the position that in many cases the facts and circumstances will be such that an apportionment based on a time basis will be acceptable.\textsuperscript{497} The regulations make this assertion with respect to services provided by individuals and non-individuals alike.\textsuperscript{498} The regulations explain how to apply time basis apportionment with respect to individuals (the income is apportioned in similar proportion to the ratio that the time the individual spent in the U.S. while performing the services bears to the total time the individual spent performing the services, both within and without the U.S.). Although it is clear how this guidance will be applied in the case of corporations, when the services are provided by employees of the corporation, it is not clear how such apportionment would work when the corporation provides the services through the use of machinery or, as in our case, via computer systems. A different apportionment basis will be required in that case.

Although the term “provision of personal services” can be defined differently for U.S. federal income tax purposes than it is defined and used in the business jargon, it is not surprising that online publishers consider themselves as providers of services. Google, for example, sees itself,\textsuperscript{499}

\begin{itemize}
\item \textsuperscript{495} See Comm’r of Internal Revenue v. Hawaiian Philippine Co., supra note 494, at 991 (property received by a corporation in exchange for performance of sugar milling services constituted income to the corporation from the performance of personal services; the court held that it did not “regard these milling services as any the less personal because they were performed, in part, through the use of machinery, or because of the magnitude of the taxpayer’s operations”).
\item \textsuperscript{496} Treas. Reg. § 1.861-4(b)(1)(i).
\item \textsuperscript{497} Id. at § 1.861-4(b)(1)(i).
\item \textsuperscript{498} Id. at §§ 1.861-4(b)(1)(i) and 1.861-4(b)(2)(i).
\end{itemize}
on the one hand, as a provider of services that allow users to access knowledge and information quickly and easily, and at the same time as a provider of “advertising solutions.”

Additional evidence that supports the characterization of income from online advertising as being from personal services can be found in historical IRS and court decisions. Although issued more than 50 years ago, these decisions concern an issue very much on point—the sourcing of income from advertising—and thus merit consideration. In C.I.R. v. Piedras Negras Broad. Co., a Mexican corporation operated a radio station from the Mexican town of Piedras Negras, which is just across the Rio Grande from Eagle Pass, Texas. The corporation derived its income from advertisements and from renting its station to customers. The court specifically noted that the corporation’s income from advertising was compensation for personal labor or services (and that the income from renting the station was income from rental or royalties from property).

Approximately 95% of the corporation’s advertising revenue was from advertisers in the United States. However, based on the location of the broadcasting equipment, and the place where the labor and activities that generated the income took place (mostly in Mexico, with only incidental activities in the U.S.), the court determined that the corporation’s income is from sources outside the U.S.

In a Private Letter Ruling from 1962, a non-U.S. corporation that published a magazine outside the U.S. was soliciting U.S. persons to advertise in the magazine. For that purpose, the non-U.S. corporation maintained three offices in the U.S. which were staffed by several employees. In its analysis, the IRS referenced the source rule for income from labor or personal service, and applied that rule in determining that the advertising income was from sources outside the U.S. because, according to the IRS, the source of the advertising income was the capital and labor employed in the publishing and distribution centers, which were located outside the U.S.

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501 Id. at 261.

The specific facts and analysis in *Piedras Negras* and the above Private Letter Ruling are very much relevant to the analysis of the source of income from online advertising. Therefore, we shall review and analyze these decisions in greater detail later in this chapter. However, for purpose of the current step of the analysis (determining the character of the income) it is sufficient to note that in both *Piedras Negras* and the 1962 Private Letter Ruling the court and the IRS were unhesitant to determin that income from advertising is from personal labor or services for purpose of establishing the source of the income.

All that being said, when taking a closer look at the characteristics of income from online advertising, some uncertainties arise as to whether income from personal services is indeed an adequate characterization such income. As noted above, online publishers could be perceived as providing two types of services – the first is the service provided to users, in the form of an online platform where users have access, for example, to a search engine or a social network website; the second is the advertising service that the online publishers provide to advertisers within the online platform. Is the income of the online publisher, from either of these services, a paradigmatic example of income from personal services? In the case of the service provided to users, a possible counter argument is that these users do not pay for the “service” they receive from the online publisher (it is provided free of charge),\(^{503}\) and thus the advertising income cannot not be considered as received from the provision of this service. At the same time, it is questionable whether the income of the online publisher can be considered as derived from the provision of advertising services, in its traditional form because, as discussed above, the party that generates the income for the online publisher is not the one for whom the service is rendered nor such party is the payor. It is true that the courts have acknowledged the ability of a corporation to provide services through the use of machinery,\(^{504}\) yet it is not clear whether a corporation can be considered as providing a personal service when the income from such service is generated by the actions of non-employees of the corporation.

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\(^{503}\) This relationship is best described by a traditional advertising motto – “If you’re not paying for something, you’re not the customer; you’re the product being sold.” See Jason Fitzpatrick, If You’re Not Paying for it, You’re the Product, LIFEHACKER (Nov. 23, 2010, 6:30 AM), http://lifehacker.com/5697167/if-youre-not-paying-for-it-youre-the-product.

\(^{504}\) See *supra* note 495.
Income from online advertising is not a typical example of income derived from the provision of personal services and such characterization is not necessarily the perfect fit. This does not mean that income from online advertising would not eventually (once the analysis is completed) be characterized as income from the provision of service, but at the very least the concerns raised above call for the exploration of other possible characterizations, as discussed in the next part.

### 8.5.1.2. Income from Rents and Royalties

Can income from online advertising be characterized as income from rents and royalties? Answering this question requires a two-step inquiry. First, the definition of royalties must be established. Only then it would be possible to determine if income from online advertising could indeed be characterized as royalties.

The difficulty completing the first step of the analysis lies in the fact that the term “royalty” has no precise definition in the Code or Treasury Regulations, and courts have struggled to define its boundaries. In *Sierra Club Inc. v. C.I.R.*, involving the classification of income of a tax-exempt organization, the Ninth Circuit held that in the absence of a definition in a statute or regulation we turn to the “ordinary, everyday senses” of the word.

Accordingly, the court, relying on the lexical definition of the word “royalty,” held that the word refers to: “a payment made to the owner of property for permitting another to use the property.” The court also referenced Revenue Ruling 81–178, in which the IRS stated that “[t]o be a royalty, a payment must relate to the use of a valuable right. Payments for the use of trademarks, trade names, service marks, or copyrights, whether or not payment is based on the use made of such property, are ordinarily classified as royalties for federal tax purposes.”

Despite the fact that traditional lists of types of property that can generate royalties do not include software rights, there is currently no disagreement that software transactions are

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505 *Sierra Club Inc. v. C.I.R.*, 86 F.3d 1526 (9th Cir. 1996).
506 *Id.* at 1531.
507 *Id.; see also* Patterson v. Texas Co., 131 F.2d 998, 1001 (5th Cir. 1942) (defining a royalty as “a share of the product or profit reserved by the owner for permitting another to use the property”).
509 *See, e.g.*, the list of intangibles included in the source rule for royalties in Section 861(a)(4) of the Code; *see also* Article 12(2) in the OECD Treaty Model, defining royalties as “payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work

*Continued on the next page...*
capable of generating royalty income. This can be learned first from the Treasury Regulations promulgated in 1998 for the specific purpose of providing classification rules for income from cross-border transactions involving software.\textsuperscript{510} These regulations attempt to distinguish between four categories of software transactions.\textsuperscript{511} For a certain type of transactions (transfer of a copyright right), the regulations provide rules for determining whether the transaction should be classified as either a sale or exchange, or a license generating royalty income.\textsuperscript{512} The second indication can be found in the Technical Explanation to the U.S. Treaty Model, which notes that any consideration received in exchange for the use of software can be treated as a royalty.\textsuperscript{513} In addition, income from software is specifically included in the definition of royalty in some of the treaties to which the United States is a party.\textsuperscript{514} Finally, the lengthy discussion and analysis regarding the possible characterization of software transactions as producing royalty income, as included in the OECD Commentaries regarding Article 12 of the OECD Treaty Model (dealing with royalties), make it clear that there is no doubt that income from the use of software could be characterized as royalties.\textsuperscript{515}

Now that we broadly understand the definition of royalty and agree that software is considered property capable of generating royalty income, we can try to determine whether or not income from online advertising can be characterized as royalty income. There are two main reasons why the answer to this question should be negative.

First, the structure of an online advertising transaction does not fit into the traditional concept of a royalty-producing transaction. To better explain this argument, consider the following fictitious scenario. The U.S. Postal Service (“USPS”) starts offering a tailor-made advertising service: using an elaborate database that records all types of letters and parcels received by the USPS’ millions of customers, advertisers can send focused offers to relevant recipients based on the

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\textsuperscript{511} Id. § 1.861-18(a)(2).
\textsuperscript{512} Id. § 1.861-18(f)(1).
\textsuperscript{513} See Technical Explanations, supra note 471, at 43.
\textsuperscript{514} See, e.g., U.S.-France tax treaty, Article 12(2)(a) (1994, as amended by the protocol signed on Jan. 13, 2009); and the U.S.-Thailand tax treaty, Article 12(3)(a) (1996).
\textsuperscript{515} See OECD Treaty Model, supra note 390, at C(12)-11, ¶ 12.
recipients’ past mail deliveries. Every offer includes a unique code, which, if used, generates income to USPS for delivery of the advertisement. This would be an off-line version of the online advertising model. The customers are offered a free service (a mailbox to which all their mail is delivered free of charge), the data is then used as a basis for the tailoring of customized ads for each customer, and only if such ads are acted upon by the customer is income actually generated for USPS. In this fictitious yet analogous example, can the USPS be described as receiving “a payment made to the owner of property for permitting another to use the property”? Such a depiction seems to be far from fitting. Instead, income generated in such a way would most likely be considered income from services that the USPS offers. This example illustrates that while online publishers allow their advertising clients access to their software systems, they do not allow them to use their rights in the intangible property. Based on the above example, it seems that consideration received by online publishers is better characterized as income from the provision of personal services, rather than royalties. However, as discussed above, characterizing online advertising income as being from the provision of personal services is not free from doubt and might also be an unsuitable choice. These results illustrate some of the complexities involved in characterizing this type of income.

A second reason supporting the argument that royalties in not the proper characterization for income from online advertising, has to do with the process through which the income is produced, the parties involved in the process and their relative contribution to the successful realization of the income. Even if we assume, for the sake of the argument, that the online publisher gives its clients—the advertisers—permission to use the publisher’s software property, the payments that the advertising clients make to the publisher are not made in consideration of that permission. The obligation to pay the publisher is materialized as a result of an action taken by the users (such as viewing an online advertisement or clicking on it) and not as a result of the advertiser’s use of the publisher’s software systems. If no single user views or clicks on the ad, no payment is required from the advertiser, despite the fact that the advertiser did indeed use the publisher’s software to incorporate the advertiser’s ads into the online system. Thus, the payment is not for the use of the online publisher’s software itself and therefore cannot be considered a

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516 Ignoring, for the sake of simplicity, the fact that most USPS customers indirectly pay for the services by way of federal taxes.
royalty. Furthermore, the payments made to the online publisher are also not in consideration for the use of the online platform used by users (such as the search engine, social network or website) because access to that platform is offered for free and does not require any payment. Support to this argument can also be found in the work of the OECD Committee on Fiscal Affairs. Based on the OECD Technical Advisory Group report on treaty characterization issues arising from e-commerce, the OECD Committee on Fiscal Affairs adopted the position that payments arising from online advertising transactions constitute business profits, which are subject to Article 7 of the OECD Treaty Model, and are not considered royalties.\textsuperscript{517}

The above analysis shows that income from online advertising is not a prototypical example of royalties either. As noted by Justice Frankfurter in the \textit{Wodehouse} case, “…proceeds sought to be brought within the term “royalties” must be of a nature which justifies that classification.”\textsuperscript{518} In the case of online advertising, the nature of the income does not justify a straightforward classification of the income as royalties (at least not without having to overcome several incompatibilities).

\textbf{8.5.2. The Analogy Method and its Unfitting Results}

The conclusion from the above discussion is that the unique characteristics of income from online advertising make it unsuitable to be categorized as either income from the provision of services or as income from royalties. Income from online advertising simply does not fit squarely into either of these statutory categories of income for which the Code provides a source rule. Therefore, the next step in determining the source of the income would be to apply the analogy method. As discussed, when courts apply the analogy method they resort to a three-step analysis: (1) compare the income in question to other categories of income for which statutory source rules exist, (2) choose the category of income the characteristics of which most resemble the income in question, and (3) apply the source rule for the category that was chosen to the income at hand.

\textsuperscript{517} OECD Treaty Model, \textit{supra} note 390, Treaty Characterisation Issues Arising from E-Commerce (adopted by the OECD Committee on Fiscal Affairs on 7 November 2002), at R(18)-32.

\textsuperscript{518} Justice Frankfurter dissent in \textit{Wodehouse, supra} note 442, at 409.
Although income from royalties and income from personal services are not an exact fit, these are clearly the two prime candidates for comparison. Both these categories have features that are sufficiently comparable with income from online advertising, thus making it appropriate to analogize from. Therefore, after a careful comparison and analogy, a court would likely hold that income from online advertising is indeed most aptly characterized as one of these two types of income, and would then apply the relevant source rule.

Which one of these two categories is a court more likely to analogize from? Although trying to predict a court’s analysis would have made for an interesting exercise, the answer to this question is in fact immaterial for the purpose of this dissertation. That is because no matter which of the two categories a court would choose as the proper basis for the analogy, the result from sourcing income from online advertising using either of the source rules applicable to these categories would yield an outcome that is inconsistent with the economic reality of the transaction in such a profound way that undermines the validity of the analogy method altogether (at least as it applies to income from online advertising).

The idea that the source rules should strive to trace the economic origin of the income is not new. The Tax Court has already said (referring to the list of source rules in the Code) that:

“The provisions do not contain a comprehensive rule for identifying an item of income with a particular foreign country. Nevertheless, the rules show that Congress sought to identify the source of income in terms of the business activities generating the income or to the place where the income was produced. See Howkins v. Commissioner, 49 T.C. 689, 694 (1968). Thus, the sourcing concept is concerned with the earning point of income or, more specifically, identifying when and where profits are earned. Commissioner v. East Coast Oil Co., 85 F.2d 322, 323 (5th Cir. 1936), aff’d. 31 B.T.A. 558 (1934), cert. denied 299 U.S. 608 (1936).”

As previously discussed, the source rules for income from royalties and for personal services are both substantive rules that attempt to source the income in accordance with its economic origin. Therefore, it seems unfitting that applying either of these rules to income from online advertising would source the income in a way that ignores significant part of the economic origin of the income.

If by application of the analogy method income from online advertising would be considered a royalty, the source of such income would be determined by the location of use of the property or the location of the rights to use the property.\footnote{I.R.C. §§ 861(a)(4) and 862(a)(4).} In this case, the online publisher’s property that is being used is the online platform that facilitates the advertising (i.e., the proprietary online software system used to implement advertisements into the publisher’s online platform – a search engine, social network, a website or a third-party website into which the online platform is integrated).\footnote{The online platform that is provided for the use of the users (such as search engine, social network or website) cannot be considered as the “property being used” for purposes of the source rule for royalties. Although such online platform is indeed being used by the users, the payment made by the advertisers to the online publisher is not in consideration for such use.}

Consider the application of this rule with the following example. An Irish online publisher gives a French advertiser the right to use the publisher’s online advertising system. The advertiser uses that system from within France. The users who generate the income to the online publisher by way of their online activity (viewing, clicking or acting upon the ad) are located in the U.S. Under this example, a straightforward application of the source rule for royalties would result in the income of the online publisher being sourced to France, because that is the place where the payor of the income (the French advertiser) used the property. This result completely ignores the underlying economics of the transaction. The use of the online publisher’s system by the French advertiser is not the objective of the transaction. The actual use of the system by the advertiser, in and of itself, does not create any value to the advertiser and it is not what the advertiser is ultimately paying for. This can be learned from the fact that the advertiser is not required to make any payments to the online publisher upon the initial use of the advertising system (i.e., when the advertiser implements its ads into the publisher’s system). The advertiser’s liability for payment is created only if and to the extent that users are exposed to the ads in a measurable

\textsuperscript{520} I.R.C. §§ 861(a)(4) and 862(a)(4).
\textsuperscript{521} The online platform that is provided for the use of the users (such as search engine, social network or website) cannot be considered as the “property being used” for purposes of the source rule for royalties. Although such online platform is indeed being used by the users, the payment made by the advertisers to the online publisher is not in consideration for such use.
way. That is when the actual economic value of the transaction is created and the online publisher’s income is generated. Although the income is in fact generated by the users (as a result of their viewing or acting upon the ad), and although a significant part of the underlying economic value of the transaction is created by the users within the jurisdiction in which they are located, the source rule for royalties does not take these facts into consideration and therefore excludes the users’ jurisdiction (in our example, the U.S.) when determining the source of the income.

Consequently, although the source rule for royalties is considered a substantive one because it theoretically attempts to locate the true economic origin of the income\(^{523}\) (i.e., the location of the use of the property that generates the income), the application of the rule to income from online advertising yields a result that is arbitrary and non-substantive. This is especially true because the jurisdiction to which the rule would source the income (the jurisdiction in which the advertiser uses the publisher’s online system) has no real economic significance in the income-generating process because the location where such use is made is meaningless with respect to the creation of value from the transaction, and it can also be controlled and manipulation.

Is it possible to consider the online publisher’s property as being used in the jurisdiction of the users? If one can reach such a conclusion, the operation of the source rule for royalties could potentially yield the desired economically-sound result. In this context, consider the following scenario (which, for comparison purposes, uses the same countries as in the example above). An Irish company gives a license to a French manufacturer to use a patent in the production of a product that will ultimately be sold in the United States. If the patent is a major component in the production process (and not merely one of many other patents), one could say that the patent is actually used in the U.S., where the final product is sold and used by customers. A similar set of facts and argument were discussed in Revenue Ruling 68-443.\(^{524}\) Under the facts of the ruling, products that incorporated a trademark were ultimately used outside the U.S. The IRS held that the royalty paid to the foreign owner of the trademark for the use of the trademark was income from sources outside the U.S., despite the fact that the initial sale of products bearing the

\(^{522}\) See supra notes 326–328 and the accompanying text.

\(^{523}\) See REUVEN S. AVI-YONAH, supra note 330, at 43.

trademark took place in the U.S. The ruling essentially holds that the place of final use of the products determined the place of use of the royalties. When applying the reasoning of this ruling to the case of income from online advertising, it is possible to argue that although the advertisers use the publisher’s intangible property (when incorporating the ads into the online system), the ultimate use of the intangibles takes place in the jurisdiction of the users, when such users view the ads or act upon it.

Although appealing, it is in fact difficult to apply the reasoning of Rev. Rul. 68-443 to the case of income from online advertising. This is because the intangibles used by the advertisers are not the same intangibles used by the users. The intangible property of the online publisher that is used by the advertisers is the online system by which the advertisers incorporate their ads and place bids on search words to be associated with their ads (in the case of search engine advertising). The users do not use this system. In fact, the users could not be more oblivious to this system. The users use the free online platform that is offered to them by the online publisher. Such platform (a search engine, a social network, or a website) is entirely different than the one used by the advertisers, and is based on an independent set of intangibles. The only link between the two systems is the ads. As the users use the online publisher’s platform they are exposed to ads based on the use that the advertisers made to the online publisher’s ad system. It is true that the system used by advertisers is integrated into the system used by users in order to display the ads to the users, but it is incorrect to say that the users actually use the same system used by the advertisers. This brings us back to the question of which use of intangibles is associated with the online publisher’s income – the use by the advertisers or the use by the users. Given that the payors of the income are the advertisers, it is hard to support a position holding that the royalties are paid for the use of the online platform by the users. This leaves only one available outcome –

525 But cf. Field Serv. Advisory, IRS FSA 200222011 (May 31, 2002) (A foreign parent licensed to its wholly-owned U.S. subsidiary the exclusive worldwide rights to sell, use, copy, manufacture or sublicense specific software that the foreign parent created. The U.S. subsidiary modified the software and sublicensed it to another U.S. company, which installed the software in the computers it manufactured and sold the computers within and outside the U.S. The sub-licensee paid royalties to the U.S. subsidiary, which in turn paid royalties to the foreign parent in accordance with the sale volume of computers by the sub-licensee. In determining the source of royalties paid by the U.S. subsidiary to its foreign parent, the U.S. subsidiary apportioned the income according to the percentage of computers sold by the sub-licensee within and outside the U.S. (in accordance with the rational of Rev. Rul. 68-443). The IRS rejected this method, saying it is unreasonable because it disregards the activities of the U.S. subsidiary, that used the license entirely in the U.S., in the manufacturing of the computers. I.e., the determining factor was acts taken by the royalty payor, and the location of down-stream sale of products did not affect the source of the income).
the source rule for royalties should be applied to the use made by the advertisers, and accordingly the income is sourced to a jurisdiction that is not the true economic source of the transaction.

A similar unfitting result would be achieved if the source rule for income from personal services would be applied to income from online advertising. Such rule would source the income to the jurisdiction in which the service was provided.\textsuperscript{526} The income would be treated as earned in consideration for the advertising services. Such income is therefore sourced to the jurisdiction of the online publisher or that of the advertiser, depending on where the services are considered to be performed (given the circumstance, it is more likely be the former). In either case, under the source rule for personal services, no income would be sourced to the jurisdiction of the users. This result, as in the case of the source rule for royalties, ignores one of the most significant economic drivers of the transaction—the contribution of the users to the process of generating the income—and consequently excludes the users’ jurisdiction when sourcing the income. This is a result that undermines the validity of yet another substantive source rule.

Can this criticism of the personal service source rule stand in light of the court’s holding in \textit{Piedras Negras}\textsuperscript{527} and the IRS decision in Private Letter Ruling 620305590A\textsuperscript{528}? The issue of sourcing income from advertising has been considered and dealt with in these two decisions. However, a closer look at the facts and principles on which these decisions are based shows that neither of these decisions contradict the position that income from online advertising should be sourced in accordance with the jurisdiction of the users.

As a reminder, in \textit{Piedras Negras} the Fifth Circuit determined that the Mexican broadcaster’s income from advertising (received mostly from U.S. advertisers) was considered income from sources outside the U.S., because the broadcasting equipment and the labor and activities that generated the income were all located or took place in Mexico (with the exception of some activity taking place in the U.S., which the court considered to be incidental and thus did not affect the outcome). From reading the \textit{Piedras Negras} opinion it is clear that the court was aware

\textsuperscript{526} I.R.C. §§ 861(a)(3) and 862(a)(3).
\textsuperscript{527} \textit{Piedras Negras}, supra note 500.
\textsuperscript{528} \textit{Supra} note 502.
of the fact that the target audience of the advertisements was located in the United States, yet the court did not ascribe any importance to that fact in the sourcing analysis. Therefore, one could argue that, based on the *Piedras Negras* decision, in the case of online advertising the location of the users (which are the audience/target of the advertisements) should not play any role in determining the source of the income. Under this approach, the income from online advertising (if considered as income from personal services) should be sourced based on the location of the equipment and labor of the online publisher’s employees. Although this is a possible argument, it will in fact be an over-simplified application of the *Piedras Negras* holding. A closer look into the court’s decision and a proper comparison to online advertising leads to a different conclusion, as explained below.

In *Piedras Negras*, the court considered the location where the advertising contracts were executed, where the equipment (i.e., capital) was located and where most aspects of the services (i.e., labor) were rendered. This is a substantive approach, that in essence attempts to find the components involved in the production of income.529 In that sense, taking into consideration the location of users in the case of online advertising would be a coherent application of the *Piedras Negras* approach. That is because the users, by their acts, are a crucial component in the income-generation process for online publishers. The court in *Piedras Negras* further noted that the language of source rules (i.e., the repeated use of the words within and without the United States) “denotes a concept of some physical presence, some tangible and visible activity.”530 Although the online publisher does not necessarily have any physical presence in the jurisdiction of the users, one cannot ignore the very “tangible and visible activity” conducted by users, when they, for example, physically click an ad. Finally, in *Piedras Negras* the court concluded that “[i]f income is produced by the transmission of electromagnetic waves that cover a radius of several thousand miles, free of control or regulation by the sender from the moment of generation, the source of that income is the act of transmission.”531 This statement is merely a continuation of the court’s main argument, under which advertising income ought to be sourced based on activities and assets, and not based on consequences with respect to which the publisher has no

529 See *Piedras Negras*, supra note 500, at 261 (“We think the language of the statutes clearly demonstrates the intendment of Congress that the source of income is the situs of the income-producing service”).
530 *Id.*
531 *Id.*
control. In the case of traditional advertising, the last step that a publisher takes when providing advertising services is to disseminate the medium into which the advertising was incorporated. Once that step is complete, the publisher has no control over who “consumes” the advertising, if at all. Therefore, if the final act in the revenue-generating process of a radio station is the act of transmission, nothing that happens after that step should affect the source of the income, because nothing that happens after that step contributes to the realization of the income. These facts are very much distinguishable from the case of online advertising, where the ads are not transmitted randomly over the airwaves for any listener, in any location, to hear. In the case of online advertising, the ads are specifically targeted to users based on such users’ personal information, location, online activity and other user-specific criteria. The online publisher has absolute control over the destination of each ad, which is not “broadcast[ed] […] equal[y] in volume in all directions,” as was in *Piedras Negras*. The equivalent act of “transmission” in the world of online advertising would be the moment when the advertiser incorporates its ads into the online publisher’s system, and metaphorically “transmits” the ads into the digital sphere. However, unlike in the radio fact pattern, there is still one significant “act” to be taken in order for the income to be produced. It is the targeting of the user and the actual act of the user that are considered the final activity taken in the income-producing process of the online publisher. Thus, the same way that the final act in the radio-broadcaster process (the act of transmission) determined the source of the broadcaster’s income in *Piedras Negras*, the final act of the online advertising process should determine the source of the online publisher’s income. In that sense, the reasoning and conclusion reached in *Piedras Negras* is very much in line with the argument proposed for the sourcing of online advertising to the jurisdiction of the users.

In Private Letter Ruling 6203055590A, the IRS followed the underlying principle of the *Piedras Negras* decision, by focusing on the factors that contributed to the production of income. The IRS held that advertising income received from U.S. advertisers should be sourced in accordance with the location of the capital and labor employed in the publishing and distributing of the magazine (which were outside the U.S.), because “with and through [the publishing and distributing centers outside the U.S.] the [foreign publisher] will carry on the activities to

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532 Id. at 260.
533 See supra note 502 and the accompanying text.
produce the advertising revenue.” As in *Piedras Negras*, the IRS decision focuses on the actual activities, equipment, and investments that are required to produce the income. Under the same reasoning, the IRS held that the location of the advertisers is not determinative of the source of the income (because payment is only the result of the production of income and not a contributing factor to the actual realization of the income).

In sum, the above analysis shows that not only the *Piedras Negras* and Private Letter Ruling 6203055590A decisions do not contradict the position that income from online advertising should be sourced to the jurisdiction of users, but also that the underlying principle of these decisions (seeking to apply the source rules based on the location of the income-producing components of the transaction) supports this position.

As we reach the end of this sub-chapter we can conclude that both the source rule for royalties and the source rule for personal services, as they are historically interpreted and applied by the courts and the IRS, would yield an economically distorted result when trying to source income from online advertising. The results in both cases are misaligned with the economic reality of the transaction, because such rules completely disregard one of the most (if not the most) important components in the process of generating income from online advertising—the reliance on and contribution of the users. Existing court and IRS decisions, that would presumably stand against such a novel approach, are found to be based, at the core, on principles that seek to locate the economic origin of the income, and thus do not contradict, and presumably even support, the concept that the location of the online advertising “consumers” should be considered as the source of the income generated from online advertising.

Should the sourcing of income from online advertising take into account the other elements involved in the production of the income – namely, labor and capital (i.e., the work of the employees of the online publisher and the computer equipment used in producing the income)? If so, should the source of the income be apportioned to different jurisdictions based on the location of these three components? Will the answer change if any of these components (employees, computers and users) are each located in more than one jurisdiction? Should any of these components have priority over the others when it comes to sourcing? These are all legitimate

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534 *Id.*
questions that should and will be dealt with in the following chapters. However, we must first finish our journey and understand how the sourcing of income from online advertising under the existing rules affects the taxation of such income when it is generated in a multi-jurisdictional scenario. This will be the topic of the following sub-chapter.

8.6. The Tax Consequences of Sourcing Income from Online Advertising According to Existing Rules

Source rules are the building blocks of international taxation and they have significant effect on the taxation of cross-border activity. That being said, source rules are not substantive tax rules – they do not determine the extent to which income will be taxed. Rather, source rules set the stage for the substantive tax rules that determine the circumstances in which residents and nonresident will be taxed when in receipt of income from sources within or without a given jurisdiction. Therefore, determining the source of income from online advertising, as was discussed in great length in the previous part of this chapter, is not the final step. Using the conclusions reached in the previous part of the analysis we can now proceed to determine how income from online advertising will be taxed under the existing U.S. and international tax rules, when the production of such income involves more than one jurisdiction.

The example presented in the previous part of this chapter will be helpful in demonstrating the application of the substantive tax rules to income from online advertising. The basic example that was presented includes an Irish online publisher (that provides, for example, a free ad-based search engine), a French advertiser (that implements its ads into the online publisher’s online system), and users that are located in the United States. The question is – will the Irish publisher be subject to tax in the U.S. with respect to income it receives from the ads that the U.S. users viewed, clicked, or acted upon? The answer to this question could depend on whether an income tax treaty is in place between the jurisdiction of the taxpayer (the online publisher) and that of the users. We shall discuss each scenario separately in the following sections.
8.6.1. No Treaty Scenario – United States Trade or Business.

The first scenario assumes that no income tax treaty exists between the jurisdiction of the online publisher (in our example, Ireland) and that of the users (the U.S.). In that case, the online publisher’s U.S. tax liability (if any) would be governed solely by the substantive tax rules under the Code.

Under the Code, the general rule with respect to U.S. Persons is quite simple – such persons are subject to tax on income from whatever source derived, be it from sources within or without the U.S. The rule for the taxation of Foreign Persons is more complex and it is bifurcated. First, a Foreign Person is subject to a 30% tax with respect to U.S.-sourced FDAP income (fixed or determinable, annual or periodical), provided that such income is not effectively connected with a trade or business that such Foreign Person has in the U.S. FDAP income has been defined broadly by the courts to include almost all U.S.-source income that is not effectively connected with a U.S. trade or business, with the exception of capital gains. In addition, a Foreign Person’s income that is effectively connected with a U.S. trade or business is subject, on a net basis, to U.S. federal income tax at the same rates that apply to U.S. Persons. Effectively connected income generally includes income from U.S. sources, but it also includes certain

535 In fact, the U.S. has entered into an income tax treaty with Ireland, so our example is not accurate. For the sake of consistency, though, we will continue using this example and simply assume that no such tax treaty exists for purpose of this part of the analysis.

536 I.R.C. § 61. See also Great-W. Life Assur. Co. v. United States, 678 F.2d 180, 183 (Ct. Cl. 1982) (stating that “[t]he determination of where income is derived or “sourced” is generally of no moment to either United States citizens or United States corporations, for such persons are subject to tax […] on their worldwide income”).

537 I.R.C. §§ 871(a) and 881.

538 See Container Corp. v. C.I.R., supra note 455, at 141 (saying that FDAP income includes “virtually all kinds of income except capital gains from the sale of property”); see also I.R.C. § 871(a)(1) (specifically titled “Income Other Than Capital Gains”). Certain U.S.-source capital gains received by a Foreign Person are nonetheless subject to the 30% tax rate. See id. § 871(a)(2).

539 I.R.C. § 871(b). Foreign corporations that do not have a U.S. trade or business can still have, under certain circumstance, effectively connected income for which they will be subject to tax in the U.S. Such effectively connected income includes, for example, income that accrued during a year in which the corporation is no longer engaged in a trade or business but the income relates to a prior year during which the corporation was engaged in such a trade or business (id. §§ 864(c)(6) and (7)). See other exceptions in sections 882(d) and 882(e) of the Code. None of these circumstances are relevant to our discussion.

540 Id. §§ 864(c)(2) and (3).
types of foreign-source income that is attributable to a Foreign Person’s office or fixed place of business within the U.S.\textsuperscript{541}

As we concluded in the previous part of this chapter, if a U.S. court would be faced with the question of what is the source of income from online advertising, such court, after applying the analogy method, is highly likely to determine that the income should be sourced in accordance with the source rules for either royalties or personal services. As discussed above, applying these source rules to income from online advertising would result in the income being sourced either to the jurisdiction of the online publisher or the jurisdiction of the advertiser. The income would not be sourced to the jurisdiction of the users (as advocated-for in this dissertation). In our example, this means that the income will be sourced either to Ireland or France, but not to the U.S. Because the income of the online publisher would be from sources outside the U.S., such income could not be taxed in the U.S. as FDAP income, because the 30% tax on FDAP applies only to income from sources within the U.S.\textsuperscript{542} The only case where a Foreign Person can be liable for U.S. taxes on its foreign-source income is when such Foreign Person has a U.S. trade or business and also has certain types of foreign-source income that are attributable to such Foreign Person’s office or fixed place of business within the U.S. Therefore, the next step would be to find whether the online publisher has a U.S. trade or business and whether the income at hand is of a type that fits this category.

The concept of U.S. trade or business is based on an underlying concept similar to that of the permanent establishment. Both regimes attempt to draw a line in the sand, beyond it a taxpayer is considered as having sufficient economic activity in the foreign jurisdiction so to justify the imposition of the tax by the source country. The term “trade or business” is incorporated into numerous provisions of the Code,\textsuperscript{543} yet neither the Code nor Treasury Regulations include a single comprehensive definition of the term. Section 864(b) of the Code only states that a trade

\textsuperscript{541} Id. § 864(c)(4)(B).

\textsuperscript{542} Id. §§ 871(a)(1) and 881.

\textsuperscript{543} A very partial list of Code sections that use the term “trade or business” includes (in order of appearance): I.R.C. § 41 (credit for increasing research activities), § 162 (trade or business expenses), § 166(d)(2) (definition of nonbusiness debt), § 167 (depreciation) § 168 (accelerated cost recovery system), § 195 (startup expenses), § 401 (qualified pension, profit sharing and stock bonus plans), § 447 (method of accounting for corporations engaged in farming), § 512 (unrelated business taxable income of exempt organization) and many more.
or business in the U.S. includes the performance of personal services within the U.S., \(^{544}\) and then provides two specific exclusions (performance of personal services for a foreign employer and trading in securities or commodities). In the absence of a statutory definition, we turn to the courts and IRS decisions to understand what are the boundaries of the term “U.S. Trade or Business.”

Both the courts and the IRS have held that whether a Foreign Person is engaged in a U.S. trade or business is a question that must be determined based on the facts and circumstances of each case. \(^{545}\) Generally, the analysis will focus on the nature and degree (i.e., the type and amount) of economic activity that such Foreign Person has in the U.S. \(^{546}\) Courts have found Foreign Persons as having a U.S. trade or business when such persons’ activities were considerable, continuous and regular. \(^{547}\)

As to the type of the activity, a purely passive one will not give rise to a trade or business. In this context, the Fifth Circuit has said that “[t]he word [business], notwithstanding disguise in spelling and pronunciation, means busyness; it implies that one is kept more or less busy, that the activity is an occupation.” \(^{548}\) Therefore, the activity must be active. In addition, the activity must be a substantive one, and not merely clerical or ministerial in nature. \(^{549}\) Promotional activities,

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\(^{544}\) Subject to the de-minimis exception allowed for Nonresident Aliens under Section 864(b)(1) of the Code.

\(^{545}\) See Lewenhaupt v. C.I.R., 20 T.C. 151, 162 (1953), aff’d, 221 F.2d 227 (9th Cir. 1955); Treas. Reg. 1.864-2(e); and IRS CCA 201501013 (Jan. 2, 2015).

\(^{546}\) See Scottish Am. Inv. Co. v. C.I.R., 12 T.C. 49, 59 (1949) (holding that “it is a matter of degree, based upon both a quantitative and a qualitative analysis of the services performed, as to where the line of demarcation should be drawn”).

\(^{547}\) See Pinchot v. C.I.R., 113 F.2d 718, 719 (2d Cir. 1940); Gilford v. C.I.R., 201 F.2d 735, 736 (2d Cir. 1953); and De Amodio v. C.I.R., 34 T.C. 894, 906 (1960), aff’d, 299 F.2d 623 (3d Cir. 1962).

\(^{548}\) Snell v. Comm’r of Internal Revenue, 97 F.2d 891, 892 (5th Cir. 1938). See also Cont’l Trading, Inc. v. C.I.R., 265 F.2d 40, 43 (9th Cir. 1959) (“it is settled law that the mere management of investments and the collection of rents, interest, and dividends is insufficient to constitute the carrying on of a trade or business”).

\(^{549}\) See Scottish Am. Inv. Co. v. C.I.R., supra note 546, at 59 (the court was not convinced the services provided by a local office (which were primarily of a clerical nature), “quantitatively extensive and useful as they may have been, approached that quality which is necessary in order that petitioners can be characterized as having engaged in business in the United States”). See also Spermacet Whaling & Shipping Co. S.A. v. C.I.R., 30 T.C. 618, 633–34 (1958), aff’d sub nom. C.I.R. v. Spermacet Whaling & Shipping Co., 281 F.2d 646 (6th Cir. 1960) (holding that taxpayer’s activities were without substance, ministerial and clerical in nature, and involved “very little exercise of discretion or business judgment necessary to the production of the income in question”).
such as advertising, would likely not rise to a level of trade or business in the U.S.\textsuperscript{550} As to the amount of the activity, occasional or isolated activities generally do not create a trade or business.\textsuperscript{551} There must be some sort of continuity, progression or sustained activity.\textsuperscript{552}

As is evidenced by the dates of the cited case law, the rules regarding the interpretation of the “trade or business” definition have been carved many years ago in the pre-digital age. As e-commerce became a prevalent method for conducting business, including across different jurisdictions, applying the concept of “trade or business” under its traditional interpretation became a challenging task. One of the critical questions that arose in this context is whether a Foreign Person that has computers servers in the U.S. is considered as having a U.S. trade or business. To clarify, this question concerns a scenario where the Foreign Person has no other assets, employees or any other type of physical presence in the U.S. – only servers. This question was discussed (briefly) in a white paper issued by the U.S. Treasury Department in 1996, which was one of the first government papers discussing the effects of e-commerce on taxation.\textsuperscript{553} In the context of the server question, the Treasury White Paper noted that “[i]t is possible that such a server, or similar equipment, is not a sufficiently significant element in the creation of certain types of income to be taken into account for purposes of determining whether a U.S. trade or business exists.”\textsuperscript{554} The Treasury White Paper further noted that if computer servers will be

\footnotesize{\textsuperscript{550} Joseph Isenbergh, \textit{The “Trade or Business” of Foreign Taxpayers in the United States}, 61 TAXES 972, 979 (1983). Isenbergh notes that there is no case law exactly on point, and he mentions that the closest authority on this issue is the \textit{Piedras Negras} case, which was discussed above \textit{id.} at n. 53. Although Isenbergh wrote these words more than 30 years ago (and well before anyone envisioned online advertising), as far as the author is aware there is still no better authority on the issue of advertising than the \textit{Piedras Negras} case. Based on the fact pattern of our example, the French advertiser will therefore not be considered as engaged in a U.S. trade or business merely by advertising to U.S. users. However, this is only a side note, because our main question regards the taxation of the online publisher, who is the one producing the income.

\textsuperscript{551} See Pasquel v. Comm’r, 12 T.C.M. (CCH) 1431 (T.C. 1953) (a single and isolated loan transaction did not amount to Foreign Person being engaging in trade or business in the U.S.).

\textsuperscript{552} See Lewellyn v. Pittsburgh, B. & L. E. R. Co., 222 F. 177, 185 (3d Cir. 1915) (also holding that “‘Carrying on business’ does not mean the performance of a single disconnected business act. It means conducting, prosecuting, and continuing business by performing progressively all the acts normally incident thereto, and likewise the expression ‘doing business,’ when employed as descriptive of an occupation, conveys the idea of business being done, not from time to time, but all the time.” \textit{Id.} at 185–86).


\textsuperscript{554} \textit{Id.} at 25.
taken into account in determining that a Foreign Person is engaged in a U.S. trade or business, such Foreign Persons will “simply utilize servers located outside the United States since the server’s location is irrelevant.” The Treasury White Paper concludes by saying that it is “necessary to clarify the application of the U.S. trade or business and permanent establishment concepts to persons engaged in electronic commerce.” However, despite such necessity, and despite the fact that 20 years have passed since the Treasury White Paper was issued, neither the Treasury Department nor the IRS have issued any such clarification or guidance. Therefore, the question of whether owning servers in the U.S. can create a U.S. trade or business to a Foreign Person remains unclear.

If an agent is engaged in a U.S. trade or business, the agent’s activities will be imputed to the foreign principal for purpose of determining whether such principal has a U.S. trade or business. It is clear under current case law that the activities of a “dependent agent” would be considered when determining whether the foreign principal has a U.S. trade or business. In addition, courts, in taking a somewhat expansive position, have held in certain cases that a U.S. trade or business can be imputed to a foreign principal even when the agent is independent. The IRS has unsurprisingly supported this expansive interpretation and has adopted it in its rulings.

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555 Id.
556 Id.
557 As discussed below, the OECD did provide guidance with respect to this question, as it applies to the finding of a permanent establishment. See infra notes 582–594 and the accompanying text.
558 See Adda v. C.I.R., 10 T.C. 273, 277, aff’d, 171 F.2d 457 (4th Cir. 1948) (a Nonresident Alien, who gave full discretion to a U.S. broker to deal in commodities under the Nonresident Alien’s name, was held to be engaged in U.S. trade or business based on the activity of the U.S. broker).
559 The term “dependent agent” is not specifically defined in the Code or Treasury regulations. Rather, it is defined by reference, as being an “agent who is not an independent agent” (Treas. Reg. § 1.864–7(d)(1)(i)). The term independent agent is defined to generally mean “a general commission agent, broker, or other agent of an independent status acting in the ordinary course of his business in that capacity” (id. § 1.864–7(d)(2)).
560 See De Amodio v. C.I.R., supra note 547, at 905 (holding that a Nonresident Alien who purchased and managed a real estate property through an independent U.S. real estate agent (who negotiated the leases, was responsible for repairs, collecting rents and paying taxes on the property, and received a commission), was engaged in a U.S. trade or business); see also Lewenhaupt v. C.I.R., supra note 545 (reaching the same conclusion based on a similar set of facts as in De Amodio).
561 See IRS CCA 201501013 (Jan. 2, 2015) (saying that “[i]n determining whether a foreign person is engaged in a trade or business within the United States, activities undertaken on behalf of the foreign person by an

Continued on the next page...
Finally, it should be noted that Section 864(b) of the Code specifically states that performance of personal services within the U.S. constitutes a U.S. trade or business.

Can our online publisher (who is a Foreign Person) be considered as engaged in a U.S. trade or business? The answer seems to be a resounding no. The case law and IRS holdings cited above all focus on the nature and degree of activity that the Foreign Person has within the U.S. Whether be it a sale, ownership, or management of property in the U.S., all these have a common denominator – there is some activity or asset, conducted or owned by the Foreign Person (directly or via an agent), that takes place or is located physically within the U.S. It would require a high degree of creative interpretation to conclude that an online publisher, that has neither assets nor employees in the U.S., is considered as having a U.S. trade or business by the mere fact that the online publisher’s algorithms target and display ads to users who are located within the U.S. This conclusion assumes that the Foreign Person does not have computer servers in the U.S., because whether such ownership could create a U.S. trade or business is currently unclear. However, making the assumption that the Foreign Person does not have servers in the U.S. is reasonable. As noted by the Treasury White Paper, the server’s location is irrelevant, and the online publisher could easily utilize servers outside the U.S. (i.e., direct all user traffic from the U.S. to servers that are located outside the U.S.).

Given that the central axis of the “U.S. trade or business” term is a notion of physical presence, it is not surprising that under the existing scope of the definition, as set by the above case law, the online advertiser, which has no assets, employees or agents in the U.S., would not be considered as having a U.S. trade or business. A similar conclusion was reached by the Treasury White Paper that specifically mentioned that while a foreign person engaging in cross-jurisdictional transactions with a U.S. resident via electronic commerce clearly has a trade or business, it is

agent are considered to be performed by the foreign person, regardless of the degree of control the foreign person exercises over the agent”).

Google, for example, has six data centers outside the U.S. (see Google.com, GOOGLE DATA CENTERS, https://www.google.com/about/datacenters/inside/locations/index.html (last visited Mar 11, 2017) and Facebook’s non-U.S. data centers are located in Sweden and Ireland (see Facebook.com, LULEÅ DATA CENTER, https://www.facebook.com/LuleaDataCenter (last visited Mar 11, 2017), and Facebook.com, CLONEE DATA CENTER, https://www.facebook.com/CloneeDataCenter (last visited Mar 11, 2017)) and Facebook will be opening another data center in Denmark (see Nikolaj Skydsgaard, Facebook to Build Third Foreign Data Center in Denmark, REUTERS.COM, January 19, 2017, http://www.reuters.com/article/us-facebook-denmark-idUSKBN15310F).
nevertheless questionable whether he has a trade or business (or a permanent establishment) in the U.S.\textsuperscript{563}

Could the users be considered as agents whose activities in the U.S. would be imputed to the online publisher for purposes of the U.S. trade or business definition? Certainly not under the common law of agency as it exists today. An agent is a person authorized by another person to act on his account and under his control, and a relationship of agency can only be created by an agreement.\textsuperscript{564} None of these requirements exist in the relationship between the online publisher and the users. The latter are not authorized to act in the name of the online publisher and they are not controlled by the publisher. There is also no agreement between the parties (other than the “terms of use” agreement with respect to the online publisher’s platform, which does not create a relationship of agency).

Finally, even if we were to say that the online publisher’s income is characterized as income from personal services, there would still be no grounds to determine that the online publisher has a U.S. trade or business. That is because Section 864(d) of the Code, which specifically says that provision of personal services can create a U.S. trade or business, requires that such services will be performed within the U.S., and that is something that the online publisher is simply not doing.

Accordingly, under existing U.S. federal income tax rules, and in accordance with the prevailing judicial and IRS interpretation and application of such rules, the online publisher would not be considered as having a U.S. trade or business. However, would it even matter? Would the online publisher be subject to tax in the U.S. even if it had a U.S. trade or business? As noted above, a Foreign Person that has a U.S. trade or business can be subject to tax in the U.S. with respect to certain foreign-source income that is treated as effectively connected to such Foreign Person’s trade or business under Section 864(c)(4) of the Code. This category includes foreign-sourced royalty income from intangibles, which, as discussed above, is one possible characterization of the income of the online publisher. However, in order for such foreign-source royalties income to

\textsuperscript{563} DEPARTMENT OF THE TREASURY, OFFICE OF TAX POLICY, supra note 553, at 25.
\textsuperscript{564} Restatement (Second) of Agency § 1 (1958).
be taxed in the U.S., the Foreign Person must maintain an office or a fixed place of business in the U.S. and the income must be attributable to that office or fixed place of business.\textsuperscript{565}

According to Treasury Regulations, whether a Foreign Person has an office of other fixed place of business in the U.S. is determined based on all facts and circumstances, and in particularly the nature of the trade or business and the \textit{physical} facilities actually required in the ordinary course of the conduct of the trade or business.\textsuperscript{566} The regulations further provide that, as a general rule, an office or other fixed place of business is a fixed facility, that is, a place, site, structure, or other similar facility, through which a Foreign Person engages in a trade or business.\textsuperscript{567} The regulations then enumerate several examples that are considered an office or other fixed place of business, such as a factory, a store, a workshop, or a mine, quarry, or other place of extraction of natural resources.\textsuperscript{568} It is clear that the concept of fixed place of business is entirely dependent on having some sort of actual physical presence in the U.S. In our example, the online publisher has no such physical office or a fixed place of business in the U.S., and therefore could not have any foreign-source income that is considered effectively connected income, even under the hypothetical assumption that the publisher does have a U.S. trade or business.

The result of our inquiry is not surprising. The online publisher’s income is sourced outside the U.S. Under the existing U.S. tax rules, foreign source income of Foreign Persons is taxed in the U.S. under very limited circumstances that require, \textit{inter alia}, that the Foreign Person be engaged in a trade or business in the U.S. (a concept that demands some sort of physical presence in the U.S.), and that the income be attributable to an office or a fixed place of business in the U.S., which is a term that is also interpreted in a very straightforward manner to require some sort of physical manifestation in the U.S. Therefore, when the Foreign Person has absolutely no physical presence in the U.S., such as in the case of the online publisher, his foreign-sourced income will not be caught in the net of the U.S. tax rules. Therefore, under existing U.S. federal income tax rules, the income of the foreign online publisher would not be taxed in the U.S. (even when making assumptions that go against the online publisher).

\textsuperscript{565} I.R.C. § 864(c)(4)(B); Treas. Reg. § 1.864-6(a).
\textsuperscript{566} Treas. Reg. § 1.864-7(a)(2).
\textsuperscript{567} \textit{Id.} § 1.864-7(b)(1).
\textsuperscript{568} \textit{Id.}
8.6.2. Treaty Scenario – Permanent Establishment

What would be the result if a tax treaty existed between the jurisdiction of the online publisher and that of the users (and in our example, between Ireland and the U.S.)? Would the online publisher be subject to tax in the U.S.? As a preliminary matter, given that we have conclude that the online publisher would not be subject to tax in the U.S. under the Code, a treaty would not change that result because tax treaties cannot subject a person to taxation where such tax does not apply under domestic law. However, for purposes of the discussion we shall assume that the online publisher is subject to tax in the U.S. under the Code, in which case the treaty analysis would be relevant. As the discussion below shows, the online publisher would not be subject to tax also under the treaty scenario.

When applying the provisions of an income tax treaty, the first step would be to determine the type of income at hand. As noted in part 8.48.4.2 of this chapter, treaties include separate articles for different types of income, each of which allocates the right to tax such income to the contracting states. As we concluded, the two likely possible characterizations for income from online advertising are royalties and income from the provision of personal services. If the income is characterized as royalties, the taxation of the income will be governed by article 12 (this is true for the U.S., OECD and U.N. Treaty Models). Although the specific language of Article 12(1) in the U.S. and OECD Treaty Models is different than that used by the U.N. Treaty Model, all three Treaty Model refer to royalties arising in a contracting state and beneficially owned by or paid to a resident of the other contracting state. Meaning, that the royalties article in the treaties applies only to royalties that arise in one of the contracting states and that are beneficially owned (or paid to, according to the U.N. Treaty Model) a resident of the other contracting state. Because in our example the beneficial owner of the income is the Irish online publisher, the U.S.-Ireland treaty could apply to the royalties income only if such income arises in the U.S. Although the U.S.-Ireland treaty does not define what “arise in” means in the context of the royalties article, it is clear (from other sources) that such income refers to royalties that are paid by a resident of a

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569 This discussion assumes that the online publisher is eligible for the benefits of the tax treaty, as determined by the “Limitation on Benefits” article of the treaty.

570 The treaty would also apply to royalties that arise in Ireland, but in that case the jurisdiction of source and residence would be the same and the treaty would be irrelevant.
contracting state (in our example, the U.S.).\textsuperscript{571} This is also the logical conclusion, because there would be no justification to give the U.S. (which is not the state of residence of the recipient of the income) a right to tax an item of income which is not sourced within its borders (as a reminder, tax treaties allocate the right to tax income between the country of source and the country of residence; a country that does not fit to either of these definitions with respect to a specific item of income is simply irrelevant to the analysis). The result is that the tax treaty simply has nothing to say with respect to the income of the online publisher, because the treaty (between the U.S. and Ireland) does not apply to this income, which arises in France, where the payor—the French advertiser—is located.

Will the result be different if the income is characterized as being from personal services? The result would in fact be the same, but the way to reach it is different. The U.S. and OECD Treaty Models do not have a separate article dealing with the provision of services. Income from such services, when received from the operation of a business, is dealt with under Article 7, which governs business profits.\textsuperscript{572} The argument that income from online advertising is properly considered business profits that ought to be governed by Article 7 is supported by the OECD report and recommendations with respect to characterization issues arising from e-commerce. Such report specifically noted that income from online advertising constitutes business profits that fall under Article 7 rather than Article 12 (royalties).\textsuperscript{573}

Article 7 states that the profits of an enterprise are taxed only in the country of residence of the enterprise, unless the enterprise carries on business in the other country through a PE situated therein, in which case the other country (the country of source) can tax the profits that are attributable to the PE. In our case, the U.S. would be able to tax the online publisher’s profits

\textsuperscript{571} See, e.g., U.S. Treaty Model, supra note 473, at Article 11(6) (stating that “interest shall be deemed to arise in a Contracting State when the payor is a resident of that Contracting State”); U.N. Treaty Model, supra note 475, at Article 12(5) (stating that “[r]oyalties shall be deemed to arise in a Contracting State when the payer is a resident of that State”); and, although less helpful, OECD Treaty Model, Commentaries to Article 12, ¶ 5 (stating that the article deals only with royalties arising from one of the contracting states and does not deal with royalties arising in a third country).

\textsuperscript{572} Article 7 applies to the “profits of an enterprise.” The term “enterprise” applies to the carrying on of any business, and the term “business” includes professional services. See U.S. and OECD Treaty Models, Article 3 (general definitions).

\textsuperscript{573} See OECD Treaty Model, supra note 390, at R(18)-1 (Treaty Characterisation Issues Arising from E-Commerce).
only if the online publisher has a PE in the U.S. and only to the extent of the profits attributable to such PE.

The concept of PE (which has been incorporated in tax-related documents since the late nineteenth century)\(^{574}\) is embedded in practically all bilateral tax treaties. The purpose of PE concept is to assign taxing rights to the source country only when an enterprise has sufficient business activity therein so as to justify the imposition of the foreign tax.\(^ {575}\) This is intended to prevent corporations from being taxed by numerous jurisdictions in which they may only have occasional or de-minimis activity but no substantive presence.\(^ {576}\)

The term PE, which is very similarly defined in Article 5 of the three Treaty Models, includes: a general definition, a non-exhaustive list of examples of types of activities that would give rise to a PE, a list of exceptions, and provisions discussing the possibility of having a PE via an agent. All these “ingredients” of the definition revolve around a unified concept of physical presence. Article 5(1) defines the term “permanent establishment” as “a fixed place of business through which the business of an enterprise is wholly or partly carried on.” The examples of a PE, as enumerated in Article 5(2), all refer to a physical place or facility (place of management, branch, office, factory, workshop, mine or quarry). Finally, all the exceptions from the definition of PE, as provided in Article 5(4), refer to activities that physically take place in the source country (such as storage and delivery of goods) or to maintaining a fixed place of business that is used for certain purposes. The Technical Explanation to the U.S. Treaty Model explains that “a general principle to be observed in determining whether a PE exists is that the place of business must be “fixed” in the sense that a particular building or physical location is used by the enterprise for the conduct of its business.”\(^ {577}\) The OECD Commentaries includes even more references to the

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\(^{575}\) See OECD Treaty Model, supra note 390, at C(7)-4, ¶ 11 (stating that the concept of PE “has a long history and reflects the international consensus that, as a general rule, until an enterprise of one State has a permanent establishment in another State, it should not properly be regarded as participating in the economic life of that other State to such an extent that the other State should have taxing rights on its profits”).

\(^{576}\) The concept of PE is supported by the argument that calculating the net profits of an enterprise (which are taxed based on net profits and not gross revenues, as in the case of dividend, interest and royalties) would create significant administrative burden for both the enterprise and the tax administration of the source country.

\(^{577}\) Technical Explanation, supra note 471, at 15.
physical presence aspect of a PE. For example, the commentary explains the term “fixed” to mean “established at a distinct place” and this means that “there has to be a link between the place of business and a specific geographical point.” The commentary also explains that the words “through which” in the PE definition should be given a broad meaning so it could apply to any situation when a business activity is carried on “at a particular location.” Finally, the commentary notes that “[c]learly, a permanent establishment may only be considered to be situated in a Contracting State if the relevant place of business is situated in the territory of that State.”

The definition of PE and the OECD Commentaries that interpret such definition lead to the following conclusion – a taxpayer can have a PE in a source country only if the taxpayer has some kind of physical presence in that country (and the other requirements of the PE definition are met). The PE definition leaves no room for interpretation that would allow it to apply to pure non-physical economic activity. This created a problem as the world entered the digital age, and an increasingly large numbers of corporations started generating income from cross-border e-commerce and other online activities.

Cognizant of this problem, in 2000 the OECD released a clarification regarding the application of the PE definition in the context of e-commerce (this was preceded by two draft papers published in late 1999 and early 2000). The clarification distinguished between the applicability of the PE definition to computer equipment (such as servers) and websites. According to the OECD clarification, the former is easily relocated and thus bears little risk of creating a PE for taxpayers against their wishes. As to the latter, it was unanimously agreed by all the committee members that a website in itself does not constitute a PE. Furthermore, it was concluded that since a website is not a person, it cannot be considered a dependent agent that could create an imputed PE. A few years later, the OECD member-countries agreed that a computer server is nonetheless capable of creating a PE if it constitutes a “fixed place” under the traditional PE

578 OECD Treaty Model, supra note 390, at C(5)-1, ¶ 5.
579 Id. at C(5)-4, ¶ 5 (emphasis added).
580 Id. at C(5)-3, ¶ 4.6 (emphasis added).
581 Id. at C(5)-5, ¶ 5.5 (emphasis added).
Consequently, the OECD adopted corresponding changes to the OECD Commentaries on Article 5. The commentaries make the distinction between a server and a website and say that a server (on which a website is stored) is “a piece of equipment having a physical location and such location may thus constitute a “fixed place of business” of the enterprise operating that server,” in which case it may constitute a PE of the enterprise that has the server at its disposal (i.e., owns or leases it). The OECD Commentaries further note that a server can constitute a PE only if it meets the requirement of being fixed. The fact that a server can be moved is irrelevant, says the commentary, what matters is whether the server has actually moved. Therefore, if a server is located at a certain place for a sufficient period of time (the commentary does not say how long is considered sufficient for this purpose), it will become fixed for purposes of the PE definition.

The next question that the OECD Commentaries addresses is whether the business of the enterprise can be said to be carried on at the location where the enterprise has such fixed servers. This question, according to the commentaries, needs to be addressed based on the facts and circumstances of each case. In this context, the commentaries note that if the operations carried on through a server are of preparatory or auxiliary nature, such activities will not support a finding of a PE, as they will fit the “preparatory or auxiliary” exception within paragraph 4 of the PE definition. The commentaries state that gathering market data for the enterprise and supplying information are examples of activities that would generally be considered as preparatory or auxiliary, provided that such functions are not, in and of themselves, an essential and significant part of the enterprise’s core business (and thus not covered by the “preparatory or auxiliary” exception). The commentaries provide two helpful examples. The first concerns an internet service provider that provides website hosting services. For such an enterprise, the operation of servers is an essential part of the business activity and, therefore, would not be

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583 See OECD Treaty Model, supra note 390, at C(5)-24, ¶ 42.2, as added on January, 28 2003 by the report entitled “The 2002 Update to the Model Tax Convention.”
584 Id. at C(5)-25, ¶ 42.2 and ¶ 42.3.
585 Id. at C(5)-25, ¶ 42.4.
586 Id.
587 Id.
588 Id. at C(5)-25, ¶ 42.5.
589 Id. at C(5)-26, ¶ 42.7.
590 Id. at C(5)-26, ¶ 42.7. and 42.8.
considered preparatory or auxiliary. On the other hand, an online retailer that sells products over the internet is not in the business of owning and operating servers. In that case, the commentaries say, the nature of the activities performed by such servers should be examined in light of the business carried on by the enterprise. If the activity is purely preparatory or auxiliary (which in the context of the online retailer includes hosting a website that is used for advertising, displaying a catalogue of products and providing information to customers), the exception will apply and the servers will not constitute a PE. If, however, the servers are used in performing the actual acts of selling goods (concluding contracts, processing payments and delivering digital goods), then the activities are not merely preparatory or auxiliary.

Now back to our study case. Will the Irish online publisher be considered as having a PE in the U.S.? Under the assumption (which we have made and explained before) that the online publisher has no assets, employees or agents in the U.S., there is absolutely no reason for it to have a PE. As the above discussion shows, the PE concept requires some sort of physical presence of the enterprise in the source country. When an enterprise has absolutely no such presence, because its entire business is conducted online, the PE definition simply does not apply. Finally, it is worth noting that under customary interpretation, and for the same reasons previously discussed with respect to the concept of U.S. trade or business, the users cannot be considered as agents of the online publisher and the latter cannot be imputed with the former’s physical presence in the U.S. for purpose of finding a PE.

Would the online publisher be considered as having a PE if he would own servers in the U.S.? According to the OECD Commentaries to Article 5, a server could constitute a PE if it is fixed, and if the business of the enterprise is carried on through the server. When conducting the

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591 Id. at C(5)-27, ¶ 42.10.
592 Id.
593 Id.
594 Id.
595 Id.

Although the OECD Commentaries are not an official source of interpretation for U.S. tax treaties, it is used in practice as one of the main sources of interpretation, in addition to the Technical Explanation. Referring to the OECD Commentaries with respect to U.S. treaties is justified because the U.S. is a member of the OECD (despite the fact that the U.S. uses its own treaty model and not the OECD one), but mostly because the U.S. Treaty Model includes numerous provisions that were based on the provisions of the OECD Treaty Model, and the Technical Explanation itself refers to the OECD Commentaries when in need of a basis for interpretation (see, e.g., Technical Explanation, supra note 471, at 16 (stating that the interpretation of Article 5(3) are based on the commentaries to such article in the OECD Treaty Model)).
facts-and-circumstances inquiry with respect to the nature of the online publisher’s business, we find that such line of business shares a greater similarity with that of the online retailer (that was provided as an example by the commentaries), rather than with the business of the internet service provider. Like the online retailer, the online publisher does not need to own servers to generate income from its business. The online publisher can host its online platforms on third-party servers, and users in the U.S. would still be able to access such platforms and be exposed to ads. Owning servers is not a core activity that is a requirement in the business of online advertising. Therefore, in accordance with the OECD guidelines, the online publisher would likely not be considered as having a PE even if it did own servers in the U.S.

Finally, even if we assume, for the sake of the argument, that the online publisher does have servers in the U.S., and that those servers are indeed found to constitute a PE, the U.S. would be able to tax the online advertiser’s income only to the extent that such income is attributable to the PE. With this respect, the Technical Explanation notes that “business profits attributable to a permanent establishment include only those profits derived from the assets used, risks assumed, and activities performed by, the permanent establishment.”596 Under the traditional interpretation of PE, which relies on the core concept of physical presence, the income of the online advertiser would not be attributed to servers in the U.S., through which none of the actual payments in our example are made. Because all the activities of the online publisher itself are conducted outside the U.S., and because the payments from the advertiser are made and processed outside the U.S., none of the online advertiser’s activities is (if to borrow from the U.S. Code) “effectively connected” with that PE,597 and therefore none of that income would be attributed to that PE and thus would not be taxed in the U.S. even if the online publisher is considered as having a PE in the U.S.

596 Id. at 22.
597 The Technical Explanation indeed states that “The “attributable to” concept […] provides an alternative to the analogous but somewhat different “effectively connected” concept in Code section 864(c).” Id.
8.7. Summary

The purpose of this chapter was to explore the concepts of character and source and to find out how income from online advertising (when generated in a multi-jurisdictional setting) is sourced and taxed under existing U.S. and international tax regimes.

We started this endeavor by going back to the “source” – the 1923 Double Taxation Report that established the foundation for modern day international taxation. In determining the source of income, the 1923 Double Taxation Report advocated an approach that seeks to locate the true economic basis of the income or, as the report aptly defined it – “the place where the wealth is produced, that is, to the community the economic life of which makes possible the yield or the acquisition of the wealth.” Several of the source rules under the Code also adopt this substantive approach and attempt to source the income to the location where it is in fact earned (as in the case of the royalties and personal services rules that were discussed at length in this chapter).

Based on this substantive approach I argue that income from online advertising should be sourced, at least in part, to the jurisdiction of the users because that jurisdiction is, literally, “the community the economic life of which makes possible the yield or the acquisition of the wealth.” The fact that users are individually targeted and displayed with ads that are tailored to each user, and the fact that the business model of online advertising requires the user to actively participate (by viewing, clicking or acting upon an ad) in order for the online publisher to receive any income, mean that the users are an integral and crucial part in the revenue-generating process of online advertising. Therefore, the users’ participation in the process and their contribution to generating the income is similar to (if not greater than) that of the assets of the online publisher and the employees working for the online publisher, and as such, the users ought to be accounted for when determining the source of the income.

However, as this chapter has shown, applying the existing tax rules to income from online advertising raises challenges and difficulties that the existing rules are not equipped to deal with. Consequently, when it comes to determining the character and source of income from online

598 1923 Double Taxation Report, supra note 348, at 23.
advertising, and determining whether such activity creates a U.S. trade or business or a permanent establishment to the online publisher, such fundamental concepts, as they are embedded in the various sections of the Code and tax treaties, yield inadequate results. Under existing rules, income from online advertising is not sourced to the jurisdiction of the users and the online publisher would not be subject to tax in such jurisdiction for that reason alone, despite the fact that such jurisdiction is arguably ‘THE’ source of the income. This unfitting result is the same whether or not a tax treaty is in place.

A quick review of Google’s and Facebook’s annual financial reports helps to clarify the magnitude of the consequences of such distorted sourcing results. In recent years, Google’s revenues from “sources” outside the U.S. (determined based on billing address) has constituted 53–55% of Google’s total consolidated revenues. 599 Despite the fact that more than half of its revenue comes from non-U.S. “sources,” only a little more than 20% of Google’ total taxes were paid to foreign jurisdictions 600 (not to mention the fact that the amount of foreign taxes paid represents an effective foreign tax rate of only 8% in 2016, and 6.4% in 2015). 601 Similar results can be found in Facebook’s financial reports. In 2015, Facebook’s revenues from outside the U.S. (also determined based on the billing address of the advertiser) were more than 52% of Facebook’s total revenues, while the percentage of foreign taxes (out of the total taxes paid by Facebook) was only 5.1%. 602

These figures show that although the lion’s share of the revenues of the two biggest online publishers is from non-U.S. advertisers (assuming advertisers with foreign billing address are non-U.S.), a significant portion of such non-U.S. income is either subject to a very low tax rate or not subject to tax at all. 603

599 Alphabet Inc., supra note 155, at 27.
600 Id. at 76.
601 Id. at 76.
602 Facebook, Inc., supra note 324, at 78, 80.
603 In addition to the improper sourcing, the low foreign tax rate paid by online publishers is a result of tax planning and complex corporate structures and intercompany transactions by which online publishers (as well as other multinational corporation) manage to tunnel their non-U.S. profits to low (or zero) tax jurisdictions. An example of these tax structures is discussed in chapter 9.1.2 below.
Therefore, determining the source of income from online advertising based on the location of the
users would have a significant impact on the tax bills of these two internet giants and those of
their competitors, as well as on the tax revenues of countries around the world (some of which
are developing countries desperate for the opportunity to collect more taxes at source) whose
residents “consume” (and generate the income from) online advertising presented on the
websites of Google, Facebook, and the like.\footnote{604} Given the long-standing double-digit growth rate
of the online advertising business,\footnote{605} more and more revenue and value will continue to be
untaxed where the economic source of the income is located.

\footnote{604} Note that sourcing online advertising income based on user jurisdiction does not necessarily mean that U.S. online publishers will be paying less tax in the U.S. That is because income paid by a non-U.S. advertiser would be sourced to the U.S. if users within the U.S. are the ones to generate the income (by viewing, clicking or acting upon the ad of such non-U.S. advertiser).

\footnote{605} See supra notes 144–152 and the accompanying text. Specifically, Google has enjoyed an average revenue growth rate of 18% in the past 3 years (ALPHABET INC., supra note 155, at 43). Facebook’s revenues have increased by 54% and 44% in 2016 and 2015, respectively (Facebook, Inc., supra note 156).
9. **The Inadequate Results of the Taxation of Online Advertising under Existing Law**

The previous chapter explored the basic rules of taxation under the Code and existing international tax norms that apply to income from online advertising when such income is generated in a cross-border setting. The application of such rules yielded certain results that I argue are inappropriate. Why such results should be considered improper and what are the leading factors that contribute to such results? This chapter will attempt to answer these questions. The first part of the chapter explains why I believe the manner in which income from online advertising is currently taxed is inadequate. The remaining parts of the chapter explore some of the factors that lead to such unsatisfactory results – the second part of the chapter explores factors related to characterization and source issues, and the third and final part of the chapter focuses on factors related to the concept of jurisdiction to tax and the manner in which such concept interacts with the digital economy in general and also specifically with online advertising.

9.1. Why Do Existing Rules of Taxation Yield Improper Results When Applied to Income from Online Advertising?

9.1.1. Ignoring the Economic Reality Leads to Inadequate Taxes

The answer to the question presented at the title of this subchapter was briefly discussed in the previous chapter but it deserves a more robust explanation and discussion. As was noted earlier in this dissertation, one of the most fundamental premises of taxation is that tax should follow the economics. Good tax law is one that applies to the actual economic consequences of the taxpayer’s actions, no more and no less. A tax that applies to less than the complete consequences of the taxpayer’s economic activity is improper because it allows the taxpayer to enjoy the economic benefits of its actions free of tax. From a policy standpoint, this creates an

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606 See *supra* notes 255–259 and the accompanying text.
inefficient tax (in a sense that it “leaves on the table” income that should be taxed to support government activities) and also raises possible equity and fairness questions, assuming the gap between the economic benefits and the tax that applies to it is not applied equally to all similarly situated taxpayers and/or to similar types of activities. In addition, from the taxpayer’s point of view, the failure of a tax to properly apply to the entirety of the taxpayer’s economic activity creates an incentive for the taxpayer to conduct more of the activity that is subject to less (or no) tax, even when such activity (or the scope of the activity undertaken) is not the most efficient activity for the taxpayer to peruse from a pre-tax point of view. These inefficiencies have a potential of having greater effect in the context of cross-border activity. In this context, the Gap could result in the economic activity not being taxed at all by one or more jurisdictions in which a meaningful part of the business activity takes place, in contradiction to generally acceptable concepts of international tax. This is the case of income from online advertising that is generated across jurisdiction lines.

U.S. federal income tax law, and the courts applying it, have implemented several tools in an attempt to close the Gap and prevent taxpayers from conducting activities and transactions that are solely tax-motivated and that provide taxpayers with tax benefits that do not correspond with the economic outcome of their actions. Such tools include, for example, the economic substance doctrine\(^\text{607}\) and the substance-over-form doctrine.\(^\text{608}\) However, these doctrines are not intended to catch all activities and all transactions that fall within the Gap. Activities with a valid business

\(^{607}\)See supra notes 299–303 and the accompanying text.

\(^{608}\)Much like the economic substance doctrine, the substance-over-form doctrine originated in the seminal case of Helvering v. Gregory, in the opinion of the Second Circuit (see supra note 299) and the subsequent U.S. Supreme Court decision (Gregory v. Helvering, 293 U.S. 465 (1935)). Simply put, under the substance-over-form doctrine “[t]he incidence of taxation depends upon the substance of a transaction” rather than its form (C.I.R. v. Court Holding Co., 324 U.S. 331, 334 (1945)). Courts apply the substance-over-form doctrine to disallow tax benefits arising out of transactions the forms of which differ from their substance. See, e.g., United States v. Scott, 37 F.3d 1564, 1572 (10th Cir. 1994) (“The income tax consequences under the Internal Revenue Code depend upon the substance of the situation, not the form”); Derr v. Comm’r of Internal Revenue, 77 T.C. 708, 722 (1981) (same); Leahy v. Commissioner, 87 T.C. 56 (1986) (“It is well established that the economic substance of a transaction rather than its form, controls for Federal income tax purposes… We must be concerned with the economic realities and not the form employed by the parties”). However, courts have held that the doctrine should only apply where a proposed recharacterization is more consistent with the underlying substance of the transaction than its form. See, e.g., Tracinda Corp. v. Commissioner, 111 T.C. 315, 326 (1998) (if “substance follows form then this Court will respect the form chosen by the taxpayer,” and “[e]ven if alternative explanations are available to account for the results of a transaction, this Court will not disregard the form of the transaction if it accounts for the transaction at least as well as alternative recharacterizations”).

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purpose and economic substance will generally not be caught under these doctrines. Therefore, taxpayers are able to take advantage of the Gap if their activities have an independent business purpose. This is true for taxpayers who plan their business activities in such a way that takes advantage of the gap (which is a valid strategy, provided such actions are not solely tax-motivated).\textsuperscript{609} This is obviously also true for taxpayers whose business activities happen to fall within the gap, without any prior planning on the part of the taxpayer, just because the rules of taxation are unable to encompass the economic activity that the rules were theoretically intended to apply to; this could be because of poor drafting of the rules or because the original drafters did not predict the developments that may occur as time passes, and the rules were not flexible enough to encompass such changes as they became reality. No matter what the reason is, tax law that does not follow the economic reality creates inefficiencies and distorts market activity and therefore such laws should be fixed to the extent possible.\textsuperscript{610}

The source rules are no different in that sense. They too are supposed to reflect the location of the economic activity that generates the income that the rules are intended to source. This is not a new concept. It has been one of the underlying principles that legislatures and courts look to when enacting and interpreting source rules. The President’s Tax Reform proposals that led to the enactment of the Tax Reform Act of 1986\textsuperscript{611} articulated this principle as follows:

“The following basic principles should be applied in formulating rules for determining the source of income. First, appropriate source of income rules should reflect the location of the economic activity generating the income and the source of legal protections facilitating the earning of that income … Second, the rules should be neutral in the sense that the United States would have no ground for objection if its source of income rules were applied by other countries … Third, the rules should not allow erosion of the legitimate U.S. tax base through taxpayer manipulation of the source rules or of the foreign tax credit limitation … Fourth, to the extent possible the rules should operate clearly and not require difficult factual determinations on a transaction by transaction basis…”\textsuperscript{612}

\textsuperscript{609} See the words of Judge Learned Hand regarding the legitimacy of tax planning, supra note 305 and the accompanying text.
\textsuperscript{610} See also the discussion in chapter 5.2 above.
\textsuperscript{612} Office of the President of the United States, The President’s Tax Proposals to the Congress for Fairness, Growth and Simplicity, General Explanation, 399 (1985), as included in 64 Bernard D. Reams Jr., Margaret
This approach, of calling upon the source rules to reflect the location of the economic activity generating the income, was adopted by the courts. In one case the Tax Court noted that:

“The provisions [I.R.C. §§ 861–863] do not contain a comprehensive rule for identifying an item of income with a particular foreign country. Nevertheless, the rules show that Congress sought to identify the source of income in terms of the business activities generating the income or to the place where the income was produced. Thus, the sourcing concept is concerned with the earning point of income or, more specifically, identifying when and where profits are earned.”

What is the location of the economic activity generating the income for the online publisher? Where is that income produced? What jurisdiction provides the legal protections facilitating the earning of that income? The answers to these questions are seemingly not straightforward when it comes to types of income and activities that take place in a non-physical realm such as the internet. Can this income even be considered as being generated in a certain “location”? Can one pin-point the place on earth where the activity that generates the income takes place? I argue that the answer to both these questions, in the context of online advertising, is yes.

It is true that there is a general tendency to consider anything that is internet-related as happening in a sphere that is beyond the physical world. Chatting with a friend on Facebook, streaming movies from the Cloud, and using Bitcoin to purchase an upgrade for an online game – none of these have any physical manifestation whatsoever, unlike their “earthly” equivalents (the letter, the DVD, or the cash used to purchase a good old-fashioned board game). It is thus understandable why many people would see these activities as being conducted without any physical presence. However, while this may be the popular view, it is not the correct one to adopt


Hunt v. C.I.R., supra note 519, at 1301 (emphasis added). A similar approach was also adopted by the IRS in determining the source of income from scholarship or fellowship (or an award for a puzzle contest), in which case the IRS held that “[a]bsent a significant economic nexus with the place where the study and research and puzzle solving activities are performed, it is more appropriate to source these payments where the principal economic nexus exists, namely, at the residence of the payor.” Rev. Rul. 89-67, 1989-1 C.B. 233 (I.R.S. 1989) (emphasis added) (this Revenue Ruling was issued prior to the promulgation of the regulations that currently provide the source rule for income from scholarships, fellowship, grants, prizes and awards; see Treas. Reg. § 1.863-1(d)).
when it comes to taxation, simply because such point of view it based on a partial observation that is focused on the wrong object. The online chat, the streamed movie, the online currency and the online game all indeed happen in the digital sphere without leaving any physical fingerprints. However, these are products and services that were created by people for the use of people, all of which have a very distinct and singular physical presence. In fact, anything that happens on the internet still has a very distinct and easily-determinable physical presence – that of the programmers developing the software, that of the computer equipment used to store and communicate the online content, and that of the users who consume and use all the online services and products. That is not to say that things would always remain this way. In the future, when artificial intelligence will be able to independently create new online products and services, and when people may be able to shed their physical bodies and live their lives entirely in the Cloud, then it would be more accurate to say that activities online truly have no physical manifestation. Until that day comes, we are very much able to identify the location of all persons and equipment that take part in online activities, even when the actual service or product are entirely virtual. That is also true for identifying the physical location of all the components that contribute to the process of generating income from online advertising.

With respect to the previous paragraph, a quick observation is in order before we proceed. In analyzing the location of the processes and equipment that take part in generating income, for income tax purposes, we generally do not consider the location of customers who purchase the products or use the services. The focus is rather on the activities and persons that create such products and provide such services. Therefore, under existing international tax norms, if a company in country X manufactures its products in that country and is able to sell such products to customers in country Y remotely—i.e., conduct all sales efforts and sign all contracts outside country Y and have presence in that country only for storage and delivery purposes, if any—then country Y would not be entitled to tax the company’s business profits because the company would not have sufficient presence to justify taxation at source. See Article 5(4)(a) of the OECD and U.S. Treaty Model, excluding from the term permanent establishment the use of facilities for purpose of storage, display or delivery. The U.N. Treaty Model does not include “delivery” in the list of PE exceptions, but it does include the general exclusion for activities that are auxiliary or preparatory in nature (see Article 5(4)(e) of the U.N. Treaty Model, supra note 475).

See Article 5(4)(a) of the OECD and U.S. Treaty Model, excluding from the term permanent establishment the use of facilities for purpose of storage, display or delivery. The U.N. Treaty Model does not include “delivery” in the list of PE exceptions, but it does include the general exclusion for activities that are auxiliary or preparatory in nature (see Article 5(4)(e) of the U.N. Treaty Model, supra note 475).
user/customer. The connection between the online publishers and the users is not one that relies solely on market demand. Rather, the users are an integral part of the revenue-producing process of the online publisher—both because of personalization and targeting and also because the users’ actions are a necessary element, without which the online publisher does not generate income. That is not a connection based on market demand. In fact, the online publisher does not sell anything to the users, but rather to the advertisers. Therefore, while the location of users is generally not the focus of income tax sourcing (unlike destination-based consumption taxes that focus on the location of the users/customers), the users in the online advertising business play a different role and thus may have a different impact on sourcing.

Now that we have established that online activity generally does have an ascertainable physical location, at least for taxation purposes, we need to go back to the question we started with – what is the location of the economic activity generating the income for the online publisher? To answer this, we must first establish a list of the essential components of the business model of online advertising. Based on the review in chapter 4 above, we can identify four such components: (i) employees of the online publisher that develop and maintain the software and hardware that support the online advertising platforms and related digital products and also employees engaged in promoting sales, (ii) computer equipment used to store and operate the online advertising software, (iii) advertisers, and (iv) users. The physical location of all these components is easily determinable. However, although all four components are essential to the business of online advertising, the location of two of such components—that of the equipment and the advertisers—is of lesser relevance for the income-generating process.

First, the location of advertisers is of less importance because they are the customers or recipients of the advertising service and, as explained above, the location of customers generally does not play a significant role in determining source and jurisdiction to tax under international income tax norms (to be distinguished from consumption taxes of international activities), simply because market demand has been traditionally recognized as creating only a weak (or no) economic connection between the taxpayer (the seller) and the jurisdiction in which the products
are consumed. In the case of online advertising that conclusion is even stronger. The advertiser could be located anywhere in the world and still use the online publisher’s system to implement the advertiser’s ads in the exact same manner and with the exact same effect. There is absolutely nothing about the location of the advertiser that affects the economic results of the transaction. Therefore, for purpose of sourcing the income of the online publisher, the location of the advertisers should not be considered as one of the locations of the activities that generate the income.

A similar conclusion should be reached with respect to the location of computer equipment and servers, but to a somewhat lesser degree. All major online advertisers own data centers that include hundreds of thousands of computer servers that are used for the operation of the online publishers’ systems. The location of data centers is generally irrelevant to the value-creation process of the online publisher. Because data centers are connected to the internet they can be located almost anywhere on earth (subject to certain constraints, as discussed below). Moreover, the location of the data centers is subject to complete control of the online publisher, that can choose to move them to a more tax-favorable location if needed. Because of these reasons, the location of the data centers should not be taken into account when determining the source of the income from online advertising. This conclusion is nevertheless subject to the following caveat.

See OECD, ARE THE CURRENT TREATY RULES FOR TAXING BUSINESS PROFITS APPROPRIATE FOR E-COMMERCE? FINAL REPORT 41 (2005), http://www.oecd.org/ctp/treaties/35869032.pdf (“...the mere fact that the realization of business transactions requires an interaction between the supply of goods or services by an enterprise and the demand in a market state has not historically been considered by countries to provide a sufficient link for considering that the profits of the enterprise arising from these transactions should, for purposes of income taxation, be sourced in the market state”).

It should be noted that if the sale of the advertising products or the provision of the advertising service would be considered as taking place in the jurisdiction of the customers, existing tax rules would source the income to that jurisdiction (based on the rules for sale of inventory that sources the income based on the place of sale (I.R.C. §§ 861(a)(6) and 862(a)(6)) or based on the source rule for services, that sources the income to the place where the service is provided (id. §§ 861(a)(3) and 862(a)(3)). In my opinion, that result serves as another example of how the existing rules are misaligned with the economic drivers of this transaction, because such rules would source the income to a jurisdiction that has the least relevance and influence on the income-generating process of the online publisher. In order to avoid such a result and to be able to shift income to a low-tax jurisdiction, online advertisers make sure that all contracts with advertisers are not signed in the advertisers’ jurisdiction but rather in a jurisdiction with a lower corporate tax rate. For a detailed discussion of the common online advertising international tax planning structure, see infra notes 625–640 and the accompanying text.


See DEPARTMENT OF THE TREASURY, OFFICE OF TAX POLICY, supra note 553, at 25.
In recent years, the volume of online activity has increased exponentially and with it the size of the online advertising market. Consequently, the online publishers were required to make greater investments in expanding their data centers and open new ones to support the growing demand. More servers and data centers mean that the online publisher needs more power, more cooling (to prevent servers from overheating), a better connection to the internet, tighter security etc. Finding a location that offers all prerequisite conditions—reliable source of energy, proper environment for a cooling facility, modern internet infrastructure, and a generally low security risk environment—means that the online publisher (as the owner and operator of the data center) is more dependable on, and receives more benefits from, the jurisdiction in which the data center is located than we had initially described. Thus, the location of the data center plays a more significant role in the income-producing process of the online publisher. These circumstances may justify prescribing some value to the location of the data center for purpose of determining the source of the online publisher’s income. This position is also supported by the OECD Commentaries, under which a server can be considered a “fixed place of business” for purpose of the PE definition, which can thus theoretically create a taxable presence for the online publisher in the jurisdiction in which the server is located (subject to all other requirements of the PE definition being met).

The two remaining factors—employees and users—are also essential to the business of online advertising, but unlike the previous two factors, the location of the employees and the users is of high relevance to the income-generating process. To better understand the importance of the location of these two factors it is helpful to go back to the fundamental definition of “source” as was introduced by the 1923 Double Taxation Report, as follows:

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619 See supra notes 144–152 and the accompanying text.

621 OECD Treaty Model, supra note 390, at C(5)-25, § 42.2.
“When we are speaking of the origin of the wealth, we refer naturally to the place where the wealth is produced, that is, to the community the economic life of which makes possible the yield or the acquisition of the wealth. The yield or acquisition is due, however, not only to the particular thing, but to the human relations which may help in creating the yield.”

Which are the communities the economic life of which make it possible for the online publishers to generate income? It seems abundantly clear that such communities are the ones where the employees and users are located.

The online publisher is highly dependent on recruiting quality professionals in a variety of fields of expertise that require significant academic education and training – software engineers and developers, data scientists, network engineers and more. The location of the online publisher’s offices and facilities, where such employees perform their work, is thus crucial in two aspects. First, the online publisher would likely be better off locating its offices in a jurisdiction with excellent higher education institutions, thus providing a larger pool of quality candidates for recruiting. Second, and maybe more important, the online publisher would prefer to locate its offices in a jurisdiction that is able to provide adequate services and a high standard of living, otherwise the online publisher would have difficulties recruiting highly-educated and qualified employees (for example, it is doubtful if Google would have been as successful had it been operating from Anchorage, Alaska rather than from Mountain View, California). In addition, the location of the offices of the online publisher can affect the level of services that the company itself would be able to receive, including, for example, legal and accounting services, municipal services, intellectual property protections etc., all of which have a significant effect on the ability of the company to generate income.

Finally, in the case of online advertising, the economic life of the community of the users is one of the most (if not the most) important factors in the revenue-generating process of the online publisher. This conclusion is based on two layers. First, the users are the ones actually generating the income for the online publisher by their actions. As explained, the advertiser has an obligation to pay for an ad and the online publisher recognizes income for that ad only once a

622 1923 Double Taxation Report, supra note 348, at 23 (emphasis added).
623 My apologies to the good people of Anchorage – no offense intended.
user views, clicks, or acts upon an ad. In that sense, the users are an integral and necessary part of the online publisher’s revenue-generating process. Second, the geographical location of the users and the fact that they are present within the borders of a specific jurisdiction, matter. Advertisers pay online publishers for the ability to target specific countries with specific advertisements based on the cultural background, consumption habits, and economic ability of the population in that country. Moreover, advertisers target specific groups within a given country, based on a variety of other criteria, including ones that are location-based. This is evidence that the location of users plays an extremely significant role in the revenue-generating process of the online publisher. When putting these two layers together—the crucial role of users in the production of income for the online publishers and the fact that the users are targeted based on their geographical location and other location-based criteria—it is clear why the location of the users plays such an important role in the revenue-generating process. It is the users lives, personal information, economic statues, and other personal traits—all of which exist and are continuously supported (at least in part) by the community and country in which the users live—that are the core assets and functions of the online advertising business. Therefore, if the source rules should follow and reflect the location of the economic activity that generates the income, then the location of the users should have a significant influence when determining the source of the income of the online publisher.

However, as we have seen in the previous chapter, applying the existing rules for determining the character and source of the income yield a result that is not aligned with the above conclusion. Although we reached a conclusion that the location of users should be a significant influencing factor in determining the source of income, it is not so under current U.S. federal income tax law and under current international tax norms. Despite being a key element in the income-generating process, and despite being one of the two components the location of which is of greater importance of such process, users and their location are not considered by existing tax laws or by any treaty as a factor that should affect the source of the income or as creating any kind of taxable presence for the online publisher.

See supra notes 326–328 and the accompanying text
9.1.2. The Consequence: Double Irish with a Dutch Sandwich

The failure to acknowledge the importance of the users to the online advertising business model means that the source rules fail to reflect the location of the economic activity that generates the income. This, in turn, creates a gap between the economics of the online advertising business and the manner in which the income from such business is taxed.

Online publishers take advantage of this disparity and of the fact that their income is not taxed by the jurisdiction where the users are located, and with some advanced tax planning they are able to shift that income to jurisdictions with low corporate tax rates, and pay even less tax by further reducing their taxable income in such jurisdictions. The main example of such tax planning is what is known as the “Double Irish Sandwich” technique, which is used (in various forms) by most major online advertisers. The technique has several components, and makes use of tax rules from multiple countries.

First, the online publisher’s U.S. parent company incorporates an Irish subsidiary (Subsidiary 1), which is entirely controlled and managed from a low-tax jurisdiction, such as Bermuda. Subsidiary 1 then incorporates another wholly-owned Irish subsidiary (Subsidiary 2), which is controlled and managed from Ireland. By incorporating these subsidiaries in the above manner the online publisher takes advantage of the discrepancy between the method of determining corporate tax residency under U.S. and Irish tax laws. Under the Code, corporations are treated as U.S. persons (and thus subject to U.S. tax) based on their place of incorporation. On the other hand, according to Irish law (as existed prior to the enactment of the Irish Finance Act 2014, which will be discussed below), a corporation is generally treated as an Irish resident for

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626 I.R.C. §§ 7701(a)(30)(C) and (4).
tax purposes if it is controlled and managed from Ireland, irrespective of its place of incorporation. 627 Thus, a company that was incorporated in Ireland but is entirely controlled and managed from outside Ireland is a tax resident of neither the U.S. nor Ireland, and it is therefore not subject to tax in either of these jurisdictions. This is what the online publisher achieves with respect to Subsidiary 1. That subsidiary, which is managed and controlled from Bermuda, is not considered to be a tax resident of either the U.S. or Ireland, or, as was aptly described by Senator Carl Levin during a U.S. Senate hearing on the issue of offshore profit shifting—“[m]agically, it is neither here nor there.” 628

In the next step, the U.S. parent company enters into a cost sharing agreement with Subsidiary 1 for the joint development of the online publisher’s intellectual property, which is in essence the entire online advertising software. Under such agreement, the rights to use the intangible property in the U.S. remain with the U.S. parent, but the rights with respect to the use of the intangible property outside the U.S. is granted to Subsidiary 1. Thereafter, Subsidiary 1 gives Subsidiary 2 a license to use the intangibles in return for royalty payments.

To minimize the online publisher’s tax liability in the jurisdictions where the advertisers are located, all advertising contracts are signed in Ireland with Subsidiary 2. 629 Therefore, all the revenues from all non-U.S. 630 advertisers are funneled to Ireland, 631 and the online publisher avoids having a taxable presence in any such other countries. In countries in which the online publisher is required to have employees to provide sales and marketing support services for the

628 US SENATE – PERMANENT SUBCOMMITTEE ON INVESTIGATIONS, supra note 286, at 3.
629 See U.K. PARLIAMENT, PUBLIC ACCOUNTS COMMITTEE, PUBLIC HEARING: TAX AVOIDANCE BY MULTINATIONAL COMPANIES – ORAL EVIDENCE, HC 716 questions 454 and 460 (2012), http://www.publications.parliament.uk/pa/cm201213/cmselect/cmpubacc/716/121112.htm (testimony of Mr. Matt Brittin, who at the time of the hearing was Google’s Vice President for Sales and Operations, Northern and Central Europe, who explained that “[e]verybody who buys advertising from Google—because that is how we make our money—buys advertising from Google in Ireland. That is in just the same way as any company can set up to trade within Europe”).
630 Google splits the non-U.S. revenues between its Irish subsidiary (which records the revenues from Europe, Middle-East, and Africa) and its Singaporean subsidiary (which records revenues from Asia-Pacific markets). For purposes of simplicity, we shall assume that the revenues of the online publisher in our example are all recorded in the Irish subsidiary.
631 See U.K. PARLIAMENT, PUBLIC ACCOUNTS COMMITTEE, supra note 629, at question 448 (testimony of Mr. Matt Brittin, who explained that “the vast majority of sales outside the U.S. will be billed in Google in Ireland.”)
local market, such activity is conducted via a local entity that receives a fee for its services (based on the cost-plus method) from Subsidiary 2.\textsuperscript{632} Such entity does not have the authority to sign contracts in the name of Subsidiary 2 (to avoid being considered an agent of Subsidiary 2 for PE purposes) and none of the online advertising revenue is recorded in such entity’s books (the revenue is recorded in Ireland with Subsidiary 2). As we know by now, there is no risk that the online publisher would be considered as having any taxable presence in a jurisdiction based on the location of the users, because the existing rules simply do not recognize that factor as creating any taxable presence or as sourcing the income to such jurisdiction. Therefore, the location of users is not a concern that the Double Irish Sandwich structure (or any other tax structure for that matter) is required to address, but it is a Gap in the tax rules that the Double Irish Sandwich scheme takes advantage of.

The result of the above is that all of the online publisher’s non-U.S. revenue is recorded by Subsidiary 2 in Ireland. Theoretically, such revenue, after taking into account relevant expenses, should have been taxed at the Irish corporate tax rate for “trading” income (generally meaning business income), which is currently 12.5%. Although this rate is currently the lowest corporate tax rate amongst all OECD countries\textsuperscript{633} and subjecting the online publisher’s income to such rate would have generated significant tax savings in and of itself (given that corporate tax rates in other countries are significantly higher), the Double Irish Sandwich technique allows the online publisher to further reduce its tax liability. This is accomplished via the royalty payments made by Subsidiary 2 to Subsidiary 1 for the right to use the intangible property. Such payments are allowed to Subsidiary 2 as a business expense and therefore significantly reduce the taxable income of Subsidiary 2 in Ireland. Consequently, only a small portion of the online publisher’s non-U.S. revenue would be subject to the already low Irish corporate tax rate of 12.5%,\textsuperscript{634} and

\textsuperscript{632} See PARLIAMENT OF AUSTRALIA, ECONOMICS REFERENCES COMMITTEE, PUBLIC HEARING: CORPORATE TAX AVOIDANCE 43 (2015) (Ms. Maile Carnegie, Managing Director at Google Australia, explained that “Google Australia gets revenue from two places. We get revenue from Google Inc. because of our R&D services, and we get revenue from Google Asia Pacific, based in Singapore, for our marketing and sales and service support that we give,” and further explaining that such revenues are based on a cost-plus basis).


\textsuperscript{634} It should be noted that certain companies pay even a lower tax rate based on special agreements signed with the Irish tax authorities that were intended to incentivize such companies to develop their operations in Ireland. A prime example is the agreement between Ireland and Apple, which was entered into in the

Continued on the next page...
the majority of the income would be shifted to Bermuda, where it would not be subject to any tax.  

Finally, in order to prevent the royalty income from being classified as Subpart F income and thus taxed in the U.S., the online publisher would make use of the check-the-box regulations that allow U.S. taxpayers to elect to treat certain entities as disregarded for U.S. federal income tax purposes. In this case, Subsidiary 2 would elect to be treated as a disregarded entity, the result of which is that Subsidiary 1 and Subsidiary 2 would be considered as one joint entity. Therefore, all royalty payments made from Subsidiary 2 to Subsidiary 1 are ignored for U.S. federal income tax purposes and are thus not considered Subpart F income.

An improvement to the Double Irish Sandwich technique that provides even more tax savings involves adding a Netherland-incorporated subsidiary, which gives this scheme its name—“Double Irish with a Dutch Sandwich.” The Dutch subsidiary, which could either be added between Subsidiary 1 and Subsidiary 2 or as a sister corporation to Subsidiary 2, is intended to

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1980s, under which Apple is subject to less than 2% corporate tax rate on its Irish revenues (see US SENATE – PERMANENT SUBCOMMITTEE ON INVESTIGATIONS, supra note 286, at 5). The agreement between Apple and the Irish government has been under investigation by the European Commission, which, in August 30, 2016 conclude that such agreement was illegal under the UE state aid rules, and required Ireland to recover unpaid taxes from Apple for the years 2003 to 2014 of up to €13 billion, plus interest (see European Commission, PRESS RELEASE DATABASE, STATE AID: IRELAND GAVE ILLEGAL TAX BENEFITS TO APPLE WORTH UP TO €13 BILLION (2016), http://europa.eu/rapid/press-release_IP-16-2923_en.htm (last visited Mar 12, 2017)). The decision was heavily criticized by U.S. government officials, whose main concern was that subjecting U.S. companies to higher taxes in Europe would generate enormous foreign tax credits and would deprive the U.S. government of significant amounts of tax once these earnings are repatriated back to the U.S (see Reuters, U.S. Treasury Accuses EU of Grabbing Tax Revenues With Apple Penalty, FORTUNE.COM, August 31, 2016, http://fortune.com/2016/08/31/u-s-treasury-accuses-eu-of-grabbing-tax-revenues-with-apple-penalty). Ireland and Apple have both submitted appeals to the General Court of the EU regarding the decision (see Ireland Department of Finance, PRESS RELEASE: IRELAND PUBLISHES LEGAL ARGUMENTS IN APPLE STATE AID CASE (2016), http://www.finance.gov.ie/news-centre/press-releases/ireland-publishes-legal-arguments-apple-state-aid-case; Julia Fioretti, Apple Appeals Against EU Tax Ruling, Brussels Says No Cause for Low Tax Bill, REUTERS.COM, December 19, 2016, http://www.reuters.com/article/us-eu-apple-taxavoidance-idUSKBN148007).


Treas. Reg. §§ 301.7701-1 through 301.7701-3.

Absent the check-the-box election for Subsidiary 2, the royalty payments would have been characterized as foreign personal holding company income (I.R.C. § 954(c)(1)(A)), which in turn is considered as foreign base company income (id. § 954(a)(1)), which is included in the definition of Subpart F income (id. § 952(a)(2)).
minimize the withholding taxes that could apply to the royalty payments made by Subsidiary 2 to Subsidiary 1. Under certain circumstances, such royalty payments could be subject to withholding tax in Ireland. To resolve this, Subsidiary 1 would license the intellectual property to the Dutch subsidiary which, in turn, would sublicense it to Subsidiary 2. Royalty payments made from Subsidiary 2 to the Dutch subsidiary would not be subject to withholding in Ireland because European Union (“EU”) law prohibits withholding tax on payments made between two corporations that are residents of EU countries. The Dutch tax that would apply to the Dutch subsidiary would be minimal because the royalties income would be offset by the payment of royalties to Subsidiary 1. Such up-stream payments would also be free of withholding tax in accordance with Dutch law. In order to complete the structure’s tax efficiency, the Dutch subsidiary would also make a check-the-box election to be treated as a disregarded entity for U.S. federal income tax purposes.

Making use of the Double Irish Sandwich tax planning technique has been known to save online publishers billions of dollars in taxes each year. These savings result from the ability of the

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638 See European Council, DIRECTIVE 2003/49/EC (A COMMON SYSTEM OF TAXATION APPLICABLE TO INTEREST AND ROYALTY PAYMENTS MADE BETWEEN ASSOCIATED COMPANIES OF DIFFERENT MEMBER STATES) (2003), http://eur-lex.europa.eu/eli/dir/2003/49/oj. Several years prior to the enactment of this directive it was argued that the directive would facilitate profit shifting by multinational corporation. See Frans Vanistendael, Impact of European Tax Law on Tax Treaties with Third Countries, 8 EC TAX REVIEW 163, 169 (1999). (stating that the enactment of the directive “will, of course, facilitate the tax life of many European multinational groups of enterprises, but the situation will become even better for enterprises having their headquarters in third countries and which do business in the European Union through subsidiaries. For interests and royalties of these companies from third countries, the European tax landscape becomes as flat as a snooker table on which the interest and royalty balls will roll freely from the table through the holes on its rim”). Vanistendael also predicted that the combination of zero withholding between EU members together with the fact that some EU members have no taxation at source or have zero withholding rate under tax treaties with non-EU members, will result in “interests and royalties [] flow[ing] from the European Union through the gates open via these tax routes” (id. at 169). That is exactly what happened, as in the case at hand.


online publishers to shift their income to a low corporate tax jurisdiction, and from their ability to shield such income from the hands of the U.S. CFC rules.

In 2014, as a result of global criticism for the use of the Double Irish Sandwich tax structure, including harsh criticism delivered by U.S. senators during a 2013 Senate hearing with respect to the use of such tax technique by Apple, Ireland made a significant legislative change to its corporate residency rules that would prevent companies from continuing to utilize the Double Irish Sandwich technique. Ireland’s new corporate residency rules state that, in addition to the management and control test, an Irish incorporated company will also be regarded as an Irish resident for tax purposes. The new corporate residency rule applies to any company incorporated in Ireland after January 1, 2015. Companies that were incorporated before that date are grandfathered from the application of the new rule, but such grandfathering would terminate on January 1, 2021 (or upon an earlier change of control of the company that results in a major change in the nature of the business of the company). The new legislative change would prevent online publishers (and other multinational corporations using the Double Irish Sandwich tax technique) from shifting income outside of Ireland and into the tax-haven island of their choice.

The Irish Government declared that this legislative change would bring an end to the Double Irish Sandwich tax technique. However, a closer look reveals that this is not entirely correct.

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644 Id.

645 See Full Text: Michael Noonan’s Budget 2015 Speech, The Irish Times, October 14, 2014, http://www.irishtimes.com/business/economy/full-text-michael-noonan-s-budget-2015-speech-1.1962981 (in his 2015 budget speech, Michael Noonan, Ireland’s Minister of Finance, stated that he is “abolishing the ability of companies to use the “Double Irish” by changing our residency rules to require all companies registered in Ireland to also be tax resident”).
As noted, the legislative change means that an Irish incorporated company that is managed and controlled outside Ireland would nonetheless be considered an Irish tax resident (meaning that the royalties received by Subsidiary 1 would be taxed in Ireland). However, if under the provisions of a tax treaty a corporation is treated as not being a resident of Ireland but rather a resident of the other contracting state, such rule prevails over the domestic Irish rule. Ireland has a vast network of income tax treaties. It so happens that Ireland has at least one treaty which uses the management-and-control test for determining corporate residency and that was entered into with an EU country that has a low corporate tax rate on royalties – that is the treaty between Ireland and Malta. Although Malta has a 35% corporate tax rate, foreign-incorporated companies that are managed and controlled in Malta are completely exempt from Maltese corporate tax on all royalty income, provided such income is from sources outside of Malta and is not received in Malta (i.e., in a Malta bank account). In addition, because Malta is a member of the EU, there is no withholding tax on royalty payments made from an Irish company to a Maltese company. Therefore, royalty income received by Subsidiary 1 (incorporated in Ireland and managed and controlled in Malta) from Subsidiary 2 would be tax free in both Ireland and Malta. Thus, it seems that the news of the death of the Double Irish Sandwich has been premature, and that online advertisers will be able to continue using this tax technique to avoid paying significant taxes where their income is economically generated.

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646 Ireland Tax Consolidation Act 1997 (as amended by subsequent Acts up to and including the Finance Act 2015), § 23A.
647 Article 4(3) of Ireland-Malta income tax treaty (Nov. 14, 2008) states that in the case that a corporation is considered as a resident of both contracting states under their respective domestic laws, such corporation is deemed to be the resident of the state in which the corporation’s place of effective management is located. Because Malta has a management-and-control corporate residency rule, if Subsidiary 1 were to be incorporate in Ireland but managed-and-controlled in Malta, then under Malta law and the treaty, the corporation would be considered as a Malta tax residence and not as an Irish one, circumventing the new place-of-incorporation Irish rule.
649 See European Council, supra note 638.
650 See Jeffrey L. Rubinger and Summer Ayers LePree, DEATH OF THE “DOUBLE IRISH DUTCH SANDWICH”? NOT SO FAST, BILZIN SUMBERG’S TAXES WITHOUT BORDERS (October 23, 2014) http://www.taxeswithoutbordersblog.com/2014/10/death-of-the-double-irish-dutch-sandwich-not-so-fast (describing how the Double Irish Sandwich technique would continue to be available even after the Irish legislative change, mentioning Malta and the United Arab Emirates as alternative jurisdictions to Bermuda). Additional

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That being said, even if the Irish legislation would have completely eliminated the ability of online publishers to take advantage of the Double Irish Sandwich technique, it would still not have changed the ability of the online publisher to shift all of its non-U.S. income to Ireland by making sure that all contracts with advertisers are signed in Ireland. The result of such income shifting, would mean that all of the online publisher’s non-U.S. income would be subject to tax in only one jurisdiction, which happens to have the lowest corporate tax rate amongst OECD countries (12.5%). This is a direct result from the fact that under existing international tax norms, the location of the users has no relevance in determining the tax liability of the online publisher. Had it been the case that the income was considered sourced to the jurisdictions of the users and the online advertising activity (of targeting users and “mining” their personal data) was considered as creating a taxable presence for such publishers in the jurisdictions of the users, then online publishers would not have been able to practice such tax “alchemy”\(^651\) and would not have been able to shift their income to Ireland, Bermuda or any other country because such income would have been taxed at the source.\(^652\)

The ability of the online publishers (and other multinationals) to avoid any kind of taxes at source and shift their income to low or zero tax jurisdictions has outraged governments around the world, as they see some of the largest multinational corporations getting richer and legally escaping paying taxes on income that they generate from such jurisdictions. In this context, Senator Carl Levin, during the 2013 Senate hearings on profit shifting, said (with respect to Apple’s ability to avoid paying U.S. and foreign taxes on its non-U.S. income) that:

“It is completely outrageous that Apple has not only dodged full payment of U.S. taxes, but it has managed to evade paying taxes around the world through its convoluted and pernicious strategies.”\(^653\)

\(^{651}\) As used by Senator Levin during the 2013 Senate hearing on profit shifting, supra note 628, at 3.

\(^{652}\) For a discussion about the enforcement and collection challenges arising from taxing the online publisher by the jurisdictions of the users, see chapter 10.2.5 below.

Senator Levin’s words express the thoughts and feelings of many legislators around the globe, more and more of which say that the ability of multinational corporations to avoid paying taxes in the jurisdiction in which they have significant economic activity is economically unjustified and socially unacceptable.  

Politicians are advocating for this argument not necessarily because this is the correct international tax policy, but mainly because profit shifting is depriving countries from billions of dollars of tax revenue with respect to income that originates from such countries, and no country likes to give up its rights to tax income at source.  

In addition to the understandable political argument, the fact that online publishers are able to generate income from advertising that is targeted to, and generated by, the human capital of countries without paying any taxes in such jurisdictions is a distorted result that ignores the underlying economic components of this business. This result completely disregards the fact that in the twenty-first century, personal data is like any other resource located within a country’s borders, and the exploitation and “mining” of such resource justifies the creation of a taxable nexus for the person receiving such income within the jurisdiction within which such person is “mining” personal information. We will further discuss this justification in the last chapter of the dissertation.

9.2. “Sources” of the Problem – Part I: Characterization and Source Rules

There are several reasons that could potentially explain why existing tax rules are doing such a bad job at sourcing and taxing income from online advertising. These reasons can be grouped into two major categories – (i) reasons relating to character and source rules, which are reviewed

654 See, e.g., Josh May, Theresa May Rails Against Tax Avoidance and Says Big Businesses “Need to Change,” POLITICSHOME.COM, July 11, 2016, https://www.politicshome.com/news/uk/political-parties/conservative-party/news/77180/theresa-may-rails-against-tax-avoidance-and (prior to her election as Prime Minister of the U.K., Theresa May said “[i]t doesn’t matter to me whether you’re Amazon, Google or Starbucks, you have a duty to put something back, you have a debt to fellow citizens and you have a responsibility to pay your taxes”); François Hollande Attacks US Tech Firms’ Tax Schemes, THE GUARDIAN, February 6, 2014, https://www.theguardian.com/world/2014/feb/06/francois-hollande-us-tech-firms-tax-schemes (citing the French President saying that the practice of income shifting around Europe by Silicon Valley companies is not acceptable).

655 See Helvering v. Stockholms Enskilda Bank, 293 U.S. 84, 89 (1934) (saying that “[t]he general object of this act is to put money into the federal treasury; and there is manifest in the reach of its many provisions an intention on the part of Congress to bring about a generous attainment of that object by imposing a tax upon pretty much every sort of income subject to the federal power. Plainly, the payment in question constitutes income derived from a source within the United States; and the natural aim of Congress would be to reach it” (emphasis added). This holding was later cited by the U.S. Supreme Court in the Wodehouse case, supra note 442, at 378.
and discussed in this part of the chapter, and (ii) reasons relating to the concept of jurisdiction to tax, which are explored in the next part.

This part of the chapter is further divided into three sections. The first section discusses the difficulties in determining the character of income in the digital economy. The second section argues that the fundamental concepts of source are based on archaic principles that have not evolved to suit the modern types of income. The third and final section discusses and analyzes the argument that there is no unifying concept of source and that the lack of such concept is one of the leading reasons for the inability of source rules to properly apply to digital types of income, including income from online advertising.

9.2.1. Classifying and Characterizing the Income

As explained in prior chapters, characterizing an item of income is a necessary step before the relevant source rule could be applied. However, the task of characterizing income has become increasingly more complicated as the level of global economic activity increased. As we have seen previously in this dissertation, this is not a unique problem of the twenty-first century. New types of transactions have been posing characterization challenges since the first half of the twentieth century. Cases like Wodehouse,\textsuperscript{656} Ingram,\textsuperscript{657} Karrer,\textsuperscript{658} and Boulez\textsuperscript{659} have all ended up in court because of difficulties in classifying certain types of income as being generated from a royalty, service and sale transaction. The common ground of all these cases is that they introduced new and unique features into classic transaction structures, and such features made it difficult to classify the income that arose from such transactions as belonging to one of the traditional types of income (for example, the lump sum upfront payment that Wodehouse received and his relinquishment of control over the intangible property did not squarely fit into the common format of a royalty transaction, as it was known in the 1940s). And then technology and innovation kicked in, and threw the traditional well-defined types of income completely out of balance. New technology created new characterization difficulties in two fronts – it allowed

\textsuperscript{656} See supra note 442.
\textsuperscript{657} See supra note 448.
\textsuperscript{658} See supra note 451.
\textsuperscript{659} See supra note 452.
for the expansion of globalization, cross-jurisdictional trade, and global mobility, and also created new spheres for trade and commerce to develop and new types of transactions to emerge.

In 1998, after nearly two decades of constant technological development and innovation during which software has become a booming industry, the IRS issued regulations that include rules with respect to classification of transactions involving computer programs.\textsuperscript{660} That was the first time that the IRS or Congress have issued any kind of guidance or legislation on the issue of characterizing income (let alone technology-based income) since the rules on re-characterizing certain service contracts as leases of property were enacted in 1984,\textsuperscript{661} and that was also the last time to date. This means that the last time the IRS and Congress addressed the issue of income characterization in a well-thought manner was nearly 2 decades ago. Just to put thing in perspective, in 1998 Google was first incorporated and Mark Zuckerberg, founder of Facebook, was 14 years old. Since 1998 the digital world has evolved in an unimaginable fashion – e-commerce, online payments, cloud service, digital currency, smart phones, and of course the unbelievable expansion of, and reliance of much of the internet on, online advertising. This technological revolution has created new types of businesses and new types of transaction models that generate income in novel and innovative ways. The Code, regulations and even case law, some of which is decades-old,\textsuperscript{662} simply fail when applied to such new types of income.

As we have seen in the previous chapter, the same applies when attempting to determine the character of income generated from online advertising. We saw that characterizing this type of income as being derived from one of the classic categories of income—services or royalties—creates significant difficulties because of the unique features of the business model of online advertising. This process is like forcing a square peg into a round hole – it is physically impossible, but if we push really hard we can force it in, but with significant collateral damage. In our context, that damage is in the form of the economically-distorted fashion in which income

\textsuperscript{660} T.D. 8785, 63 Fed. Reg. 52971 (10/2/98), as corrected by Ann. 98-109, 1998-2 C.B. 741 (12/14/98). The Regulations provide four possible classifications for software transactions: (i) transfer of a copyright right in computer program; (ii) transfer of a copy of computer program (a copyrighted article); (iii) provision of services for the development or modification of a computer program; or (iv) provision of know-how relating to computer programming techniques. The first two characterizations are further classified as either a sale or a license/lease. Treas. Reg. §§ 1.861-18(f)(1) and (2).


\textsuperscript{662} See, for example, the court holding in Piedras Negras, issued in 1942, supra note 500.
from online advertising is taxed, resulting in the ability of the online publisher to shift income and avoid paying tax at source, in complete contradiction to way the economics of online advertising work in reality.

What is the proper character of income from online advertising? Is it truly entirely active income in nature? Is this a kind of hybrid income that should be bifurcated and assigned different types of character to different portions of the income? Is there room to introduce new types of income, based on the ability to generate income across jurisdictions via the internet and to “mine” personal data across oceans and borders? Should the fact that users are the ones generating the income affect the character of it? All these questions deserve an answer, or at least a proper discussion. Such a discussion follows in the next chapter, but at this point it suffices to say that the existing types of income that are recognized by tax law are simply incapable of handling the new types of income created by the digital age, and that inability is one of the main reasons causing inadequate tax treatment for online publishers.

One commentator noted that “income characterization issues are likely to present some of the most intractable problems in creating a reasonable tax regime for electronic commerce.”

Surprisingly enough (or not), although these words were written twenty years ago they are still relevant today, but only to a much greater extent and effect.

9.2.2. Applying Old Rules to a New Economy

The concept of taxation at source is an old one. In England, taxation at source is traced back to the early sixteenths century. The first time the term “from sources within the United States” appeared in the Code (in the context of taxation of Foreign Persons) was the Revenue Act of 1916. Prior statutes also embodied the concept of source taxation, albeit without using the word ‘source’: the Revenue Act of 1909 levied a “special excise tax” on foreign corporations equal to 1% of the foreign corporation’s net income that is above $5,000 received from “business

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665 The Revenue Act of 1916, §§ 1(a) and 10, 39 Stat. 756.
transacted and capital invested” in the United States.\textsuperscript{666} The Revenue Act of 1913 included a similar version to the one included in the Revenue Act of 1909,\textsuperscript{667} and in addition levied a 1% tax of the net income from “all property owned and of every business, trade, or profession carried on in the United States” by nonresident aliens.\textsuperscript{668}

Although the Revenue Act of 1916 was the first act of legislation to include the specific terminology regarding income derived from sources within the U.S., that act did not include a comprehensive list of source rules to define what is the source of various types of income.\textsuperscript{669} The Revenue Act of 1918 expanded the list of examples that attempted to explain what type of income is considered “from sources within the United States” by adding dividends received from U.S. corporations and income from the manufacture and sale of goods within the U.S.\textsuperscript{670} The Revenue Act of 1921 was the first to introduce a more detailed list of source rules for interest, dividends, personal services, rents and royalties and gains from the sale of real property.\textsuperscript{671} The Revenue Act of 1921 included specific source rules explaining under what circumstances such types of income are to be treated as income from sources within the United States.\textsuperscript{672} The Internal Revenue Code of 1939 expanded that list of source rules\textsuperscript{673} and from that point in time

\textsuperscript{666} The Revenue Act of 1909, § 38, 36 Stat. 112 (emphasis added).
\textsuperscript{667} The Revenue Act of 1913, § II(G)(a), 38 Stat. 172.
\textsuperscript{668} The Revenue Act of 1913, § II(A)(1), 38 Stat. 166 (emphasis added). It appears that the change of approach in the Revenue Act of 1916 (abandoning the reference to property and business carried in the United States in favor of the broader “sources within the United States”) was intended to place the taxation of nonresident aliens on a stronger footing. It is contemplated that the practical reason for this change was to override two Attorney General opinions that held that based on the provisions of the Revenue Act of 1913, interest on bonds paid by a U.S. citizen or resident, and dividends paid by a U.S. corporation, are not subject to tax when received by a nonresident alien. See Richard R. Dailey, The Concept of the Source of Income, 15 Tax L. Rev. 415, n. 3 (1959).
\textsuperscript{669} The Revenue Act of 1916 included only an example with respect to interest income, saying that “…a like tax shall be levied, assessed, collected, and paid annually upon the entire net income received in the preceding calendar year from all sources within the United States by every individual, a nonresident alien, including interest on bonds, notes, or other interest-bearing obligations of residents, corporate or otherwise.” The Revenue Act of 1916, supra note 665, § 1(a) (emphasis added).
\textsuperscript{670} The Revenue Act of 1918, § 213(c), 40 Stat. 1057.
\textsuperscript{671} The Revenue Act of 1921, § 217, 42 Stat. 227.
\textsuperscript{672} Id.
\textsuperscript{673} Internal Revenue Code of 1939, § 119, 53 Stat. 1.
the list of source rules remained largely unchanged for nearly five decades even when the Code underwent a comprehensive overhaul and was renamed the Internal Revenue Code of 1954.\footnote{See Internal Revenue Code of 1954, Report of the Committee on Finance, United States Senate, 83rd Congress 2nd Session, Report No. 1622, at 416 (June 18, 1954) (saying that Section 861–864 of the Internal Revenue Code of 1954 correspond to Section 119 of the Internal Revenue Code of 1939 and that no substantial changes were made in these sections).} Why were there no major changes to the source rules during such a significant portion of the twentieth century? The answer is simple – when something is not broken there is no need to fix it. For the most part, the source rules did the job they were meant to do. The rules were enacted based on the old-world economy of classic interest, dividend, royalties, services and sales transactions. The source rules were added to the Code specifically to apply to these types of transactions and therefore the rules were able to provide adequate results in a predictable manner. And indeed, a comprehensive study of the source rules, conducted by the American Law Institute in the late 1970s, concluded that although a few tweaks can improve some imperfections, the source rules performed reasonably well.\footnote{See American Law Institute, Federal Income Tax Project: International Aspects of United States Income Taxation (Proposals of the American Law Institute on United States Taxation of Foreign Persons and of the Foreign Income of United States Persons) (1978), as cited by Michael J. Graetz, \textit{David R. Tillinghast Lecture: Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies}, 54 TAX LAW REVIEW 261, 317 (2000).}

In 1984 several changes were made to the source rules,\footnote{The Deficit Reduction Act of 1984 (Pub. L. 98-369) (the Act made changes to the source rules for purpose of limiting foreign tax credits (\textit{id.} §§ 121–22), added the source rule for transportation income (\textit{id.} § 124), and added rules with respect to the allocation of research and development expenses to income from U.S. sources (\textit{id.} § 126).} but it was the Tax Reform Act of 1986\footnote{Tax Reform Act of 1986, \textit{supra} note 611.} that introduced the most significant changes and additions to the source rules in several decades. Those changes, which were part of a complete revamp of the Code, included new source rules for income from sales of personal property, income from space and certain ocean activities, and international communications income. The changes to the rules also included amendments to the source rule for transportation income and to certain provisions related to the sourcing of interest income and more.\footnote{\textit{Id.} at §§ 1211–1216.} At that time, these changes, and especially the source rules for communications and space income, must have been considered as being in the forefront of tax law and represented the adaptation of the Code to income derived from modern forms of
technology. That being said, at the time of the writing of this dissertation more than thirty years have passed since the Tax Reform Act of 1986, and aside for several mostly non-substantial changes, the source rules have largely remained the same since. The new source rules of the Reform Act of 1986 might have been considered advanced at the time, but they were added to the Code several years before the internet was even developed, and thus the then-recently updated source rules were soon again trailing behind technology.

During the thirty years that passed since the last major update of the source rules, the world’s economy has shifted into high gear and experienced an exponential growth in cross-border trade and transactions, supported by technological innovations and the repaid expansion of the internet, and resulting in the creation of new types of transactions. Consequently, a gap was created and was constantly being widened between the traditional source rules and the modern income-producing activities (especially ones based on the digital economy) that such rules were supposed to apply to. The source rules were drafted in an era when physical location was a key factor in determining source and the location of services, sales, and persons was easily determinable. All of that has changed with the technological revolution. Income-producing activity was no longer bound to a single jurisdiction and could be conducted entirely in the virtual realm of the internet. Therefore, source rules have gradually become outdated, and in the absence of any significant updates they simply cannot properly apply to the economic realities that are created by modern types of transactions. Thus, applying the current source rules to the modern technology-based economic activity would be like forcing the rules into a Procrustean bed.

The fact that the source rules are outdated and cannot adequately apply to modern economic activity is not a new discovery. In fact, this problem was identified in 1997 by the Treasury White Paper, which was one of the first (if not the first) governmental documents addressing the

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679 One of the only material changes to the source rules since 1986 was made by the Small Business Jobs Act of 2010, which added the source rule for guarantee fees in I.R.C. § 861(a)(9) (supra note 467, § 2122).

680 See supra note 39 and the accompanying text.

681 The credit for this colorful yet very fitting metaphor goes to Walter Hellerstein, who used it to express a similar conclusion with respect to the application of state taxation to cloud computing. Walter Hellerstein, supra note 108, at 11.
challenges that tax systems are faced with in light of the digital economy. In this context, the Treasury White Paper noted:

“In the world of cyberspace, it is often difficult, if not impossible, to apply traditional source concepts to link an item of income with a specific geographical location. Therefore, source based taxation could lose its rationale and be rendered obsolete by electronic commerce.”

Despite the warning, which came from the U.S. Treasury Department itself nearly twenty years ago, nothing was done and the source rules remained unchanged while the technology locomotive continued to push through and to widen the gap further and further. Scholars have criticized the existing rules, members of Congress called for a reform of the rules, and even senior members of the business community (whose companies are able to generate significant profits based on the incompetence of the source rules) have admitted that the Code is simply outdated.

To conclude, the existing source rules are based on archaic principles that have not evolved to suit the modern types of income generated by the digital economy. Therefore, it is no surprise why the source rules are doing such a bad job at sourcing and taxing income from online advertising.

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682 DEPARTMENT OF THE TREASURY, OFFICE OF TAX POLICY, supra note 553, at 23.


685 See Testimony of Tim Cook, Apple’s CEO, US SENATE—PERMANENT SUBCOMMITTEE ON INVESTIGATIONS, supra note 286, at 37 (saying that “[u]nfortunately, the Tax Code has not kept up with the digital age.”)

686 The inability of traditional rules to appropriately apply to modern economic activities is not unique to tax law. Other fields of law also struggle with this problem. One of the most prominent examples is the law of intellectual property and the difficulties in applying it in the context of software. See Xuan-Thai Nguyen and Jeffrey A. Maine, supra note 153, at 8 (explaining that software does not fit comfortably into either of the established categories of protected intellectual property—copyright, patents, trade secrets—because software can contain both tangible and intangible elements and be subject to different protections under intellectual property law). See also Andrew Nieh, Software Wars: The Patent Menace, 55 N.Y.L. SCH. L.
9.2.3. Lack of a Unified Concept of Source

The lack of a unified concept of source is the last of the three factors explaining why source and character rules do such a poor job when applied to digital-based income. Although being last to be discussed, it is in fact the most important of the three and the one that has the most impact on the process of sourcing income. In a sense, we saved the best for last. Had there been a coherent legal concept of source that served as a backbone for interpreting and applying the source rules, the previously-mentioned causes of difficulties—the challenges of characterization and the fact that source rules are an archaic legal concept—could both have been overcome, and would not have posed a significant obstacle for the process of characterizing and sourcing new types of income.

The lack of a comprehensive concept of source has been a problem that courts and practitioners have had to deal with for many years, even before digital types of income emerged. As we have seen in previous chapters of this dissertation, when confronted with a new type of income for which a known character and source rule did not exist, courts had to apply the analogy method which, in the absence of a unified concept of source, had no theoretical bedrock to build on and therefore resulted in a variety of different holdings that were based mostly on the impression and discretion of the specific judge writing the court’s opinion. It was thus reasonably expected that sourcing new digital-based types of income would face the same problem, but only in a more meaningful way, given that the degree of resemblance between the digital-based income and the traditional types of income (i.e., the basis for the analogy) has only decreased. For example, this issue was flagged during the early days of the technological revolution in a study conducted by the American Law Institute regarding the international aspects of the U.S. income tax. The study noted that:

“A comprehensive rationale has never been presented for the source rules that now exist, either in the U.S. or elsewhere; and it is difficult, if not impossible, to articulate generally valid and neutral principles for assigning a geographical source to income. The process seems, however, to require a balancing of the

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687 See Wodehouse, Ingram, Karrer, and Boulez in supra notes 442, 448, 451 and 452, respectively.
strength of conflicting claims and considerations as they apply to particular types of income.”

Could one take the position that a comprehensive rational for the source rules was in fact in place since the early days of source taxation, and such rational is that the income should be sourced to the “the community the economic life of which makes possible the yield or the acquisition of the wealth,” as determined by the 1923 Double Taxation Report, meaning, in short, that the source rules should be looking for the origin of the yield of the income? The principle of economic origin of the income is indeed the bedrock on which source taxation has developed and such proposition should serve as one of the concepts that underlie the source rules. And indeed, the location of the economic activity generating the income has been cited in the past as one of the concepts that should be applied in formulating source rules. However, this underlying concept may be too amorphous to serve as the sole concept for source taxation. Finding the economic origin of income has proven to be a difficult task in practice, and in the absence of additional principles to provide guidance, we end up back in square one – having no practical concepts to look to when drafting and interpreting source rules. The difficulty in finding the economic origin of income was noted by Professor Seligman, who wrote in his 1928 book (which reviewed the 1923 Double Taxation Report and the 1925 Technical Experts Report) that:

“The problem of the situs of the property is difficult enough; that of the origin of the yield of the income is vastly more difficult.”

Seligman attributes significant parts of the difficulty to the complexities of the concept of income, and also to the development of the modern corporation that “produces a large part of the earnings and profits of modern life.” Seligman then provides the following example to illustrate the difficulty in determining the origin of the income:

“The whole income of an individual may be derived from corporate securities kept in one country, the dividends of which are distributed from the home office
in a second country, while the business of the corporation, whose capital is almost entirely owned in a third country, may be carried on in a fourth country, and the profits may be derived from the sale of commodities produced in a fifth country, the sales being made to individuals in half a dozen other countries. In which of all these different countries is the income earned? What is the place of origin of the income?693

The fact that this example has the same merit today as it did in 1928 demonstrates that not much progress has been made since the early days of source taxation in establishing a unified concept of source that can help determine and interpret the source rules. The difficulty of prescribing a geographical location to the economic origin of income, as described by Seligman, has been and still is a concrete problem when attempting to apply the “economic origin” as the underlying principle of source rules.

The lack of a unified concept of source resulted in an assortment of source rules in the Code, many of which came into fruition as a result of different agendas and purposes and were drafted based on a variety of underlying principles and policy considerations. Consequently, many of the source rules currently in the Code and Treasury regulations do not seek to locate the true economic source of the income and certainly do not form a harmonized body of rules that can provide a substantive basis for courts (and practitioners) to rely on when determining the source of new types of income. In the following sections I review several of the source rules currently included in the Code and Treasury regulations and show how the piecemeal approach taken by U.S. legislators with respect to source rules in the past several decades created a myriad of rules that have little in common, that lead in many cases to economically-skewed results, and are certainly not based on a unified concept of source.

9.2.3.1. Re-sourcing Interest and Dividend Income

The first example focuses on the source rules for interest and dividend income. The basic rule for both these passive types of income is similar – income is generally sourced in accordance with the place of incorporation of the person making the payment (the obligor in case if interest and

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693 Id. at 30–31.
the company in the case of dividends). These rules ignore certain factors that can potentially represent (in a varying degree) other economic origins of the income. For example, for purpose of determining the source of interest income the rule does not take into account the place of payment, the source of the funds used to make the payment, the location of the funds used to pay the debt, the residency of the paying agent, or the location of any security for the debt or of the debt itself (if in bearer form). Further, the general source rule for dividend income ignores the source of the earnings used by the corporation to pay the dividends.

The source rules for interest and dividend income effectively reject a flow-through approach to sourcing, and determine the source based on the location of the payor. When the payor is a legal entity, its location is subject to manipulation (especially in today’s global economy) and when the “source” of income can be so easily controlled it is doubtful that the source rules point to the true economic source of the income. While other source rules point to a location where an actual economic activity takes place (sale, use of property, provision of service), it is difficult to see how source rules based on the place of incorporation of the payor could yield an economically-sound result. This argument is especially true with respect to dividend income. A corporation is nothing but a legal construct that provides certain protections to its shareholders. The distribution of dividends is simply a mechanism for passing previously-earned funds from the entity to its owners. No economic activity happens when dividends are distributed, and such payment creates no added value. The value was already created when the corporation generated the income. The fact that such event lacks any economic significant is supported by the existence of flow-through

694 See I.R.C. §§ 861(a)(1) and 862(a)(1) for interest income, and I.R.C. §§ 861(a)(2) and 862(a)(2) for dividend income.
695 See Treas. Reg. § 1.861-2(a)(3) and A.C. Monk & Co., Inc. v. Comr., 10 T.C. 77, 82–83 (1948) (interest payments made by a U.S. corporation to a Chinese sales agent is from U.S. sources, irrespective of the fact that the payment was made from the U.S. corporation’s bank account in China and that the funds in the account originated from the U.S. corporation’s sales in China).
696 See A.C. Monk & Co., Inc. v. Comr., id.
697 See Rev. Rul. 66-32, 1966-1 C.B. 174 (1966) (interest payments made by the German government to U.S. persons for damages sustained during World War I were held to be from sources without the United States, despite the fact that the funds used to make such payments were held in special deposit accounts with the United States Treasury).
698 See Rev. Rul. 71-516, 1971-2 C.B. 264 (1971) (the place of payment or the nationality of the paying agent is not determinative).
699 See Appeal of Estate of McKinnon, 6 B.T.A. 412, 415 (1927) (interest paid by a nonresident obligor to a nonresident obligee under bearer bonds that were held within the United States as security was treated as income from sources without the United States).
entities, such as partnerships, that require their owners (partners) to include in income their distributive share of the entity’s income, the character and source of which pass through to the partners. The need to determine the source of dividend income is simply a result of the dual-level taxation of corporations (compared to the single-level tax of flow-through entities), and the artificial barrier put in place between shareholders and the earnings of the corporation is nothing but a legal structure that creates no economic value. Therefore, determining the source of dividend income based on the place of incorporation of the paying corporation is bound to generate a non-economic source rule.

That being said, the source rules for interest and dividend income also recognize that in certain circumstances the economic reality behind these types of income is not adequately represented by the basic residency rule. In this context the rules offer a set of re-sourcing exceptions. As discussed below, although at first these re-sourcing rules seem to be a proper way of locating the economic source of the income, the rules are in fact one-sided and they ignore the economic reality when the result shifts income away from the U.S.

The Code includes special rules for re-sourcing interest and dividend income that would have been considered foreign source income under the general rules but are in fact derived primarily from U.S. sources. With respect to interest income, the Code provides that interest paid by a foreign corporation engaged in a trade or business in the United States during the taxable year in which the interest is paid, or that has income that is treated as effectively connected with a U.S. trade or business during that year, will be U.S. sourced. A similar rule exists for dividend income – when at least 25% of a foreign corporation’s income is effectively connected with a U.S. trade or business (for the 3-year period ending with the close of such corporation’s taxable year preceding the declaration of the dividends), a portion of the dividends paid by the foreign corporation would be considered U.S.-source income, subject to certain exceptions (the

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700 See I.R.C. § 702(b) and Treas. Reg. § 1.702-1(b).

701 The common legal theory for justifying sourcing dividend income to the jurisdiction of incorporation says that the corporation derives its legal capacity from the jurisdiction in which it incorporated, and therefore the dividends should be attributed to that jurisdiction (See American Law Institute FEDERAL INCOME TAX PROJECT: INTERNATIONAL ASPECTS OF UNITED STATES INCOME TAXATION (1978), as cited by Joel D. Kuntz, Robert J. Peroni, U.S. INTERNATIONAL TAXATION, ¶ A2.03[3][a] (Westlaw, 2016)). This explanation has become more difficult to support in the globalized economy, where corporation can easily be incorporation around the globe, even online with a click of button.

percentage of U.S.-source income is equal to the same ratio that the corporation’s income that is effectively connected with a U.S. trade or business bears to the corporation’s total gross income).

Another re-sourcing rule exists under the foreign tax credit provisions of the Code. In order to prevent taxpayers from artificially increasing their foreign tax credit by channeling U.S.-sourced income through a U.S.-owned foreign corporation (thus converting what would have been a U.S.-source income into foreign-source income), Section 904(h) treats certain types of income, derived from U.S.-owned foreign corporations, as from U.S. sources (for foreign tax credit purposes) despite the fact that under the regular rules this income would have been foreign-sourced. This provision applies to certain types of income received from a foreign corporation in which 50% or more of the voting power or value is held (directly or indirectly) by U.S. Persons. This re-sourcing provision applies to Subpart F income, passive foreign investment income, interest income and dividend income. The rule converts such foreign-source income into U.S.-source income to the extent such amounts are attributable to income of the U.S.-owned foreign corporation from sources within the U.S.

According to the above re-sourcing rules, when interest and dividends are paid with earnings that are economically connected to the U.S. to a significant extent, the payments of such interest and dividends, even though technically paid by a foreign corporation, are re-sourced to be treated as

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703 Id. § 861(a)(2)(B). See also Forres v. C.I.R., 25 B.T.A. 154 (1932) (which includes the earliest application of the rule, which in its prior version included a threshold of 50% of gross income from U.S. sources (Sections 213 and 217(a)(2)(B) of the Revenue Act of 1921 and 1924). In Forres, the corporation was incorporated, controlled, and located in England, the stock certificates were located in England, the funds from which the dividends were paid were kept in England, and the payments were made in England. However, more than 50% of the gross income from which the dividends were paid came from U.S. sources. The court concluded that “these extreme conditions” do not remove the income “beyond the taxing jurisdiction of the United States as a sovereign” and noted that the language of the rule is unambiguous (id. at 161). See also Ross v. C.I.R., 44 B.T.A. 1, 13 (1941) (followed Forres and held that dividends received by a Canadian citizen, who had no nexus with the U.S., from a Canadian corporation, more than 50% of the gross income of which was from U.S. sources, was subject to U.S. tax).

704 I.R.C. § 904(h)(6).

705 Income received from passive foreign investment companies with respect to which the taxpayer has made a Qualified Electing Fund election. Id. § 1293.

706 Id. § 904(h)(1)–(4).

707 Id. The re-sourcing rule of Section 904(h) includes a de-minimis exception under which payments of interest and dividend made by a U.S.-owned foreign corporation would not be subject to the rule if during the relevant tax year less than 10% of such corporation’s income was derived from U.S. sources. Id. § 904(h)(5).
being from U.S. sources. On the face of it, this seem like a good example of rules that aim to locate the true economic source of the income and prevent taxpayers from taking advantage of formalistic rules in a way that does no coincide with the economic reality. However, one cannot ignore the fact that these rules are entirely one-sided. The rules only apply to income that is foreign and re-source it to be treated as U.S.-source income. The Code (currently) does not include an equivalent rule that re-sources income from U.S. sources as being from foreign sources. However, even that is subject to certain exceptions, as explained below.

Under former I.R.C. §§ 861(a)(1) and 862(a)(1), as were in effect until December 31, 2010, interest received from a U.S. corporation at least 80% of the gross income of which (during the relevant testing period)\(^{708}\) was derived from the active conduct of a trade or business in a foreign country (or possession of the U.S.) (an “80/20 Corporation”) was considered foreign source income (the “80/20 Rule”). When the 80% test was met all interest received from such corporation was re-sourced as foreign-source income, and not just the relative portion of the income.\(^{709}\) The Code did not include a comparable re-sourcing rule for dividends paid by a domestic corporation which originated primarily from foreign-source income of the paying corporation. However, until December 31, 2010, the Code did include a rule under which a portion of the dividends paid by an 80/20 Corporation to a Foreign Person was exempt from the 30% tax on FDAP income.\(^{710}\) I.e., although the income was still considered U.S.-sourced, it was exempt from withholding at source. The portion of exempt dividend income was equal to the ratio between the 80/20 Corporation’s foreign-source income and its total world-wide income.

Repeal of the 80/20 Rules, with respect to both interest and dividends, was originally suggested by the Obama Administration’s budget proposal for 2010, explaining that the 80/20 Rules are subject to manipulation and thus should be repealed.\(^{711}\) The 80/20 Rules were ultimately repealed

\(^{708}\) The testing period was the three-year period that ended with the close of the taxable year of the 80/20 Corporation immediately preceding the payment. *Id.* § 861(c)(1)(C) (2010).

\(^{709}\) However, the ‘relative-portion’ rule did apply when interest was paid between related parties. *Id.* § 861(c)(2) (2010).

\(^{710}\) *Id.* §§ 871(i) and 881(d). The 80/20 Rule did not apply where the income was not FDAP but rather effectively connected to the Foreign Person’s U.S. trade or business.

a year later by the Education, Jobs and Medicaid Assistance Act of 2010.\footnote{P.L. 111-226, § 217 (2010). See also JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN THE 111TH CONGRESS 451–454 (2011), https://www.jct.gov/publications.html?func=startdown&id=3777.} However, the said Act also included a grandfathering rule under which interest and dividend payments made by an Existing 80/20 Corporation\footnote{As defined in P.L. 111-226, § 217(b) (2010), currently in I.R.C. § 871(l)(1)(A).} is exempt from the 30% tax on FDAP income to the extent of the Existing 80/20 Corporation’s active foreign business percentage\footnote{I.R.C. § 871(i)(2)(B).} (which is equal to the percentage of the company’s foreign active income out of its global income).\footnote{Id. § 871(l)(2).}

As these last few paragraphs demonstrate, the re-sourcing rules in the Code are far from a unified body of rules that represents a coherent theory seeking to source income in accordance with its economic origin. The rules are partial and one-sided; there are grandfathering rules that apply only to a specified group of taxpayers; some of the rules re-source only a relevant portion of the income while other rules apply to the entirety of the income, with no clear economic rational to support it. In addition, even the foreign tax credit re-sourcing rule discussed above was not added to the Code with the intent of strengthening the economic rational of source rules, but rather it was added to serve as an anti-avoidance measure, to ensure that taxpayers are not “gaming the system” and artificially increasing their foreign tax credits.

Finally, it should be noted that the provisions that re-source dividends paid by a foreign corporation as being partly from U.S. sources could also be considered as a violation of international law. Such provisions effectively cause foreign shareholders of foreign corporations to become subject to U.S. tax jurisdiction even though such foreign shareholders may not have any nexus with the U.S. – neither by way of territoriality nor nationality. Such provisions have thus been criticized as being contradictory to the recognized principles of jurisdiction under international law.\footnote{See RUTSELSILVESTRE J. MARTHA, THE JURISDICTION TO TAX IN INTERNATIONAL LAW: THEORY AND PRACTICE OF LEGISLATIVE FISCAL JURISDICTION 162 (1989).} Although the U.S. Supreme Court has held that imposition of taxes in the
absence of jurisdiction is void, later decisions by the U.S. Board of Tax Appeals have ignored the jurisdictional issue and applied the re-sourcing provisions.

9.2.3.2. Income from the Provision of Services

The second stop in our journey through the economics of source rules (or lack thereof) takes us to income from the provision of personal services. Such income is generally sourced based on the place of performance or delivery of the services. Given that the performance of the services is considered the factor generating the income, sourcing the income to the location where the services are provided has economic rational. In addition, case law and Treasury Regulations make it clear that the source of income from personal services is not affected by other factors, such as residence or nationality of the payor or payee, the place in which the contract for service was made, or the place or time of payment, all of which do not point to the true economic source of the income.

When personal services are rendered partly within and partly without the U.S. the Code requires that the income from such services be treated as being partly from sources within and partly from sources without the U.S. Treasury Regulations require that the income be apportioned (to U.S. and non-U.S. sources) on the basis that “most correctly reflects the proper source of the income under the facts and circumstances of the particular case.” The only additional guidance provided by regulations is included in the statement that “[i]n many cases, the facts and circumstances will be such that an apportionment on the time basis … will be acceptable.”

See City of St. Louis v. Wiggins Ferry Co., 78 U.S. 423, 430 (1870) (“Where there is jurisdiction neither as to person nor property, the imposition of a tax would be ultra vires and void”). See Forbes and Ross, supra note 703. Cf. the dissenting opinion in Ross, arguing that the Board has improperly ignored the jurisdictional question.

I.R.C. §§ 861(a)(3) and 862(a)(3).

See Dillin v. Comm’r of Internal Revenue, 56 T.C. 228, 244 (1971) (“The source of income is determined by the situs of the services rendered, not by the location of the payor, the residence of the taxpayer, the place of contracting, or the place of payment”); Roerich v. C.I.R., 38 B.T.A. 567, 583 (1938), aff’d sub nom. Roerich v. Helvering, 115 F.2d 39 (D.C. Cir. 1940) (the IRS argued that payments made by the U.S. Government to a nonresident alien for personal services performed in Asia were “necessarily from sources within the United States.” The U.S. Board of Tax Appeals rejected the argument by saying that “is without force against the unambiguous language of the controlling statute”); and Treas. Reg. § 1.861-4(a)(1).

I.R.C. §§ 863(b)(1) and (3).


Id. at § 1.861-4(b)(1)(i). The regulations make this assertion with respect to services provided by individuals and non-individuals alike. Id. §§ 1.861-4(b)(1)(i) and 1.861-4(b)(2)(i).
the context of individuals the regulations explain that applying time basis apportionment means dividing the income to U.S. and non-U.S. sources in the same ratio that the days spent by the individual performing the service in the U.S. bear to the total number of days spent performing the service (within and without the U.S.). It seems clear that this explanation would apply also to corporations, whose income from service would be apportioned based on the time of such corporations’ employees performing the services.

Thus far these source rules and regulations seem to have economic rational and they would be expected to perform well in sourcing service income in an economically sound manner. However, the lack of a unified concept of source creates challenges when corporations provide services using technology. In the digital age it is possible for a service provider to have all of its employees (developers, engineers, service and sales representative) be located within a single jurisdiction, yet provide services to persons in other jurisdictions. In that case, employees spend all of their time in the same jurisdiction, and it is rather the technological means that cross jurisdictional lines and allow companies to provide services to foreign persons. The time basis apportionment of service income is clearly not applicable to services that are rendered in another jurisdiction solely by computer systems. Treasury regulations do not provide any guidance as to how income should be apportioned in such a scenario (other than sending the taxpayer to apply the ambiguous “facts and circumstances” test), and we are left only to guess how a court would apply the apportioning rules to this type of income (not to mention the fact that the lack of guidance and an underlying unified concept of source, creates a slew of practical problems for taxpayers and their professional advisors that encounter this issue).725

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725 The IRS has issued proposed regulations that, when finalized, would add a new “event basis” rule for the apportioning of compensation received for the performance of labor or personal services at a specific event (REG-114125-07, 72 Fed. Reg. 58787 (Oct. 17, 2007)). Under the proposed regulations, which are intended to apply mainly to artists and athletes that are employees, compensation attributed to the labor or personal services performed at a specific event will be sourced to the location of that event (Prop. Treas. Reg. §§ 1.861-4(b)(2)(ii)(G) and (c) examples 7 to 10). While the preamble makes it clear that the IRS intended for these proposed regulations to apply to artists and athletes, the rule is not exclusive and will apply to other persons. Therefore, the rule could provide some rational basis for apportioning income from the provision of online services. For example, one could treat the usage and access of the online services by out-of-jurisdiction customers as an “event” and apportion the income from such services accordingly. This, Continued on the next page...
9.2.3.3. Transportation Income

Next we review the economic rational of the source rule for income generated from transportation activity. Until 1986, income received from transportation between the U.S. and a foreign country was classified as either rental or services, and the source of the income was determined accordingly. If the income was characterized as being from rental activity it was considered foreign source income to the extent allocable to periods during which the vessel was outside the territorial borders of the United States.\footnote{JOINT COMMITTEE ON TAXATION, supra note 612, at 924–25.} If the income was characterized as services it was considered foreign source income based on the percentage of expenses incurred outside the U.S. out of the total expenses incurred for the voyage.\footnote{Id. at 924–25.} The result of these rules was that for voyages connecting the U.S. and a foreign country, most of the income was treated as foreign source (because most of the route, and thus also most of the expense, was outside U.S. territorial borders). Congress believed such a result is inappropriate because it increases taxpayers’ foreign tax credit limitation with respect to income most of which does not have nexus with a foreign country.\footnote{JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984 371 (1985).}

Therefore, Congress changed the source rule for transportation income and based it entirely on the start and end point of the journey (i.e., Congress took out of the equation any time/expenses spent on or above the high-seas or foreign jurisdictions). Under the existing rule, if either the start or end point of the journey is within the U.S., 50% of the income is considered U.S.-source

\footnote{\textit{\textsuperscript{726}} \textit{\textsuperscript{727}} \textit{\textsuperscript{728}}}
If both the start and end point are within the U.S., all the income is sourced to the U.S. The legislative history provides further explanation for the reason behind the change. The Joint Committee on Taxation report states as follows:

“Consistent with its general reevaluation of prior law’s source rules, Congress generally did not believe that U.S. persons should be allowed to generate foreign source income (or loss) unless the income (or loss) is generated within a foreign country’s tax jurisdiction and subject to foreign tax. Congress believed that the United States has the right to assert primary tax jurisdiction over income earned by its residents that is not within any other country’s tax jurisdiction. (Prior law’s treatment of this income as foreign source had the effect of relinquishing primary tax jurisdiction over a substantial amount of this income).”

The above language shows that one of the main reasons for changing the source rule for transportation income was Congress’ intent not to “leave any tax money on the table.” The second reason was the concern that taxpayers with transportation income would have an inflated foreign tax credit limitation. Meaning that the change in this source rule came to fruition because of an interest to protect and increase the U.S. tax base. While the revised 50-50% rule may achieve this goal, it does so at the cost of creating a completely arbitrary result that lacks an economic rational. It is true that an economic analysis of cross-jurisdiction transportation income may have resulted in a similar rule, but the fact is that such an analysis was never conducted and was not part of the process of replacing the source rule. Such analysis could have considered, for example, whether other jurisdictions (in addition to the ones where the journey begins and ends) should be allocated part of the income because they provide safe passage through their territorial

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729 I.R.C. § 863(c)(2). Note that the effect of this source rule is somewhat limited given the exemption included in I.R.C. §§ 872(b)(1), (2) and 883(a)(1), (2). According to this exemption, income derived by a Foreign Person from the international operation of ships or aircrafts is generally exempt from tax in the U.S. (even if the income is sourced to the U.S. under the 50-50% rule) if the foreign jurisdiction of which the Foreign Person is a resident provides a reciprocal exemption for U.S. residents (and other conditions are met). In addition, many tax treaties provide a similar exemption under the “Business Profits” or “Shipping and Air Transport” articles.

730 Id. § 863(c)(1). The source rule for journeys between two U.S. ports was introduced by the Deficit Reduction Act of 1984, and was intended to bring under U.S. taxation the full income of persons transporting crude oil from Alaska to the West Coast of the U.S. See JOINT COMMITTEE ON TAXATION, supra note 728, at 371.

731 See JOINT COMMITTEE ON TAXATION, supra note 612, at 926–27 (emphasis added).
air space (which in this day and age is not something to be taken for granted) as well as professional air traffic control services that allow a flight to safely reach its destination. Again, an economic analysis (which I do not attempt to undertake here) that would have taken these factors into consideration might have concluded that when taking global transportation traffic into account, the claims of the pass-through jurisdictions is globally off-set against the claims of the start and end point jurisdictions (given that most countries are likely included in both groups) and thus allocating the income only to the start and end jurisdictions does not undermine the economic rational of the 50-50% rule which is also easier to administer. However, such an analysis was not conducted and thus we are left with a seemingly arbitrary rule.

9.2.3.4. Income from Communication Activities

The source rule for income received from communication activities is another excellent example that shows the lack of a unified concept of source. The unique feature that makes this source rule interesting is the fact that the rule actually includes two rules that provide an entirely different outcome based on the taxpayer’s residency. Note that this is not a residency-based source rule of the type we have discussed before – i.e., it is not a rule that sources the income to the jurisdiction of which the payor is a resident (as in the case of dividend or interest income). The source rule for income from communication activities relies on the residency of the recipient of the income, not the payor of the income.

International communications income, to which the rule applies, is defined as all the income derived from the transmission of communications or data from the U.S. to any foreign country (or possession of the U.S.) or from any foreign country (or possession of the U.S.) to the U.S.732 The source rule for such income is bifurcated as follows: (i) international communications income that is derived by a U.S. Person (including a CFC) is sourced 50% within the U.S. and 50% outside the U.S.;733 and (ii) international communications income that is derived by a Foreign Person (not including a CFC) is sourced entirely outside the U.S.734 However, if international communications income is attributable to an office or a fixed place of business that

732 I.R.C. § 863(e)(2).
733 Id. § 863(e)(1)(A); Treas. Reg. § 1.863-9(b)(1).
734 I.R.C. § 863(e)(1)(B)(i); Treas. Reg. §§ 1.863-9(b)(2)(i) and (ii).
the Foreign Person maintains in the U.S. (or to a U.S. trade or business engaged by the Foreign Person), that income will be sourced entirely to the U.S.\textsuperscript{735}

This bifurcated source rule begs the question – how can the same activity be sourced to different jurisdictions simply because the recipient of the income is a resident of a different country? Consider the following scenario – person A, located in the United States, decides to make a phone call to his friend, person B, who lives in Spain. To do so, person A makes use of Voice Over IP software that is owned and operated by a U.S. company. Under the rule described above, the income received by such U.S. company from person A would be considered as being 50% from U.S. sources and 50% from non-U.S. sources. Now, imagine person A making the exact same call, but this time deciding to use another software, that provides the exact same service, but is operated by a Swedish company (that does not have any offices or business in the U.S.). Same transaction, same people, same equipment, but an entirely different sourcing result. It is evident that economic analysis of the source of the income was not the main driver behind the enactment of this source rule.

The source rule for income from communication activities was one of the source rules that were introduced by the Tax Reform Act of 1986.\textsuperscript{736} The formal and clear purpose of the rule was to prevent foreign tax credit manipulation and improper inflation of the foreign tax credit limitation.\textsuperscript{737} Namely, Congress sought to assert tax jurisdiction (with respect to U.S. Persons) over income that was generated not within the jurisdiction of any foreign country which, prior to the enactment of the 1986 source rules, was considered from foreign source and allowed U.S. Persons to offset their U.S. taxes.\textsuperscript{738} Congress recognized there is a possibility that a foreign jurisdiction would tax international communications income (unlike in the case of income from

\textsuperscript{735} I.R.C. § 863(e)(1)(B)(ii); Treas. Reg. §§ 1.863-9(b)(2)(iii) and (iv). Income derived from U.S. communications activities (i.e., communications between two points within the U.S. or from a point in the U.S. to a point in space or international waters) is sourced entirely to the U.S. (\textit{id.} §§ 1.863-9(h)(3)(iii) and 1.863-9(c)). Income derived from foreign communications activity (i.e., communications between two points outside the U.S., or between a foreign country and a point in space or international waters) is sourced entirely outside the U.S. (\textit{id.} §§ 1.863-9(h)(3)(iv) and 1.863-9(d)). Income from space or ocean communications activity (i.e., between two points in space or in international waters) is sourced under the rule applicable to income from space and ocean activities (\textit{id.} §§ 1.863-9(h)(3)(v) and 1.863-9(e)).

\textsuperscript{736} Supra note 611, § 1213(a).

\textsuperscript{737} See \textsc{Joint Committee on Taxation, supra} note 612, at 933.

\textsuperscript{738} \textit{Id.} at 933.
space and ocean activities, as discussed below), and therefore asserted partial jurisdiction over such income by splitting the source of the income in half – 50% within the U.S. and 50% without. 739

In addition to the fact that the agenda behind the source rule was entirely focused on bolstering anti-abuse measures with respect to the foreign tax credit (to protect the U.S. tax base) and lacked any additional economic consideration with respect to the actual source of the income (i.e., the jurisdiction in which the income was generated, irrespective of the residency of the taxpayer), one should also note the complete arbitrariness of the 50-50% split and the unfounded asymmetry between the rule that applies to U.S. Persons and that which applies to Foreign Persons. For some reason, which is not explained in the legislative history, Congress believed that it would be justifiable for a foreign country to tax no more than 50% of a U.S. Person’s international communications income, regardless of whether such U.S. Person had a business presence in such jurisdiction. On the other hand, Congress believed that all of the international communications income received by a Foreign Person that is attributable to such person’s U.S. trade or business (or fixed place of business) should be U.S.-sourced. The asymmetry in this rule is clear, and it is not supported by any coherent economic rational.

One interesting aspect arising from the analysis of the source rule for international communication income is the fact the rule (as implemented by the Treasury Regulations) recognizes the possibility for a Foreign Person to be engaged in U.S. trade or business and generate U.S.-source income without having any fixed place of business in the U.S. Although not included in the Code, the U.S. Treasury Department and the IRS added this exception to the regulations based on their interpretation of Congress’ intent. According to the regulatory history, the IRS was concerned that a Foreign Person could engage in significant communications activity in the United States without having a fixed place of business, and the IRS believed that Congress intended that such Foreign Persons, engaged in substantial business in the U.S., would be subject to U.S. tax on their income from such international communication activity. 740

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739 Id. at 934.
This is a unique concept that goes against the existing case law interpretation of the term “U.S. trade or business.”\textsuperscript{741} As discussed earlier in this dissertation, when seeking to determine whether a Foreign Person has a U.S. trade or business, case law and IRS holdings focus on the nature and degree of activity that such person has \textit{within} the U.S. The source rule for international communications income reaches beyond those traditional interpretations to recognize the possibility that a foreign person could generate business income from within the U.S. without having any presence (or at least without having a fixed presence) within the U.S. This distinguishing feature of this source rule may be the harbinger for more expansive regulations that would eventually adapt the source rules to the digital age. That being said, it is worth noting that the Treasury regulations regarding the source rule for international communication income were promulgated in 2006, whilst the source rule itself was added to the code two decades earlier, in 1986. This gap in time between the original enactment and the interpreting regulations could raise a question regarding the legitimacy of the expansive regulatory interpretation, which was clearly looking to address situations that were not technologically available at the time when the legislator added the source rule to the Code. Can the regulator provide expansive interpretation for old rules in order to make them applicable to the modern economy? Should such broad interpretation be held to be overreaching and improper, or should it be upheld because it brings economic rational into a set of rules that lack it? Albeit interesting, we shall leave these questions unanswered, as they are, unfortunately, beyond the scope of this dissertation.

\textbf{9.2.3.5. Income from Space and Ocean Activities}

The final source rule that we will discuss in this context is the rule for income from space and ocean activities. As with the source rule for income from international communication activities, the underlying concept behind the source rule for income from space and ocean activities was to limit the ability of taxpayers to inflate and manipulate foreign tax credits limitations.

Prior to the enactment of the source rule for income from space and ocean activities (which was introduced by the Tax Reform Act of 1986), the source of such income was determined based on the type of activity performed is such locations. For example, personal service income was

\footnote{\textit{See supra} notes 545–552.}
generally sourced to the location in which the services were performed, and manufacturing income was generally sourced to the location of the manufacturing activity. Such activities, when taking place in space or on the high-seas, were conducted outside the territorial boundaries of the United States and therefore the predominant portion of the income was treated as foreign source income.\textsuperscript{742} Congress believed that other countries had no apparent right to tax (and in fact did not tax) income derived from space and ocean activities because such activities, by nature, take place outside the taxing jurisdiction of any and all other countries.\textsuperscript{743} Therefore, Congress believed that the rules allowed U.S. Persons with income from space and ocean activities to inappropriately inflate their foreign tax credit limitation despite such income not being subject to tax in any foreign country (or even being within the tax jurisdiction of any such foreign country).\textsuperscript{744}

The result was a special rule that sources income from space and ocean activities\textsuperscript{745} to the jurisdiction of which the taxpayer is a resident. If the income is derived by a U.S. Person (including a CFC), the entire income is generally determined to be from U.S. sources.\textsuperscript{746} If the income is derived by a Foreign Person (other than a CFC), the income is generally sourced outside the U.S.\textsuperscript{747}

There are two interesting observations to make with respect to this source rule. First, the rule applies to all activities that take place in a specific location. This source rule is not limited to a specific kind of activity or type of payment (as is the case of all other source rules). Any type of

\textsuperscript{742} JOINT COMMITTEE ON TAXATION, supra note 612, at 932.
\textsuperscript{743} Id. at 933.
\textsuperscript{744} Id.
\textsuperscript{745} The term “space or ocean activity” includes (i) any activity conducted in space, and (ii) any activity conducted on or under water not within the jurisdiction (as recognized by the United States) of a foreign country, possession of the United States, or the United States (including Antarctica). I.R.C. § 863(d)(2)(A). The Code and Treasury Regulations do not include a definition of the term “ocean,” but based on the definition of the term “ocean activity” it can be understood that “ocean” means the area on or under water not within the jurisdiction (as recognized by the United States) of a foreign country, possession of the United States, or the United States. Such areas are referred to by the regulations as “international water”. Treas. Reg. § 1.863-8(d)(1)(ii). The term “space” is residually defined as “any area not within the jurisdiction (as recognized by the United States) of a foreign country, possession of the United States, or the United States, and not in international water. Id. § 1.863-8(d)(1)(i).
\textsuperscript{746} I.R.C. § 863(d)(1)(A); Treas. Reg. §§ 1.863-8(b)(1) and (2)(ii). However, if the income derived by a U.S. person (or a CFC) is attributable to functions performed, resources employed, or risks assumed in a foreign country, such income will be from sources outside the U.S. Id. § 1.863-8(b)(1).
\textsuperscript{747} I.R.C. § 863(d)(1)(B); Treas. Reg. § 1.863-8(b)(2). If the Foreign Person has a trade or business in the U.S. and the income is attributable to functions performed, resources employed, or risks assumed within the U.S., such income is from U.S. sources. Id. § 1.863-8(b)(2)(iii).
activity that takes place in space or the high-seas will be subject to this rule.\textsuperscript{748} The activity does not have to be space or ocean-related in its essence. Second, this source rule is the only one that results in active business income being sourced based on the residency jurisdiction of the taxpayer. The result is that no Foreign Persons would be subject to tax in the U.S. for any income from space and ocean activities (because such income would be non-U.S.-source income for such Foreign Persons).\textsuperscript{749} Given that U.S. taxpayers are subject to tax on their worldwide income, such taxpayers were subject to tax on their space and ocean income even before the change that was made to the source rule. Thus, the only effect this rule has on U.S. taxpayers is to limit their foreign tax credit limitation.

The source rule for income from space and ocean activity is yet another example of a rule that was enacted predominantly to address issues of foreign tax credit limitations. Given the relative ease in which corporations today can change their tax residency (by reincorporating in different jurisdiction, taking advantage of residency rules in tax treaties or using the check-the-box regulations), it seems that the source of income from space and ocean activities can be easily controlled and manipulated by taxpayers. That alone shows that the source rule for such income is lacking a sound economic basis, because it cannot be the case that the true source of the income could be changed simply by obtaining a certificate of incorporation from another jurisdiction, even if no change has been made to the actual activity that generates the income.

The only other source rules that source income based on the residence jurisdiction of the taxpayer are the rules for capital gains\textsuperscript{750} and notional principal contracts.\textsuperscript{751} According to the U.S. Treasury Department, the rationale for sourcing such items of income to the residence of the taxpayer is that “the country of residence represents the location where the economic activity that produces the income occurs.”\textsuperscript{752}

Three types of activities are exempt from the space and ocean activities source rule (because they are subject to other specific rules): (i) transportation income; (ii) international communication income; and (iii) natural resources activity within the U.S., any foreign country or any U.S. possession. I.R.C. § 863(d)(2)(B); Treas. Reg. § 1.863-8(d)(3).

\textsuperscript{748} Subject to the functions, resources and risks exception in Treas. Reg. § 1.863-8(b)(2).

\textsuperscript{749} I.R.C. § 865(a).

\textsuperscript{750} Treas. Reg. § 1.863-7(b)(1).

\textsuperscript{751} DEPARTMENT OF THE TREASURY, OFFICE OF TAX POLICY, supra note 553, at 22.

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On the other hand, one could argue that this rule (as modified by the functions, resources and risks exception) provides the economically correct source of the income because the country of residence (or the country in which the functions performed, resources employed and risks assumed with respect to the income) is the only jurisdiction that provides any actual benefits to the taxpayer and with which the income has any nexus (even though such nexus may be very weak). The activity itself takes place in a location that is by definition, and also under international law, not within the jurisdiction of any country. The jurisdiction of residence is the only one involved in the process of generating the income.

Finally, before we conclude this review of the economic rational of the source rules (or lack thereof), it is worth mentioning that in 1996 another residency-based source rule was proposed by the U.S. Department of Treasury in its discussion paper on the tax aspects of e-commerce. This proposal was likely influenced by the fact that the majority of companies that generated income via e-commerce activities at that time were residents of the U.S. (and the problem of income shifting was at its infancy). Although the U.S. Treasury Department acknowledged the difficulties in applying traditional source concepts to income from electronic commerce activities, it provided no real discussion about the economic rationale that supports residence-based taxation for income from electronic commerce.

Although there are interesting economic arguments to be made regarding the true source of income from space and ocean activities, the fact is that no such arguments or discussions were included as part of the legislative process of enacting the source rule for such income. As noted, this rule was enacted as an anti-avoidance measure to curtail improper inflation of the foreign tax credit limitation. Had there been any kind of unitary concept of source under U.S. tax law, the legislator, at the very least, would have at least had to address that concept when enacting new source rules, especially rules such as the one for income from space and ocean activities, which creates unique challenges to the traditional concept of source.

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753 See discussion below under part 9.3.2 of this chapter.
755 Id. at 22–23. For arguments regarding the continued validity of source taxation in the digital age, see, e.g., Joseph L. Andrus, supra note 663; David L. Forst, The Continuing Vitality of Source Based Taxation in the Electronic Age, 15 TAX NOTES INT. 1455 (1997).
As the above review of the various source rules demonstrates, many of the rules were not enacted with the goal of finding the economic source of the income, and the operation of the rules do not necessarily reflect the economic reality of the transaction from which the income is derived. Some of the rules are partial and one-sided, some were enacted for purpose of preventing abuse of the foreign tax credit, and some are simply arbitrary. When viewed together, as a single body of law, it is evident that the rules lack a coherent unified concept of source.

Legislative and administrative processes to amend and adjust the source rules, in order to provide adequate rules for new types of income, are generally extremely slow and in the context of source rules practically do not exist. Neither Congress nor the IRS have the flexibility (due to political and administrative reasons) to provide quick amendments to the Code and Treasury Regulations in a way that will provide clearer characterization and source rules for new types of income that the digital market is creating.

One would hope that in such a case the analogy method would be able to fill in the gap and provide a practical tool to courts for sourcing new types of income. Unfortunately, the lack of a shared foundation for all source rules makes applying the analogy method very difficult. As was well-explained by Edward Kleinbard, “[r]easoning by analogy is a potent tool when applied to incremental variations on a familiar theme, but it fails miserably when applied to genuine innovations.” When confronted with the need to determine the source of a new type of income, a court will compare the transaction that generates the income to the pool of existing types of income, and will look for similarities and comparable features in order to apply the relevant source rule. That approach works well when the new type of income is only slightly different from the existing types of income, because the analysis has numerous shared features to rely on, resulting in an analogy that has significant basis for reference and comparison. When the new type of income is novel and incomparable to the traditional types of income, the analogy analysis has nothing to “attach to” and is simply rendered useless. In that case, a unified concept of source could have helped the analogy method by providing basic principles that could be used

as an “anchor” for the analysis, even when the new type of income had no similarities with the existing types of income. Because such unified concept of source does not exist, when the analogy method is confronted with new types of income emerging from the digital economy (which can hardly be described as “incremental variations” of existing types of income) it ‘miserably fails’ to yield economically sound results.

In summary, this chapter attempted to explain why existing tax rules are doing such a poor job at sourcing and taxing income from online advertising. The first set of reasons, which we have explored above, relate to character and source rules. Among these reasons we found that existing rules encounter difficulties in determining the character of new types of income, the fundamental concepts of source are based on archaic principles that have not evolved to suit the modern types of income and, finally, that there is no unifying concept of source that could have served as a foundation for proper sourcing of digital types of income. Next, we tackle the issue of jurisdiction to tax.

9.3. “Sources” of the Problem – Part II: Jurisdiction to Tax

In the final part of this chapter we delve into one of the most fundamental concepts in international taxation—jurisdiction to tax—and we explore some of the problems and challenges that arise when such concept is faced with the changes brought by technology and the digital economy. As we will see, the results of the confrontation between the digital economy and the concept of jurisdiction to tax is helpful in explaining some aspects of the inadequate and non-economic results of the taxation of online advertising under the existing rules and norms.

This part if the chapter is divided into five sections. The first section discusses the important role that territoriality had in shaping the concept of jurisdiction in international law. Based on this discussion, the second section takes us on a short detour to explore territorial issues related to the international law that applies to space and the high seas. A review of these special regimes serves as a helpful background for the third section, which discusses the interplay between the concept of territorial-based jurisdiction (including jurisdiction to tax) and cyberspace. The final two sections of this part bring this chapter to a close by identifying and discussing several issues related to the concept of jurisdiction that provide additional explanation as to why current international tax norms do such a poor job at taxing income from online advertising.
9.3.1. Territory and Jurisdiction

International law is based on the concept of state, which in turn is based on the concept of sovereignty, which, in its turn, is founded upon the existence of territory. Without territory there cannot be a state. The concept of sovereignty is not to be confused with jurisdiction. While sovereignty generally refers to a “legal personality of a certain kind, that of statehood,” jurisdiction refers to the rights, liberties and powers of such state.

The basic concept of jurisdiction, as it is used in international law, is defined as “the power of the state under international law to regulate or otherwise impact upon people, property and circumstances and reflects the basic principles of state sovereignty, equality of states and non-interference in domestic affairs.” Most scholars in the field of international law treat jurisdiction as a multi-aspect notion but some disagree as to the proper division of the concept to its sub-categories and the scope of such categories. That being said, most scholars identify three categories of jurisdiction – legislative, executive and judicial. Legislative jurisdiction (also known as prescriptive jurisdiction) refers to the competence of the state, under international law, to prescribe laws within its territory. Such aspect of jurisdiction includes the power of the state to levy taxes upon persons that are not within the territory of the state, provided there is some connection between the state and the person being subject to tax, be it based on territoriality or nationality. Executive jurisdiction refers to the power of the state to act within the territory of another state. Because of the separate sovereignty of states, it follows that a state’s officers can only act within their own state’s territory. Finally, judicial jurisdiction refers to the power of the state’s courts to adjudicate on matters or with respect to people that are foreign to the state.

As the definitions above demonstrate, the concept of jurisdiction is, in its essence, defined and limited by the geographic territories of the states, and states may not exercise jurisdiction (of any...
form) outside their respective territories in the absence of a permissive rule under international law.\footnote{James Crawford, supra note 760, at 456. Territoriality also has a prevalent role in private international law. \textit{Id.} at 474 (explaining that the “territoriality principle in private international law is likewise pervasive, notably in common law systems where the presence of a defendant within the jurisdiction is sufficient to ground the court’s adjudicative power”).}

The key role that territoriality had taken in international law and in the forming of the concept of jurisdiction could be traced back to the Peace of Westphalia in 1648, that ended the Thirty Years’ War and the Eighty Years’ War in Europe by a series of peace treaties that recognized the sovereignty of the European princes in their respective territories. Territorial sovereignty has been a pillar of international law ever since.\footnote{Mark W. Janis, \textit{An Introduction to International Law} 318 (4th ed. 2003).} The importance of territoriality in defining the concepts of sovereignty and jurisdiction was firmly acknowledged under U.S. law in the seminal opinion of Chief Justice John Marshall in the case of \textit{The Schooner Exchange v. McFaddon}, where Justice Marshall said that “[t]he jurisdiction of the nation within its own territory is necessarily exclusive and absolute”\footnote{The Schooner Exch. v. McFaddon, 11 U.S. 116, 136 (1812).} and any exception to “the full and complete power of a nation within its territories, must be traced up to the consent of the nation itself. They can flow from no other legitimate source.”\footnote{Id.}

While Jurisdiction is primarily territorial and has originally developed based on the concept of territoriality, there are other criteria for jurisdiction,\footnote{Malcolm N. Shaw, supra note 758, at 646.} most of which have developed during the twentieth century. Such other bases for jurisdiction include: (i) nationality (also known as the “active personality principle”) – a state may have extra-territorial jurisdiction over persons (individuals and entities) based on their nationality; based on this criteria the U.S. has exercised jurisdiction to tax its citizens on a global basis;\footnote{See Mark W. Janis, supra note 768, at 320; see also Cook v. Tait, 265 U.S. 47, 56 (1924) (holding that “the government, by its very nature, benefits the citizen and his property wherever found, and therefore has the power [to tax the citizen and its property]”). See also \textit{Restatement (Fourth) of Foreign Relations Law: Jurisdiction}, § 214 TD No 2 (2016).} (ii) the effects principle – a state has extra-territorial jurisdiction over conduct that has a substantial effect within the territory of the state;\footnote{Mark W. Janis, supra note 768, at 322. See also \textit{Restatement (Fourth) of Foreign Relations Law: Jurisdiction}, supra note 772 at § 213 TD No 2.} (iii) the protective principle – a state has power to enact laws with respect to extra-territorial

\footnote{See Mark W. Janis, supra note 768, at 320; see also Cook v. Tait, 265 U.S. 47, 56 (1924) (holding that “the government, by its very nature, benefits the citizen and his property wherever found, and therefore has the power [to tax the citizen and its property]”). See also \textit{Restatement (Fourth) of Foreign Relations Law: Jurisdiction}, § 214 TD No 2 (2016).}
activity that is aimed against crucial interest of the state;\textsuperscript{774} (iv) the universality principle – based on moral and public policy grounds, a state has jurisdiction over persons who have committed crimes against humanity;\textsuperscript{775} and (v) the passive personality principle – a state has jurisdiction over non-citizens when their actions effect persons with respect to which the state asserts jurisdiction (even if such actions do not affect the territory of the state).\textsuperscript{776} Although international law allows states to exercise jurisdiction based on these non-territorial criteria, the general rule is that such forms of jurisdiction is defined and limited by territorial rights.\textsuperscript{777}

We see from the above review that the concept of jurisdiction is closely tied to and limited by territoriality. Although economic, political and technological changes (such as the globalized economy, the reach of international organizations and the development of the laws of the sea and space) have challenged the territorial exclusivity of states and created more modern bases for jurisdiction, territorial sovereignty nevertheless remains a significant concept in international law,\textsuperscript{778} and territoriality remains a core concept of jurisdiction under international law.

\subsection*{9.3.2. A Short Detour – Territorial Jurisdiction over the High Seas and Outer Space}

The next step, in the context of this dissertation, would be to examine the interplay between the concept of territorial-based jurisdiction and online activity that takes place in the territory-less realm of cyberspace. However, prior to that discussion, it is worth making a short detour to review how the concept of jurisdiction had evolved in the past when it encountered other domains of trade that also had unique traits of territoriality (or lack thereof), such as the oceans and outer space. A discussion of the territorial jurisdiction issues that arise with respect to these

\textsuperscript{774} \textsc{Mark W. Janis}, supra note 768, at 325. \textit{See also} \textsc{Restatement (Fourth) of Foreign Relations Law: Jurisdiction}, supra note 772 at § 216 TD No 2.

\textsuperscript{775} \textsc{Restatement (Fourth) of Foreign Relations Law: Jurisdiction}, supra note 772 at § 217 TD No 2.

\textsuperscript{776} \textsc{Mark W. Janis}, supra note 768, at 325. \textit{See also} \textsc{Restatement (Fourth) of Foreign Relations Law: Jurisdiction}, supra note 772 at § 215 TD No 2.

\textsuperscript{777} \textit{See} Banković et al. v. Belgium et al., European Court of Human Rights, Application no. 52207/99, at section 59 (2001) (ECLI:CE:ECHR:2001:1212DEC005220799), available at http://hudoc.echr.coe.int/eng# (“itemid”:[“001-22099”]) (stating that “…from the standpoint of public international law, the jurisdictional competence of a State is primarily territorial. While international law does not exclude a State’s exercise of jurisdiction extra-territorially, the suggested bases of such jurisdiction (including nationality, flag, diplomatic and consular relations, effect, protection, passive personality and universality) are, as a general rule, defined and limited by the sovereign territorial rights of the other relevant States”) (emphases added).

\textsuperscript{778} \textsc{Malcolm N. Shaw}, supra note 758, at 488.
domains will serve as helpful background to the discussion of the interaction between territorial jurisdiction (and jurisdiction to tax) and the digital economy.

International law divides the physical world into three types of territorial regimes. First are the areas subject to the territorial sovereignty of states. Second, are areas that as a legal matter could be subject to territorial sovereignty of a state, but have not yet been placed under such sovereignty (also known as res nullis). The third category includes territories that as a legal matter cannot be placed under the territorial sovereignty of any state (also known as res communis, which stands for “things common to mankind”).\textsuperscript{779} \textit{Res communis} includes, for example, the high seas and outer space.\textsuperscript{780}

The territorial claim of the sea is based on the territorial claim on the adjacent land.\textsuperscript{781} Although the Portuguese during the seventeenth century claimed significant parts of the high seas as being part of the Portuguese territory, such position was countered by Grotius (considered to be one of the founding fathers of international law), who claimed that the high seas are \textit{res communis} and cannot be appropriated to any given nation.\textsuperscript{782} The latter position prevailed and later became part of customary international law.\textsuperscript{783} However, the geographical point that marked the start of the high seas was always in flux, as nations attempted to increase their territorial reach into the seas.\textsuperscript{784} Historically, the part of the sea that was considered to be within the territory of the coastal state (i.e., the territorial waters) was determined based on the point up to which the state could exert its military control from the shore, yet as military technology evolved the part of the sea subject to the territorial claims of the states extended even further.\textsuperscript{785}

\textsuperscript{779} A fourth type of territorial regime which is less common today is that of territories that possess an independent status but are not states and are not subject to the sovereignty of any other state. Such was the case for trust territories administered under the League of Nations Mandate following World War I, in accordance with Article 22 of the Covenant of the League of Nations. \textit{See The Covenant of the League of Nations (Including Amendments Adopted To December, 1924), http://avalon.law.yale.edu/20th_century/leagcov.asp.}

\textsuperscript{780} JAMES CRAWFORD, supra note 760, at 203; MALCOLM N. SHAW, supra note 758, at 492.

\textsuperscript{781} MALCOLM N. SHAW, supra note 758, at 553.

\textsuperscript{782} Id. at 553–54.

\textsuperscript{783} Id. at 554.

\textsuperscript{784} Id.

\textsuperscript{785} Id.
In the middle of the twentieth century, after hundreds of years during which the law of the sea had evolved to become an established part of customary international law, a series of international conferences were held, which eventually led to the signing of four conventions on the law of the sea in 1958\(^{786}\) that had set the foundation for the adoption of the 1982 convention on the Law of the Sea under the auspices of the United Nations.\(^{787}\) The U.N. Convention on the Law of the Sea is, to this day, the main agreement governing the international law of the sea. The U.N. Convention on the Law of the Sea defined the territorial waters as generally reaching 12 nautical miles from the shore.\(^{788}\)

Apart from the territorial waters, over which states can exercise complete territorial sovereignty, there are three areas of the seas that received special treatment in the U.N. Convention on the Law of the Sea with respect to the scope of jurisdiction and sovereignty rights granted to states in such areas. The first is the high seas, which is defined as “all parts of the sea that are not included in the exclusive economic zone, in the territorial sea or in the internal waters of a State…”\(^{789}\) The U.N. Convention on the Law of the Sea reflects the customary international law with respect to the high seas by saying that no state can acquire sovereignty over the such area.\(^{790}\) The second special regime applies to the international seabed. In 1970, the UN General Assembly adopted a declaration proclaiming the seabed, the ocean floor and any resources thereof, as common heritage of mankind \((\textit{res communis})\) and thus beyond the limits of any national jurisdiction.\(^{791}\) The U.N. Convention on the Law of the Sea further developed the international regime for exploration and exploitation of natural resources in the seabed. Most notably, the convention established the International Seabed Authority that would govern the exploitation of such natural resources.


\(^{788}\) \textit{Id.} at Article 3. The convention also recognizes the Contiguous Zone (extending 12 nautical miles past the territorial waters), the Exclusive Economic Zone (extending 200 nautical miles past the territorial waters), and the Continental Shelf (extending past the Exclusive Economic Zone), with respect to which the respective state has various rights and interests. However, no state has full territorial sovereignty over any of these areas.

\(^{789}\) \textit{Id.} at Article 86.

\(^{790}\) \textit{Id.} at Article 89.

resources and would share the benefits from such resources based on equitable criteria. The third special regime applies to the continental shelf. States have sovereign rights over the continental shelf adjacent to their territorial waters only for purpose of exploiting the natural resources therein, and they may not exert territorial sovereignty over such area.

Finally, it should be noted that in addition to the territorial waters, the only other aspect of maritime trade with respect to which states have territorial sovereignty are ships. Under international law, a nationality of a ship is determined based on the country the flag of which the ship is flying. Such country generally has full jurisdiction over the ship. However, when a ship enters a port, the ship generally owes temporary allegiance to the local sovereign, which thus has jurisdiction over the ship during that time.

The law of outer space has a much shorter history, for obvious reasons. A country has jurisdiction over the air space that is above its “earthly” territories. Similar treatment for outer space was not possible, because it would have required any country that has a satellite orbiting the earth to request permission from all countries above which the satellite was passing, which would have been an extremely cumbersome process. Therefore, countries have agreed to apply the principle of res communis to outer space, such that no country may assert its sovereignty on any portion of outer space.

This understanding was embodied in several United Nations resolutions and treaties. Similar to the concept that applies to ships, objects launched into outer space

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793 MALCOLM N. SHAW, supra note 758, at 588. Where the continental shelf of a given coastal state exceeds the customary 200 nautical mile line, the state must make payments to the International Seabed Authority for the exploitation of the non-living natural resources beyond that line. Such payments are to be shared by the International Seabed Authority amongst the states based on equitable criteria, taking into account the needs of developing countries and especially developing countries that are also landlocked. Id. at 590.
794 JAMES CRAWFORD, supra note 760, at 464.
795 Id. at 464.
797 MALCOLM N. SHAW, supra note 758, at 543.
798 Id. at 544.

Continued on the next page...
space that are included within a registry of a certain country are subject to the jurisdiction of that country.  

As we see from the above review, cyberspace was not the first domain that would not easily surrender to territorial claims and territorial sovereignty. In the case of the oceans and outer space, the ultimate result (i.e., parts of, or all of, such areas being excluded from territorial jurisdiction of any state) was not necessarily due to the lack of human aspiration. During the course of history, kings, rulers and states desired and attempted to expand their territorial reach. More territory means expanded sovereignty, which in turn means jurisdiction to tax more people and more economic activity. The fact that during the seventeenth century the Portuguese claimed significant parts of the high seas as being part of their territory proves just that. Would the international law of the seas have ended up different had the Portuguese, or any subsequent other maritime empire, owned technology that would have enabled it to successfully exert jurisdiction over the high seas? Such a scenario is not entirely unreasonable, especially when considering the historical track record of territorial expansions. It seems that states were willing to forego the ability to claim territorial sovereignty over the high seas and space because at the time that these respective legal regimes were developed no state possessed the ability to actually control such vast parts of the earth in order to claim territorial sovereignty over it.

But such hypotheticals are beside the point. The fact that no state can claim territorial sovereignty over the high seas and outer space meant that no state could exercise jurisdiction to tax over such areas. That means that the concept of taxation at source is irrelevant for income derived from such areas, because no state could claim that the income is sourced within its own territorial jurisdiction. Therefore, determining the source of such income is also generally irrelevant, except for states that also apply a nationality-based jurisdiction-to-tax principle and provide their citizens / residents with a foreign tax credit regime. In that case, determining the source of the income is relevant, but only for purposes of preventing improper inflation of the foreign tax credit limitation. As discussed earlier in this chapter, that was indeed the motivation

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Treaty on Principles Governing the Activities of States in the Exploration and Use of Outer Space, including the Moon and Other Celestial Bodies, id. at Article VIII.
behind the enactment of the source rule for ocean and space activity in 1986.\textsuperscript{801} Thus, we are left with two significant parts of the earth—space and the high seas—where source-based taxation is by and large irrelevant.

\textbf{9.3.3. Jurisdiction in the Age of Cyberspace}

Does the concept of jurisdiction (and specifically jurisdiction to tax) faces the same challenges and difficulties with respect to cyberspace as it did with respect to the high seas and space? If so, does that mean that a similar non-territorial fate awaits cyberspace, and is this a sign for the upcoming demise of source-based taxation?

A comparison of cyberspace with the high seas and space shows that cyberspace has unique features that make it an even more problematic candidate for territorial-based jurisdiction. The main issue with cyberspace is the lack of a physical fingerprint. Although the high seas and space are treacherous territories that humanity had, and still has, difficulties conquering, both refer to places on and around earth that are identifiable. An activity that takes place on the high seas or at space could be assigned a specific location. As discussed earlier, had history taken a different turn, both the high seas and space could have been subject to the territorial sovereignty of certain states (and assuming that international law is not set in stone, that could still be the case in the future). Exerting territorial jurisdiction over such places is conceptually possible, albeit practically difficult. That is not the case with respect to cyberspace.

Cyberspace has no physical location and does not exist in the physical world. Therefore, as a conceptual matter, no state can have any territorial claim over online activities. In addition, unlike the high seas and outer space, the fact that cyberspace does not exist in the real world means that it has no boundaries and thus has unlimited “space” to expand to.\textsuperscript{802} In such a case, even if technology would enable states to claim sovereignty over specific “parts” of cyberspace, such claim would be meaningless because any online activity that took place in such parts could

\begin{footnotesize}
\begin{enumerate}
\item See part 9.2.3.5 of this chapter.
\item Although outer space is to some extent unlimited in the same manner, a certain location in space is not necessarily equal to another location. The old real-estate saying of “location, location, location” will also likely be true if and when humanity inhabits space. That is not the case in cyberspace, where there is only one infinite space, where all players enjoy the exact same benefits and the existence of one player does not preclude any other player from enjoying the exact same benefits. That is the nature of a space that does not exist in the real world.
\end{enumerate}
\end{footnotesize}
simply “relocate” to a different “part” of cyberspace.\textsuperscript{803} Although this is a somewhat absurd scenario, it simply shows how the application of traditional concepts of territory and jurisdiction to cyberspace generates irrational and inadequate results.

It is thus clear that the difficulty to identify the corresponding real-world location of acts that take place online creates significant challenges for territorial jurisdiction.\textsuperscript{804} It should be noted that although cyberspace challenges the concept of jurisdiction to the extreme, such concept has been under constant pressure to accommodate new types of economic activity for decades. First it was quasi-intangible assets such as stock and bonds, then the development of intangible assets, followed by the creation of cyberspace accompanied by innovative mobile technology that allows any person to conduct economic activity on cyberspace while having complete flexibility to move between locations (and jurisdictions). And indeed, the physically-oriented concepts of jurisdiction to tax has been identified as problematic in certain circumstances many years before the technological revolution. For example, the following was published in a 1961 article discussing jurisdiction to tax: “Not many lawyers or legislators would regard a fifty-year old statute regulating divorce, or trustee investment, or security issues and stock exchanges, as particularly appropriate to 1961. \textit{Perhaps our pre-war rules of jurisdiction are obsolescent too.}”\textsuperscript{805} That problem had only intensified since.\textsuperscript{806} 

\textsuperscript{803} Some scholars suggest that cyber-space should be recognized as a distinct “place” that is separate from the physical world, and thus jurisdiction over such “place” (and the laws that govern it) cannot be based on traditional territorial concepts. \textit{See} David R. Johnson & David G. Post, \textit{Law And Borders: The Rise of Law in Cyberspace}, 48 STANFORD LAW REVIEW 1367 (1996). \textit{ Cf.} Jack L. Goldsmith, \textit{The Internet and the Abiding Significance of Territorial Sovereignty}, 5 INDIANA JOURNAL OF GLOBAL LEGAL STUDIES 475 (1998) (arguing that the internet is not a separate place and that territorial regulation of the internet is feasible and legitimate).

\textsuperscript{804} See David R. Johnson and David G. Post, \textit{supra} note 803, at 1367 (arguing that “[g]lobal computer-based communications cut across territorial borders, creating a new realm of human activity and undermining the feasibility—and legitimacy—of laws based on geographical boundaries”). \textit{See also} Georgios I. Zekos, \textit{Cyber-Territory and Jurisdiction of Nations}, 15 J. INTERNET L. 3, 12–14 (2012) (discussing how online activity is destabilizing the relationship between territorality and the authority of the state to regulate, requiring courts to broadly interpret existing legal concepts in order to allow for their application to online activity).

\textsuperscript{805} Martin Norr, \textit{Jurisdiction to Tax and International Income}, 17 TAX L. REV. 431, 461 (1961) (emphasis added) (calling for a “full-scale study of the whole problem of jurisdiction to tax and the extent to which is should properly be exercised”).

\textsuperscript{806} Many scholars and practitioners have identified and discussed the problem that jurisdiction, generally, and jurisdiction to tax, specifically, does not go “hand in hand” with cyberspace and the internet. \textit{See, e.g.}, Reuven S. Avi-Yonah, \textit{supra} note 153; \textit{Richard A. Westin, supra} note 153; \textit{Richard Doernberg ET AL., supra} note 153; Arthur J. Cockfield, \textit{Jurisdiction to Tax: A Law and Technology Perspective}, 38 GA. L. Kickstarters.

\textit{Continued on the next page...}
On this issue, tax law is not alone. Cyberspace has created challenges for the traditional jurisdictional framework in the context of a slew of other (non-tax) fields of law, and courts have been presented with a variety of complicated jurisdictional questions such as whether websites and blogs create personal jurisdiction for their owners and publishers, what are the “choice of law” rules for online transactions, what copyright rules will govern works published online, should domain names be protected as trademarks, what criminal law should apply to cross-border computer-related crimes, and other challenges brought by human rights law and international trade.807

As a reminder, in this chapter we are looking for the reasons that can explain why taxation of online advertising under the existing U.S. and international tax regimes generate inadequate results. The historical bond between territory and jurisdiction is clearly one of them. The above discussion shows that conventional concepts of jurisdiction have a hard time coping with cyberspace because of the difficulty of assigning a physical location to online activities. That conclusion clearly applies in the case of online advertising. Where does the online advertising business takes place? Is it in the jurisdiction of the publisher, the advertiser, the users, all of the above or none of the above – existing theory of territorial taxation does not have an answer to this question. Therefore, as long as there is no theoretical development that helps to identify the real-world location that corresponds to the online advertising activity, the application of existing tax norms is bound to produce inadequate results.

What does this mean for the future of jurisdiction to tax online activity? Is such activity destined to be subject to a regime similar to that which applies to income derived from space and ocean activities? Should international tax norms abandon any attempt to apply territorial jurisdiction (i.e., source taxation) to income derived in cyberspace? Such an approach has in fact been

advocated by the Treasury White Paper from 1996, discussing the possible difficulties involved with applying source-based taxation to e-commerce. In that paper, the U.S. Treasury Department cited to the source rules for income generated from space and ocean activities as an example of the decline of source-based taxation and its replacement with residence-based taxation.\(^{808}\) The Treasury White Paper concludes that such trend could be accelerated by technological developments, that could render source-based taxation obsolete.\(^{809}\) Have the twenty years that passed since the Treasury White Paper was published proven such theory to be correct? Is the position advocated by the Treasury White Paper justified in the case of online advertising? For now, we leave these questions unanswered, as they will be discussed in the next chapter. In the meantime, we continue to explore additional problems with respect to the concept of jurisdiction in the twenty-first century.

### 9.3.4. The Treaty Mismatch

Another problem with the application of the concept of jurisdiction to tax in the context of online advertising is what I refer to as the “treaty mismatch.”

To explain this concept we must first take a step back. As is evident from the discussion so far, there is a clear dichotomy between the mono-jurisdictional nature of tax and the multi-jurisdictional nature of modern economy. The world (and international law) is based on the concept of independent sovereigns, which are financially separate from one another – each state has its own revenues, expenses, assets and liabilities. Such a structure of financially independent states must rely on clear fiscal borders to determine the division of economic rights and duties (with respect to people and property) as between the states. In order to protect the fiscal independence of the sovereign and to prevent economic value from escaping the borders without being subject to tax, states would levy taxes based on such fiscal borders – at first, indirect taxes on property and trade, and later in history (more significantly since the mid-nineteenth century)\(^{810}\) also direct taxes on the personal income of those who have some political allegiance.

\(^{808}\) DEPARTMENT OF THE TREASURY, OFFICE OF TAX POLICY, supra note 553, at 23.

\(^{809}\) Id. at 23.

to the state (residents or citizens), even when such income was derived across the border. The taxation of cross-border economic activity caused an almost certain risk of double taxation that could thwart the development of such economic activity. Although the problem of double taxation has been known since ancient times,\(^{811}\) it significantly intensified during the second half of the nineteenth century as a result the accelerated development of international trade.\(^{812}\) That was the motivating factor for the development of income tax treaties for allocating taxation rights between states, the first one being signed in 1899 between Austria-Hungary and Prussia.\(^{813}\) Since then, more than 3,000 tax treaties have been signed between countries around the globe and for decades such network of treaties had indeed managed to solve (if not all, then at least a significant portion of) the problem caused by the dichotomy between the mono-jurisdictional nature of tax and the multi-jurisdictional nature of modern economy.

And this is where we get back to online advertising. As discussed in chapter 6.2 above, online advertising is an economic activity that involves three parties (publisher, advertiser and user) and the relationships between such parties cannot be separated into independent two-sided transactions. Thus, online advertising is a multi-party transaction in which all three parties could be located in three different tax jurisdictions. In contrast, the thousands of tax treaties that have been signed between countries around the globe are all bilateral – i.e., all such treaties were entered into by only two states, to govern the allocation of taxation rights with respect to economic activity that is subject to tax in both such states. Not even a single substantive multilateral income tax treaty has been signed between more than two states (excluding the EU tax regime). The only significant multilateral income tax treaties are: (1) the OECD Multilateral Convention on Mutual Administrative Assistance in Tax Matters,\(^{814}\) which, as the title suggests, only governs issues of administrative cooperation and does not include any provisions with respect to allocation of taxation rights; and (2) the OECD Multilateral Convention to Implement

\(^{811}\) Id. at 21.

\(^{812}\) Id. at 23.

\(^{813}\) Id. at 24.

Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting, which, although governing substantive tax issues, is only a mechanism for the effective implementation of certain agreed changes across the network of existing bilateral treaties.

As one can logically expect, the provisions of a bilateral income tax treaty cannot properly be applied to a multi-party economic activity. This is the treaty mismatch. Applying a bilateral tax treaty to the income derived from online advertising is bound to generate a result that ignores at least one side of the triangular relationship that comprise the online advertising business structure. That treaty mismatch is one of the reasons why current international tax norms do such a poor job at taxing income from online advertising.

9.3.5. Taxation of Online Advertising at Source

In this dissertation I argue that online advertising should be taxed, at least partly, in the jurisdiction where the users are located. If we were to ignore (for purpose of the argument) the treaty mismatch discussed above, taxation of online advertising by the jurisdiction in which the users are located could only be possible under existing tax norms and treaties if the online publisher is considered as having significant economic activity in such jurisdiction, and such level of activity meets the threshold of either the Permanent Establishment definition or, in case a treaty is not in place, the “trade or business” provision under domestic tax law.

As discussed in chapter 8.6 above, both the PE concept and that of a “U.S. Trade or Business” (which we use as an example for the domestic law concept) fail to encompass the online activity involved in online advertising as creating any presence for the online publisher within the users’ jurisdiction, let alone sufficient presence to justify imposition of tax “at source.” The reason for such result is partly due to the treaty mismatch discussed above but it is mainly due to the fact that the concepts of PE and that of “U.S. Trade or Business” are traditionally applied in the context of activities that have some level of physical presence in the jurisdiction at hand, and are

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816 Under existing international tax norms, it is doubtful that a treaty between the jurisdiction of the online publisher and the jurisdiction of the users (if such treaty existed) would at all be relevant, because the online publisher is not considered as generating any income from the jurisdiction of the users and no payments are being made between any persons residing in these two jurisdictions.
thus ill-equipped to handle activity that lacks that feature. While technology has gradually taken the physical aspect of certain types of businesses out of the equation, the PE and U.S. trade or business concepts have not been updated, either by legislative changes or juridical interpretation, to apply to activities that happen entirely in cyberspace, and especially not to such a unique type of activity as online advertising. This problem with the PE concept is not a new one, and yet the existing literature and institutional research that attempted to brush the dust off of this outdated concept, have all been limited to the issue of website and servers and did not take the next step to discuss the application of the PE concept to more advanced and innovative online business models, such as online advertising. Even the OECD BEPS project, that dedicated two separate teams to research the tax challenges of the digital economy and recent challenges to the definition of PE, ended up issuing reports that provide no real progress or solution for the issue at hand.

The outdatedness of the concepts of PE and the equivalent concepts under domestic law (including U.S. Trade or Business) is one of the key reasons why existing tax rules and norms do such a poor job at taxing income derived from international online advertising and, together with other imperfections of international tax law, explains how the major online publishers in this multi-billion-dollar industry are able to shift their profits so easily and enjoy very low tax rates with respect to significant portions of their income. As to the justifications for taxing online advertising “at source” – those have been discussed in the prior chapter and will be further

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820 For further discussion on the final reports of the OECD BEPS Project, see chapter 10.2.2.2.3 below.
elaborated in the next chapter, as we delve into a discussion regarding a possible solution to this problem.

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In this chapter I explained why the application of the existing rules of taxation to income derived from online advertising yields inadequate results that are inconsistent with the basic premise of tax law that tax should follow the economics. This chapter answered the question why such results are inadequate and also explored some of the reasons that enable this result – reasons that are related the manner in which existing character, source and jurisdiction rules and concepts interact with the unique characteristics of income derived from online advertising. The next chapter will explain why taxation of online publishers by the jurisdictions of the user is adequate and justifiable and will include a proposal for such form of taxation.
10. TAXATION OF ONLINE PUBLISHERS BY THE JURISDICTIONS OF THE USERS

The previous two chapters explained how and why the existing rules of taxation do a poor job when applied to online publishers. It is thus time to present an appropriate alternative. This chapter includes three parts. The first part will discuss the legal justification for the taxation of online publishers in the jurisdictions of the users. The second part includes a proposed framework for the taxation of online publishers. The proposal discusses issues of character, source, and taxable presence, and it includes a new proposed PE threshold and an accompanying tax, as well as a suggestion for a multinational enforcement initiative for the collection of such tax. The third part of the chapter reviews and discusses the main unilateral measures adopted by countries around the world in an attempt to tax the digital economy, and the application of such measures to the taxation of online publishers.

10.1. Justifying the Taxation of Online Publishers by the Jurisdictions of the Users

10.1.1. Jurisdiction to Tax – Theory

In order to make the case that online publishers ought to be taxed by the jurisdictions of the users, we must first understand what is the general justification for any jurisdiction to levy taxes. The issue of jurisdiction to tax has been the focus of numerous books and articles, but for purpose of this dissertation it will suffice to review several of the main theories that scholars and courts have developed to justify the act of taxation.

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Scholars have proposed several theories in an attempt to explain the legal justification of taxation. The four most discussed theories are the benefits theory, the sovereignty theory, the realistic theory and the economic allegiance theory.

According to the sovereignty theory, a state’s jurisdiction to tax derives from sovereignty, that is, taxation is justified “as an expression of the will of the state.”

Therefore, jurisdiction to tax is limited to the boundaries of sovereignty under international law.

Thus, the scope of a state’s jurisdiction to tax under the sovereignty theory is defined and limited by the scope of sovereignty that a state has over a person – a national sovereignty, or a more limited territorial sovereignty. These bases correspond with the general justification for taxing residents and nonresidents. Under the sovereignty theory, a state can tax nonresidents (with respect to which the state has no national sovereignty) only if the state has territorial sovereignty over such nonresidents. However, the state has jurisdiction to tax residents or citizens with respect to acts that take place inside and outside the state’s territorial borders, based on the broader national sovereignty. The sovereignty theory has been cited by U.S. courts, especially in the early twentieth century.

The basic principle behind the realistic theory states that jurisdiction is power and without power there is no jurisdiction. This approach is opposite to the sovereignty theory, which states that without jurisdiction there is no power. The rationale behind the realistic theory was well explained by Edward Stimson almost a century ago, when he said that:

“The fundamental principle of jurisdiction is simple enough. Jurisdiction is physical power. A sovereign State has no physical power of persons and property outside its territory.”

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823 Id. at 148–49.
824 See, e.g., Burnet v. Brooks, 288 U.S. 378, 396 (1933) (stating that “[a]s a nation with all the attributes of sovereignty, the United States is vested with all the powers of government necessary to maintain an effective control of international relations... So far as our relation to other nations is concerned, and apart from any self-imposed constitutional restriction, we cannot fail to regard the property in question as being within the jurisdiction of the United States; that is, it was property within the reach of the power which the United States by virtue of its sovereignty could exercise as against other nations and their subjects without violating any established principle of international law” (emphasis added)).
825 RUTSEL SILVESTRE J. MARTHA, supra note 716, at 19.
826 EDWARD S. STIMSON, supra note 821, at 111., as cited in RUTSEL SILVESTRE J. MARTHA, supra note 716, at 19.
Accordingly, the realistic theory argues that a state’s jurisdiction to tax is only limited by the state’s ability to enforce and collect taxes. Thus, theoretically, if the state has the ability to collect taxes outside its territorial borders, that power also provides it with the legal justification to levy taxes thereof, because its ability to collect creates jurisdiction. If, however, the state has no ability to enforce and collect taxes in a given location, the state does not have jurisdiction to tax. Under the realistic theory, a state’s jurisdiction to tax is defined not by rules of international law but rather only by the limits of the state’s power.\footnote{See Martin Norr, supra note 805, at 431 (“No rules of international law exist to limit the extent of any country’s tax jurisdiction”).} The realistic theory has been criticized (ironically) as being non-realistic, because states often exercise their powers outside their territorial borders, albeit sometimes against international law, but it is generally agreed that those extra-territorial acts do not grant such states jurisdiction to tax.\footnote{Rutel Silvestre J. Martha, supra note 716, at 19.} This theory has also been criticized as being based on pragmatism and not being purely juristic.\footnote{Id. at 19.}

The economic allegiance theory was developed by the four economists in the 1923 Double Taxation Report. The four economists presented four questions that are intended to identify the jurisdictions to which a taxpayer owes economic allegiance and which thus have a legitimate claim to tax the taxpayer’s income: (1) where is the yield physically or economically produced? (2) where are the final results of the process as a complete production of wealth actually to be found? (3) where can the rights to the handing-over of these results be enforced?, and (4) where is the wealth spent or consumed or otherwise disposed of?\footnote{1923 Double Taxation Report, supra note 348, at 25.} The four economists eventually endorse only two of these queries as the primary bases for economic allegiance – the location where the income is economically produced (the source jurisdiction) and the location where the income is consumed or disposed of (the residency jurisdiction).\footnote{Id.} Thus, under the economic allegiance theory both source and residence countries have jurisdiction to tax. That, however, was not the main conclusion of the 1923 Double Taxation Report, which was mainly focused on proposing a solution for the problem of double-taxation that could arise when both source and residency jurisdictions tax the same income. As discussed in greater detail in chapter 8.2 above, the four economists adopted a classification and assignment method, under which the primary

\footnote{827: See Martin Norr, supra note 805, at 431 (“No rules of international law exist to limit the extent of any country’s tax jurisdiction”).} \footnote{828: Rutel Silvestre J. Martha, supra note 716, at 19.} \footnote{829: Id. at 19.} \footnote{830: 1923 Double Taxation Report, supra note 348, at 25.} \footnote{831: Id.}
right to tax each category of income would be granted to either the origin or residence country in accordance with the location where the primary economic activity generating the income takes place.\textsuperscript{832}

The fourth theory that provides normative justification for taxation is the benefits theory. The 1923 Double Taxation Report briefly discussed the benefits theory (which at the time was called the “exchange theory”) and concluded that this theory was supplanted by the theory of ability to pay.\textsuperscript{833} Under the ability-to-pay theory, taxes should be assessed based on each person’s comprehensive income and not be divided into ‘buckets’ based on geographical source.\textsuperscript{834} This theory thus supports granting greater taxing rights to the country of residence, which has the ability to assess taxes on its residents’ income from domestic and international sources in a comprehensive manner. As evidenced by the extensive discourse discussed below and the reliance on the benefits theory by courts and scholars in the decades that followed the 1923 Double Taxation Report, it is clear that the decline in the importance of the benefits theory mentioned by the report was only with respect to such theory’s application to the measurement of tax liability but not with respect to the importance of the benefits theory for the discourse on justification for taxation and jurisdiction to tax. As the following paragraphs show, the benefits theory has been widely recognized as the leading theory for justification to tax and it has been adopted by both scholars and courts alike.

According to the benefits theory, persons—individual and entities—that enjoy the services and protections provided by a certain community ought to participate in the costs of such community, and this creates a justification for taxation.\textsuperscript{835} The benefits theory provides that maintaining a market that individuals and businesses can exploit to generate income is costly and therefore such market participants ought to pay taxes in order to pay for the costs of maintaining the market. This basic premise was well described by Thomas S. Adams in 1917:

\begin{footnotes}
\footnote{832} Id. at 42.
\footnote{833} Id. at 18.
\end{footnotes}
“A large part of the cost of government is traceable to the necessity of maintaining a suitable business environment. Historically, some writers maintain, the city has been evolved for the very purpose of fulfilling this function. Business is responsible for much of the work which occupies the courts, the police, the fire department, the army, and the navy. New business creates new tasks, entails further public expense. A small amount of new business may not show its influence at once upon public expenditures. The relationship between private business and the cost of the government is a loose one, much like the relationship between the expenses of a railroad and the amount of traffic which it carries. The connection, however, is real and, in the long run, the more business the greater will be certain fundamental costs of government. The industry which does not pay its due share of public expense is generally a source of weakness and not a source of strength. Surveyed from one point of view, business ought to be taxed because it costs money to maintain a market and those costs should in some way be distributed over all the beneficiaries of that market. Looking at the same question from another view point, a market is a valuable asset to the social group which maintains it and communities ought to charge for the use of community assets.”

As noted by Adams, “a market is a valuable asset,” and players that make use of the market ought to pay for the use of this valuable asset. As we will see in the next part of the discussion, the premise about the “market as an asset” will play an important role in justifying the taxation of online publishers by the jurisdictions of the users.

One of the most famous (yet concise) explanation for the benefits theory was given by Justice Holmes, who said that “[t]axes are what we pay for civilized society…” Other court decisions were more elaborative and explained what benefits did citizens receive from their country – benefits that justified taxation of such citizens. For example, in Union Refrigerator Transit Co. v. Commonwealth of Kentucky (1905) the U.S. Supreme Court explained (in the context of justifying a state’s right to tax its citizen) that:

“The power of taxation, indispensable to the existence of every civilized government, is exercised upon the assumption of an equivalent rendered to the

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836 Thomas S. Adams, supra note 821, at 187 (emphasis added). See also AMERICAN LAW INSTITUTE, supra note 688, at 18 (saying that “[i]ncome might be deemed to have its origin in a country if that country’s governmental services and protections are (or may fairly be deemed to be) utilized in deriving the income. The country that provides the market for property or services from which income is realized has a claim to be the source of that income” (emphasis added)).

837 Compania Gen. de Tabacos de Filipinas v. Collector of Internal Revenue, 275 U.S. 87, 100 (1927)
taxpayer in the **protection of his person and property**, in **adding to the value of such property**, or in **the creation and maintenance of public conveniences in which he shares**, such, for instance, as roads, bridges, sidewalks, pavements, and schools for the education of his children.\(^838\)

In another case, the U.S. Supreme Court (citing a decision of the Supreme Judicial Court of Massachusetts) explained that:

> “[The income tax] is founded upon the protection afforded to the recipient of the income by the government of the commonwealth of his residence in his person, in his right to receive the income and in his enjoyment of the income when in his possession. That government provides for him all the advantages of living in safety and in freedom and of being protected by law. It gives security to life, liberty and the other privileges of dwelling in a civilized community. It exacts in return a contribution to the support of that government measured by [and] based upon the income, in the fruition of which it defends him from unjust interference.”\(^839\)

The rational of the benefits theory, as explained in these court decisions from over a century ago, has, by and large, remained the same to this day. A good example of that could be found in recent arguments made by U.S. legislators when investigating the practice of offshore profit shifting by U.S. multinationals. The main argument of the U.S. Senate’s Permanent Subcommittee on Investigations, during its 2012–13 hearings on the topic, was that U.S. multinationals benefit greatly from the U.S. economy, market and infrastructure, yet such multinationals shift their profits abroad and avoid paying taxes in the U.S. with respect to significant portions of their income.\(^840\) In that context, the Subcommittee said that:

> “U.S. multinational corporations benefit from the security and stability of the U.S. economy, from the productivity and expertise of U.S. workers, and the strength of U.S. infrastructure to develop enormously profitable products here in the United States. But, too often, too many of these corporations use complex structures, dubious transactions, and legal fictions to shift the profits from those products

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\(^838\) Union Refrigerator Transit Co. v. Commonwealth of Kentucky, 199 U.S. 194, 202 (1905) (emphasis added).

\(^839\) Maguire v. Trefry, 253 U.S. 12, 14 (1920) (emphasis added).

overseas, avoiding the taxes that help support our security, stability, and productivity.”

Further, during the second hearings that focused on the profit shifting practice of Apple, Senator Carl Levin, the Committee’s chairman, said that:

“Apple and the other companies exploiting tax loopholes depend on the safety, security, and stability provided by the U.S. Government and by this Nation. Their economic existence depends on the U.S. Government’s energetic protection of their intellectual property—property which they develop here and keep under the protection of the U.S. legal system, while shifting the income that it generates overseas.”

Senator Levin concluded by saying that “[Apple] make[s] use of this country…. Avoiding paying taxes in this country to me is not right.”

Security and stability, safety and freedom, and public conveniences and infrastructure are some of the main benefits that the above sources point to in justifying the taxation of citizens that take advantage of such benefits. It is clear why such benefits provide adequate rational for taxing citizens that reside in the taxing jurisdiction. Can these benefits also justify the taxation of citizens that do not reside in the jurisdiction? And what about the taxation of foreign persons?

The issue of justifying the taxation of U.S. citizens that are not residents of the U.S. was discussed in the seminal case of *Cook v. Tait*. There, the court explained that a nonresident citizen can (and to a certain extent, is entitled to) enjoy the protection of the United States while living abroad. According to the court, in order to provide such protection, the U.S. must maintain diplomatic representatives and armed forces, the cost of which should also be borne by the nonresident citizen through taxation.

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841 US SENATE – PERMANENT SUBCOMMITTEE ON INVESTIGATIONS, supra note 285, at 1 (emphasis added).
842 US SENATE – PERMANENT SUBCOMMITTEE ON INVESTIGATIONS, supra note 286, at 7 (emphasis added).
843 Id. at 12.
844 *Cook v. Tait*, 286 F. 409, 413 (D. Md. 1923) aff’d, 265 U.S. 47 (1924) (the court compared the benefits conferred upon a nonresident citizen by a state versus the benefits conferred by the United States, and said that “[o]ne of our American states has little or nothing it can give to one of its citizens who takes up his residence beyond its borders. If he moves to another one of our states, he practically always changes his citizenship at once. There may be rare and exceptional cases in which he does not; but, if so, it is always within his power to do it when he will, and it is safe to assume that he would do so when the state of his
As to the justification of taxing foreign persons at source, Shay, Fleming, and Peroni explain that a foreign person that invests or carries on a business in the U.S. enjoys government-provided benefits that are similar to the ones enjoyed by residents, including “government activities that create and foster general public safety, national security, a fair legal system, a transparent and safe financial infrastructure, a healthy and educated workforce, transportation and communication infrastructure, legal protection of intellectual property licensed or sold in the United States by the nonresident, and redistributive assistance to the poor that contributes to a stable social order.”

According to Shay, Fleming, and Peroni, such similarity in the benefits enjoyed by residents and foreign persons justifies the taxation at source of the income that foreign persons derive from the U.S. at a rate equal to that which applies to residents.

Shay, Fleming, and Peroni further explain that there is a broad international acceptance that source countries have a right to tax nonresidents that extract natural resources from the source country. Based on such analysis, Shay, Fleming, and Peroni argue that “there is a strong basis for imposing a comparable tax regime on a foreign person who carries on a nonextractive business in the United States.”

Shay, Fleming, and Peroni say that the U.S. market (which they define as the physical, economical and legal structure on which the foreign person depends) is “largely the result of U.S. government activities” and thus the U.S. government has a legitimate claim to tax foreign persons that exploit the U.S. market.

prior allegiance made an attempt to tax him upon income derived from property located in that in which he is living. When he goes abroad, and takes his property with him, as a practical matter, the power of his state to give him anything in return for his taxes ceases. He cannot call upon it for anything which he is likely to want and which it can give. It may not maintain diplomatic relations with the country in which he is living. It has neither an army nor a navy to give moral or physical protection to him. On the other hand, he may demand the protection of the United States, and often does. To a somewhat indefinable extent, he is entitled to it. To be in the position to afford it, the government must maintain diplomatic and consular representatives abroad, and keep up land and sea forces. In easily conceivable cases, the attempt to assert his rights may involve his country in the expenditure of billions of dollars and hundreds of thousands of lives. If he wishes to retain a citizenship which may cost his native land so dearly, it is not altogether unreasonable to require him to contribute to its support” (emphasis added)).

846 Id. at 90–91.
847 Id. at 91.
848 Id. See also Michael J. Graetz, supra note 675, at 298 (stating that “[t]he services a nation provides may contribute substantially to the ability of both residents and foreigners to earn income there. Taxing that income is one way for the source country to be compensated for its expenditures on the services it provides”).
Based on the benefits theory, it is also largely agreed that a foreign person that does not have a physical presence in a given country ought not to be subject to taxation by such country because the foreign person is not in a position to enjoy any of the benefits provided by the government of that country that would otherwise justify taxation. As discussed in chapter 8.6 above, the idea that there is no justification for taxing foreign persons that lack physical presence has become one of the fundamental principles of international taxation, and it was embedded in the tests that determine the threshold for taxation of foreign persons, both in domestic law (for example, the U.S. trade or business concept) and in tax treaties (the permanent establishment concept).

However, during the second half of the twentieth century, the development of technology allowed foreign persons to generate more income from cross-border trade that required a continuously decreasing level of physical presence, if any, at the jurisdiction of source. Such developments challenged the traditional “no physical presence – no taxation” premise and created a significant erosion in the tax base of many countries that were unable to tax the business activities of foreign persons that did not have the sufficient presence that arose to a PE (or the equivalent trade or business, albeit being a generally lower threshold, at least in the U.S. context).

Can foreign persons that have no physical presence in a jurisdiction be considered as enjoying any benefits provided by that jurisdiction, thus justifying taxation of such foreign persons, even in the lack of physical presence? The answer depends on whether we interpret the term “benefits” widely or narrowly. Under a narrow view, a foreign person that has no physical presence in a jurisdiction does not enjoy many of the benefits that courts have identified as provided by a government in this context, such as security, stability, safety, freedom, and public conveniences (such as schools) because governments provide such benefits to foreign persons only if such persons are present within the territorial borders of the country. Under this view, a foreign person selling goods into a jurisdiction has only a limited benefit from the use of the jurisdictions’ infrastructure that is required to have the foreign person’s goods delivered from out of the country to the customer in the country. This narrow view was the one adopted by the traditional international tax regime and by most countries, simply because there was no need to adopt a wider perception. In the “old” economy (i.e., pre-digital era) it would have been extremely difficult and rare for a foreign person to have significant sales (let alone provide any services) in another jurisdiction without having a material physical presence in that jurisdiction.
Thus, during the early days of international taxation, the narrow view of the scope of benefits provided by a jurisdiction to foreign persons was the only view because foreign persons could not have conducted business in another jurisdiction without a meaningful physical presence, and if they were physically present, they enjoyed the traditional benefits described under the narrow view, thus justifying taxation at source. As mentioned above, the technological revolution created the platforms for foreign persons to engage in significant business activities in other jurisdictions with very minimal or no physical presence. Under these circumstances, a wider interpretation of the benefits enjoyed by foreign persons was required in order to justify taxation of such foreign persons at source.

Under a wider point of view, a foreign person that generates income from a jurisdiction exploits the market of that jurisdiction. That market exists due to the ongoing efforts of the government that provides the physical, economic and legal structures and institutes necessary to maintain such market. This view of the benefits theory was described in one of the most influential cases in the U.S. discussing physical presence – Quill Corp. v. N. Dakota. The Quill decision did not discuss income tax issues but rather involved the issue of the ability of U.S. states to impose sales tax collection obligation on sellers that have no physical presence in the state. However, the benefits analysis that was discussed in the case is relevant and helpful in our context as well. In Quill, Justice White, who concurred in part and dissented in part, described the benefits that are enjoyed by out-of-state sellers as follows:

“Perhaps long ago a seller’s “physical presence” was a sufficient part of a trade to condition imposition of a tax on such presence. But in today’s economy, physical presence frequently has very little to do with a transaction a State might seek to tax. Wire transfers of money involving billions of dollars occur every day; purchasers place orders with sellers by fax, phone, and computer link up; sellers ship goods by air, road, and sea through sundry delivery services without leaving their place of business. It is certainly true that the days of the door-to-door salesperson are not gone. Nevertheless, an out-of-state direct marketer derives numerous commercial benefits from the State in which it does business. These advantages include laws establishing sound local banking institutions to support credit transactions; courts to ensure collection of the purchase price from the

850 Id. at 91.
seller’s customers; means of waste disposal from garbage generated by mail-order solicitations; and creation and enforcement of consumer protection laws, which protect buyers and sellers alike, the former by ensuring that they will have a ready means of protecting against fraud, and the latter by creating a climate of consumer confidence that inures to the benefit of reputable dealers in mail-order transactions.”

The benefits described in Justice White’s decision correspond with the wider “market view” discussed above. If we were to ignore the benefit of “waste disposal from garbage generated by mail-order solicitations” (which was a common practice in the early 1990s but has become irrelevant in the current world of online marketing and sales), all other benefits mentioned by Justice White rely on legal and economic structures provided by the government – monetary and banking laws, a court system, and consumer protection laws. According to Justice White, an out-of-state retailer enjoys such benefits even without having a physical presence in the state. The wider “market exploitation” approach was also adopted by Justice Stevens, who delivered the court’s decision. According to Justice Stevens –

“…if a foreign corporation purposefully avails itself of the benefits of an economic market in the forum State, it may subject itself to the State’s in personam jurisdiction even if it has no physical presence in the State…”

The court then applies this reasoning to justify an imposition of sales tax collection obligation on an out-of-state mail-order retailer that is engaged in “continuous and widespread solicitation of business within a State.” The court noted that “[s]uch a corporation clearly has “fair warning that [its] activity may subject [it] to the jurisdiction of a foreign sovereign.” Although the court in Quill eventually held, based on constitutional grounds, that physical presence in a State is required under the Dormant Commerce Clause to impose tax-collection duties, the court’s

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852 Id. at 327–28 (emphasis added).
853 Id. at 307 (emphasis added).
854 Id. at 308.
855 Id. at 308.
856 Id. at 311–13.
analysis and conclusion with respect to the benefits theory, as described above, are nevertheless relevant to our discussion.\textsuperscript{857}

Although \textit{Quill} involved a tax-collection obligation (i.e., requiring out-of-state sellers to collect sales tax from in-state purchasers), which is different than asserting an actual tax liability on the income of the out-of-state seller, the issue of subjecting foreign persons to the tax system of a jurisdiction into which such persons make significant sales has undergone major developments in recent years, and certain states in the U.S. have enacted rules that would tax out-of-state sellers that have a significant amount of sales (by number of sales or by a dollar amount) in the state, even if such sellers have no physical presence in the state.\textsuperscript{858} By enacting these rules, such states effectively adopt the expansive interpretation of the benefits theory, stating that the out-of-state seller is exploiting the local market and should thus participate in the costs of maintaining such market by way of taxation.

\textbf{10.1.2. Jurisdiction to Tax – Application}

Can we justify the taxation of online publishers by the jurisdictions of the users based on the benefits theory? If we were to adopt the narrow definition of the concept of benefits, the answer would clearly be no. Under that interpretation, because the online publisher has no presence in such jurisdictions and has no local activity, the online publisher would not be considered as benefitting from any legal, economic or physical infrastructure or services provided by the government of the users’ jurisdiction. Therefore, under that interpretation, there is no justification for the jurisdictions of the users to tax the online publisher based on the benefits theory.

Can the online publisher reach users in foreign jurisdictions without having any form or local activity in such jurisdictions? Generally, the answer is yes, but not always. For example,

\textsuperscript{857} We shall return to discuss \textit{Quill} and other U.S. State tax issues later in this chapter when we discuss the issue of taxable presence.

\textsuperscript{858} See, e.g., the Ohio Commercial Activity Tax (Ohio Rev. Code Ann. § 5751.01(H), (I) (West)) (applying to the gross receipts of taxpayers that have a nexus in the state. A taxpayer is considered as having nexus for purpose of the tax if he has more than $500,000 in sales to customers in Ohio).
Google’s apps and online services are offered in practically every country on earth, but Google does maintain offices in 37 countries. Therefore, Google has no presence in most countries, and per the narrow view of the benefits theory, such jurisdiction would not have legitimate justification to tax Google. As a side note we should mention that although the benefits theory does provide justification for countries in which Google has offices to tax Google (because Google has actual presence in such countries and it enjoys the legal, economic and physical infrastructure and services provided by the governments of such countries), Google, like many other online publishers and multinational corporations, adopted a business structure that allows it to minimize the taxes it has to pay even in countries in which it is physically present. The structure that such companies use works as follows – the online publisher establishes a local entity or branch that provide research and development services and sales support, yet none of the advertising revenue generated by users in such jurisdiction are booked by the local entity or branch (because all advertising contracts are concluded outside the local jurisdictions); all the advertising revenue is recorded by a foreign entity in the online publisher’s corporate group; such foreign entity also pays a service fee to the local entity/branch for the R&D and sales services the latter has provided on a cost-plus basis. This structure neutralizes the online publisher’s presence in the jurisdiction of the users for purpose of taxing the actual advertising revenues that such users help generate.

Now back to the benefits theory. I argue that we can reach a different result if we adopt the broader interpretation of the benefits theory. Under this approach, foreign persons that exploit a local market receive benefits from the government that maintains and supports that market. Although market demand traditionally has not been recognized as creating sufficient economic connection between a foreign seller and the jurisdiction of the buyer/consumer (based on the notion that the foreign seller has no presence in such jurisdiction and thus could not be considered as enjoying any benefits conferred by the jurisdiction), in the case of online advertising there is a significantly higher level of connection than that which exists in the basic

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859 With the exception of several countries that block certain Google services and websites (see Google.com, TRANSPARENCY REPORT, https://www.google.com/transparencyreport/traffic/disruptions/#group=REGION (last visited Mar 12, 2017), Google is accessible to any user with an internet connection around the globe (Google has country-specific domains for 192 countries, see https://www.google.com/supported_domains).


861 See supra notes 629–632 and the accompanying text.
market-demand example. The argument about market demand not justifying taxation may be true with respect to the ability of the jurisdictions in which the online advertisers are located, but not so with respect to the jurisdictions where the users are located.

The manner in which an online publisher exploits the market of (and receives benefits from) the jurisdiction of the users is much more substantial than in the standard market-demand case of a foreign seller. The users are one of the most valuable and crucial “means of production” of the online publisher, and the publisher utilizes the users for purpose of generating income in three different ways. First, the users actually generate the income for the advertiser—unless a user views, clicks, or acts upon an ad, the advertiser has no obligation to pay the online publisher. That fact makes the users a de facto “mean of production” for the online publisher, i.e., a concrete and crucial factor in the income-producing process, without which the online publisher simply cannot generate income. The fact that the online publisher utilizes the users as if they were “assets” for purpose of generating income, should by itself provide sufficient justification for taxing the online publisher by the jurisdiction of the users.

The second facet of the exploitation of users by the online advertiser is what I refer to as the “mining of personal information” and the role of such information in generating the income. Online publishers’ technology continuously mines personal data of users. Such data includes user-generated content (emails, social media posts and photos) and objective data with respect to the user and its online activity (location, searched terms etc.). Then, once the information is mined, the online publisher integrates the information (including with additional information it purchases from third-parties), in order to target the user with what the online publisher thinks would be the most effective advertisements—i.e., ads that would cause the user to click or act upon it, thus generating income for the online publisher. The personal information and data of the users is a key aspect in the business model of the online publisher.

The third facet of the exploitation by the online publisher focuses on the role of the market in which the users reside and operate. The online publisher exploits the economic potential of the users. That economic potential was cultivated, maintained and made possible partly due to government services that are provided to the residents and to the advertisers that ultimately seek

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862 See supra note 223.
to sell services and goods to such residents. The online publisher is basically “taping” onto the
great enterprise that the jurisdiction of the users has built and is maintaining, and offers
advertisers access to that economic market in a very efficient way – advertising which is custom-
made for each user and the effectiveness of which is measurable by the actions of the users.
Although reliance on the economic potential of the advertisement audience and of the market in
which they operate is a common feature for most forms of advertising, when such reliance is
taken together with the two factors discussed above (users generate the income for the online
publisher after being targeted by specific ads which are tailored for them following the mining of
their personal data), it is clear, at least in my view, that online publishers significantly exploit the
users and the market developed by the jurisdiction where such users reside.

Shay, Fleming and Peroni say that a government has a legitimate claim to tax foreign persons
that exploit the local market (which they define as the physical, economical and legal structure
on which the foreign person depends) because such market is mainly the result of government
activities.863 I argue that in the case of online advertising, the market being exploited is much
broader and the exploitation much more significant – it includes the actual people residing in the
country, their personal information and their economic potential – all of which rely on the
existence of a market which is maintained by government activities. Based on this reasoning, the
jurisdictions where the users reside have a legitimate claim to tax online publishers because of
the benefits the online publishers derive from such jurisdictions – the benefits from the
exploitation of personal data of the residents of such jurisdictions and the exploitation of their
markets in general. The online publisher can enjoy such benefits because the “means of
production” (the users) are located in such jurisdictions. It is hard to see how under these
circumstances the online publishers would not be considered as enjoying significant benefits
from the jurisdictions of the users.

10.1.3. Does Taxation of Online Publishers by the Jurisdictions of the Users Coincide with Fundamental Principles of the International Tax Regime?

Many tax scholars and practitioners have adopted the view, advocated by Reuven Avi-Yonah,\textsuperscript{864} that an international tax regime exists and that it has become part of customary international law.\textsuperscript{865} If that is the case,\textsuperscript{866} countries are not free to enact and adopt tax rules that are inconsistent with the customary international tax regime.\textsuperscript{867} The underlying structure of international tax rules and norms can be understood to reflect two fundamental principles – the benefits principle (which states that active business income should be taxed primarily by the source jurisdiction, and passive investment income should be tax primarily by the jurisdiction of residence) and the single tax principle (under which income should be taxed no more and no less than once).\textsuperscript{868}

Is the taxation of online publishers by the jurisdictions of users consistent with these fundamental principles of international taxation? To answer this question we shall review each of these principles separately.


\textsuperscript{866} Other scholars and practitioners criticized this view and argued that an international tax regime does not exist. See, e.g., H. David Rosenbloom, \textit{The David R. Tillinghast Lecture: International Tax Arbitrage and the International Tax System}, 53 TAX L. REV. 137 (1999); Michael J. Graetz, \textit{supra} note 675; Tsilly Dagan, \textit{The Tax Treaties Myth}, 32 JOURNAL OF INTERNATIONAL LAW AND POLITICS 939 (2000); and Porus F. Kaka, \textit{The David R. Tillinghast Lecture – Source Taxation: Do We Really Know What We Mean?} (Sept. 20, 2016) (available https://www.youtube.com/watch?v=dp-0Y_uXEiU) (stating that “if you are a sovereign state, there are no rules of international tax which limit the extent of your country’s tax jurisdiction outside the treaty network”). The view that no international tax law exists is not a new one. Such view was presented by scholars as early as the mid-twentieth century. See, e.g., Martin Norr, \textit{supra} note 805, at 431 (stating that “[n]o rules of international law exist to limit the extent of any country’s tax jurisdiction”); Stanley S. Surrey, \textit{Current Issues in the Taxation of Corporate Foreign Investment}, 56 COLUMBIA LAW REVIEW 815, 817 (1956) (stating that “[t]he boundaries of the tax jurisdiction of the federal government are here not limited by any legal lines [citing to the \textit{Cook v. Tait} case, \textit{supra} note 844]. Instead, the assertion of jurisdiction is essentially a matter of national policy and national attitudes as to the proper obligations of American citizens and corporations in meeting the costs of government”).

\textsuperscript{867} Reuven S. Avi-Yonah, \textit{supra} note 821, at 1.

\textsuperscript{868} \textit{Id.} at 1; and Reuven S. Avi-Yonah, \textit{supra} note 683, at 493.
According to Avi-Yonah, the benefits principle (not to be confused with, but related to, the benefits theory for justification of taxation) is embodied in the notion that the “ultimate goal underlying the international tax regime is that active business income should be taxed in the country in which it originates (the source country) and passive income should be taxed in the country in which the recipient of the income resides (the residence country).” 869 This goal is based on the presumption that cross-border active income is mostly earned by corporations and passive income is earned by individuals. 870 Avi-Yonah explains that taxation of individuals by their country of residence is justified because (i) the residence of individuals is relatively easy to determine, (ii) individuals have one residence jurisdiction and thus distributional concerns are properly addressed in the jurisdiction of residence, (iii) residence generally overlaps political allegiance, thus taxation based on residence is a proxy for taxation with representation, and (iv) residence based taxation is compatible with capital export neutrality. 871 According to Avi-Yonah, taxation of corporations by the jurisdiction of source is justified because (i) the reasons for taxing individuals on a residence basis do not apply to corporations, and (ii) corporations derive significant benefits from the source countries, and thus source-based taxation is justified by, and consistent with, the benefits theory, as discussed in the previous part. 872

Therefore, in order for taxation of online publishers by the jurisdiction of the users to be consistent with the benefits principle, the income of the online publisher must be recognized as active business income, and the jurisdiction of the users must be recognized as the jurisdiction of source. Based on the facts discussed so far, both these requirements are met. The multinational online publisher is a corporation that conducts an active business for purpose of generating revenues from advertising. Therefore, it is clear that the income of the online publisher is from the conduct of an active business. The only aspect of online advertising that is inconsistent with the traditional manner of conducting a cross-border active business is that the online publisher is able to generate income without having any employees or equipment at the jurisdiction from which it derives the income. I.e., much like a passive investor, the online publisher is able to...

870 Reuven S. Avi-Yonah, supra note 869, at 1310.
871 See id. at 1311–1316; and Reuven S. Avi-Yonah, supra note 153, at 520–21.
872 Id.
generate revenue from a foreign jurisdiction in which it (arguably) has no presence. I say
arguably because the online publisher actually does have a very distinct presence in the
jurisdictions of the users – the presence of the users themselves, which, as argued above, are an
integral part of the business model and are a de facto “means of production” for the online
publisher, without which the publisher cannot generate income. This reasoning, together with
other more detailed arguments discussed in chapter 9.1.1 above, have already led to the
conclusion that the jurisdiction of the users should be considered, at least partly, as the source of
the income of the online publisher. Accordingly, taxation of the (active) income of online
publishers by the jurisdictions of the users (where income is, or at least ought to be, sourced
from) is consistent with the benefits principle.

Before moving on to discuss the single tax principle, two side notes are in order. First, as
mentioned in the beginning of this discussion, certain scholars oppose the notion that an
international tax regime exists and that such regime embodies the benefits principle. For
example, Shay, Fleming and Peroni argue that taxing nonresidents on all U.S. source income
(and not just active income as suggested by the benefits principle) is justified based on the notion
of domestic fairness, which requires that nonresidents contribute to the cost of government and
be charged for exploiting the U.S. market; the authors acknowledge that because most countries
give their residents a credit for taxes paid to the source country, full taxation at source may be
unfair to such countries of residence that are thus not able to fully apply the ability-to-pay
principle when taxing their residents (because of the tax credit). However, the authors say that
the primary obligation of the U.S. is to improve the well-being of its own citizens, and it has no
obligation to improve the tax equity of nonresidents on the account of U.S. citizens.873 Shay,
Fleming and Peroni effectively argue that there is no justification to limit taxation at source only
to active business income, and that passive income of foreign persons should also be taxed at
source. If we agree that the jurisdiction of the users should be considered, at least partly, as the
source of the income of the online publisher, this counter argument offered by Shay, Fleming
and Peroni would not affect the conclusion reached in the prior paragraph with respect to the
taxation of online publisher by the jurisdiction of source.

Second, in a 2015 article, Avi-Yonah, who is likely the most passionate proponent of the benefits principle (and the notion of an international tax regime), re-evaluated the benefits principle and argued that most of the existing problems of the international tax regime could be solved if we reverse the benefits principles – passive income would be taxed at source and active income would be taxed at residence. According to Avi-Yonah, 90% of multinationals are headquartered in G20 countries and thus a coordinated effort by such countries (that have a tax rate of at least 20%) to tax the worldwide income of such multinationals currently, would solve most of the problem (which is that a significant part of the income of such multinationals currently goes untaxed because of profit shifting tax strategies, such as the Double Irish Sandwich). According to Avi-Yonah, source countries would be able to tax the income at source and residence countries would still give a foreign credit for taxes paid to the source countries. The key, says Avi-Yonah, is that the income would in any case be taxed, even if source countries do not tax it. Does this re-formulation of the benefits principle changes the ability and justification of the users’ jurisdictions to tax online publishers? I believe it does not. The revised benefits principle proposed by Avi-Yonah is essentially a back-stop to non-taxation at source, intended to ensure that all income is taxed somewhere (in line with the single tax principle, as discussed below). The revised benefits principle does not preclude the source jurisdiction from having the “first bite” and asserting its taxing power. When the source country taxes the income (as suggested with respect to the jurisdiction of the users), the result is unchanged as compared to the current regime. Can the revised benefits principle by itself resolve the problem that online publishers are not taxed at source? I believe the answer is no. Under the revised benefits principle, the income of the online publisher ought to be taxed by the residence jurisdiction, yet that is already the result under the existing regime, since all advertising revenues are funneled to a low-tax residence jurisdiction, such as Ireland, where the profits subject to residence taxation are further minimized by making deductible royalty payments to zero-tax jurisdictions. Even if we were to ignore all these intermediary entities and argue that the ultimate U.S. parent of the online publisher ought to be taxed for the full income, we would end up with a result that is again similar to the one already achieved by the existing rules (because U.S. corporations are subject


875 Id.
tax for their worldwide income), but the ultimately-intended result of preventing non-taxation would still be frustrated by the existing rule of deferral (under which U.S. companies are able to avoid residence taxation for foreign active income until such income is repatriated to the U.S.). Although such income is trapped outside the U.S., it seems that the multinational corporations have ample patience and they continue to accumulate foreign earnings, which in the meantime remain untaxed, in direct contradiction to the single tax principle.

According to the single tax principle, income from cross-border transactions should be subject to tax once – not more than once and not less than once (the income would be subject to tax under the appropriate residence or source rate, as determined under the benefits principle).\(^{876}\) This principle is traced back to the 1923 Double Taxation Report, which stated that “[t]he ideal solution is that the individual’s whole faculty should be taxed, but that it should be taxed only once, and that the liability should be divided among the tax districts according to his relative interest in each.”\(^{877}\) According to Avi-Yonah, the single tax principle has since been adopted by the architects of the international tax regime, from T.S. Adams through Stanley Surrey and David Tillinghast,\(^{878}\) and eventually become a fundamental building block of U.S. international tax policy.\(^{879}\)

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\(^{876}\) In addition to Avi-Yonah, the single tax principle has been supported by various other scholars, such as Yariv Brauner, *An International Tax Regime in Crystallization*, 56 TAX L. REV. 259, 291–302 (2003); Ring, *supra* note 865, at 105, to name a few. *But cf.* H. David Rosenbloom, *supra* note 866 at 144 (arguing that nations are not required to “ensure that tax applies to income somewhere,” and that it is not clear that anything should or can be done against taxpayers that take advantage of tax arbitrage); Mitchell A. Kane, *Strategy and Cooperation in National Responses to International Tax Arbitrage*, 53 Emory L. J. 89, 114–16 (2004) (arguing that there is no international law requiring that any jurisdiction taxes a given item of income at a rate higher than zero, and also arguing that the single tax principle incorrectly assumes there is an international consensus on the meaning of income); Adam H. Rosenzweig, *Harnessing the Costs of International Tax Arbitrage*, 26 Va. Tax Rev. 555, 588–89 (2007) (arguing that the single tax principle does not necessarily represent an existing consensus among nations).

\(^{877}\) 1923 Double Taxation Report, *supra* note 348, at 20. The principle was also acknowledged by the technical expert committee in its 1927 report, stating that “[t]he most elementary and undisputed principles of fiscal justice, therefore, required that the experts should devise a scheme whereby all incomes would be taxed once, and once only” (*see* Double Taxation and Tax Evasion – Report Presented by the Committee of Technical Experts on Double Taxation and Tax Evasion, *supra* note 372, at 23).


Taxing online publishers by the jurisdictions of the users does not violate the single tax principle, but rather fulfills it. As described in chapter 9.1.2 above, existing domestic and international tax rules allow multinational online publishers, who currently are not subject tax at the jurisdictions of the users, to shift income across the globe and artificially reduce their taxes in a manner that undermines the single tax principle. Under the current regime, online publishers are subject to no tax at source (i.e., the jurisdiction of users) and are subject to very low rates of tax at the jurisdiction of residence. This result defies the single tax principle and stands against existing U.S. tax policy. Therefore, taxation of online publishers by the jurisdictions where users are located does not violate the single tax principle but rather complies with it. The taxation of online publishers by the jurisdictions of the users could create double-taxation if such publishers are also taxed by their countries of residence. However, such problem is not different from the risk of double-taxation imposed by any other form of source taxation and it should be dealt with in the same manner – by the residence country yielding to the primary taxing right of the source country, by providing a tax credit or exemption either under domestic law or under a tax treaty.

This part of the chapter focused on the question of whether taxation of online publishers “at source”, i.e., by the jurisdictions in which the users reside, as argued by and supported by this dissertation, can be justified under existing tax norms. As the discussion above shows, such taxation at source is both justified based on the prevailing theory of jurisdiction to tax (the benefits theory) and it also complies with two of the fundamental building blocks of international tax policy – the benefits principle and the single tax principle. The next part of the chapter will describe a suggested framework of the theoretical and practical principles for taxing online publishers by the jurisdictions of the users.

880 Reuven S. Avi-Yonah, supra note 821, at 34 (explaining that the U.S. adopted a policy of agreeing to reductions in source-based taxation only when the income is taxed by the state of residence – a policy which has resulted in the U.S. insisting on a limitation on benefits provisions in all of its tax treaties since 1986).

881 But cf. EUROPEAN COMMISSION, COMMISSION EXPERT GROUP ON TAXATION OF THE DIGITAL ECONOMY – REPORT 47 (2014), http://ec.europa.eu/taxation_customs/sites/taxation/files/resources/documents/taxation/gen_info/good_governance_matters/digital/report_digital_economy.pdf (concluding that there is no convincing argument why the collection of personal data via electronic means in a country would in itself create a taxable presence in that country). As made clear in this dissertation, I respectfully disagree with this approach, and I present what I believe is a valid argument for the creation of such taxable presence, at least with respect to online advertising.
10.2. Proposed Framework for Taxing the Income of Online Publishers

Countries and corporations alike agree that income ought to be taxed where value is created. Thus, for example, as part of its adoption of the OECD’s BEPS Project, the Group of Twenty (“G20”) Ministers of Finance noted that “[p]rofits should be taxed where economic activities deriving the profits are performed and where value is created.”882 Similarly, Google itself has repeatedly argued that its profits should be subject to tax in the place where economic value is created, however Google also believes that the value it generates comes only from the technology that Google develops in the U.S.

Google expressed these arguments during hearings conducted in 2012, 2103 and again in 2016 by the Public Accounts Committee of the U.K. Parliament as part of the committees’ inquiry into the amounts of corporate taxes paid in the U.K. by multinational companies and a subsequent inquiry into the tax settlement that Google reached with HM Revenue & Customs (“HMRC”) in January 2016. During the 2012 hearing, Matt Brittin, who at the time was Google’s Vice President for Sales and Operations, Northern and Central Europe, expressed Google’s position on the issue as follows:

“[w]e pay corporation tax here [in the U.K.] on the activity that our people here do. But, if you think about Google, it is technology. The 17,000 engineers in California who build and continue to invest in developing the technology create the economic value for Google…. [w]hat creates economic value for Google is the technology and the computer science.”883

Because the location where the value is created is such a crucial issue in determining the taxation of online publishers (and other multinational corporations), it is no surprise that Mr. Brittin emphasized this issue again in his final remarks in the hearing, by stating that “[t]he fundamental issue for us is that our economic activity, which generates the algorithms that make a lot of products work, comes from engineering that is all coming from California. That is why we pay

883 U.K. PARLIAMENT, PUBLIC ACCOUNTS COMMITTEE, supra note 629, at Q478-79 (emphasis added).
tax where the profits are generated, which is how the tax system operates. In the 2016 hearing, Mr. Brittin, now the head of Google Europe, Middle East and Africa, reiterated Google’s position on this issue, again arguing that most of Google’s value is created in the U.S. by the technology developed there.

Although everyone seems to be agreeing on the principle (that income ought to be taxed where the value is generated and where the economic activity that creates such value is located), there is disagreement as to the location where such value is created in the case of online publishers. It is only natural for Google to argue that most of its value is created by technology developed in the U.S., because under that argument Google’s income should be taxed in the U.S. and not in other jurisdictions, including not in jurisdictions where users are located. That result is beneficial for Google because under the existing rules Google is able to avoid U.S. taxation for its non-U.S. income (until such income is repatriated to the U.S.) and it is also able to significantly reduce its non-U.S. taxes by shifting substantial portions of its profits to low- and zero-tax jurisdictions. However, the claim that all (or most) value in online advertising is generated by technology ignores one of the most crucial elements for the creation of the value in this line of business – the users. As I have argued in length in earlier parts of this dissertation, the users that generate the income for the online publisher have a substantial part in the creation of value, and the economic source of such income ought to be considered, at least to a certain degree, as being derived from the jurisdictions where the users are located. To use the language of the four economists in the 1923 Double Taxation Report, such jurisdictions is where the yield is economically produced, i.e., these are locations where a significant part of the value in this line of business is created.

Based on the discussion in the prior part of this chapter we reached a conclusion that according to the benefits theory for assertion of jurisdiction to tax, countries in which users are located have a legitimate claim to tax online publishers’ income that is generated by such users. This part of the chapter will try to establish a framework that will translate that normative conclusion into the language of tax law. As described in chapter 8 above, taxation of online publishers by the

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884 Id. at Q613.
886 See the description of the Double Irish Sandwich tax structure in chapter 9.1.2 above.
jurisdictions of the users is not a result that can be achieved by a simple application of existing international tax rules and norms. Therefore, establishing a framework for the taxation of online publishers that would achieve such result would require the introduction of new concepts and the adoption of some creative interpretation of the existing rules. This part of the chapter will explore such proposed framework in six steps. The first step will discuss the proper character and source rule for income from online advertising; the second step will discuss the allocation of such income between source and residence countries and will propose a new PE threshold; the third step will propose a new tax that would be applied to income of online publishers by the jurisdictions of the users; the fourth step will discuss issues relating to the adoption of such proposals; the fifth step will review possible options for enforcement and collection of the proposed tax; and the sixth step will evaluate the proposed PE threshold and proposed tax under OECD criteria. Each one of these steps is discussed, in order, in the following sub-parts:

10.2.1. Character and Source

The first step in characterizing and sourcing income from online advertising is determining what type of income this is. Chapter 8.6 above included a lengthy discussion of the types of income that I believe are inappropriate for the characterization of income from online advertising. There, I argued that such income cannot be properly characterized as either income from services nor royalty income, and thus determining the source of income from online advertising by analogizing from the source rules for services or royalty income yields a distorted result. The manner in which income from online advertising is generated is so unique, as compared to the traditional forms of business transactions, that it simply cannot be compared to any of the traditional types of income.

The key aspect of income from online advertising that makes it so unique, and thus incomparable to other types of income, is the role of users. The personal information of users is a crucial resource in the online publishing business model, and the online publishers mine and exploit that resource for purposes of generating income. Without users and their personal information, online advertising in its current form would simply not exist. Therefore, I propose categorizing income from online advertising as a new type of income – one that is derived from the mining and exploitation of personal data.
Given that existing tax laws do not include a specific source rule for income derived from the mining and exploitation of personal data, the next step in determining the source of such income would be to apply the analogy method. The type of income that most resembles income from mining and exploitation of personal data, and which also has a source rule that could be used as the basis for the analogy, is income from the exploitation of natural resources. Analogizing based on this type of income is appropriate, as explained below.

Oil, coal, precious metals and other natural resources located within the territorial borders of a given jurisdiction are considered assets of such jurisdiction and the exploitation of such assets justifies taxation. Indeed, there is a broad international consensus that a country has a right to tax income that is generated from the extraction or exploitation of natural resources located within that country.\footnote{Stephen E. Shay, J. Clifton Fleming, Jr., and Robert J. Peroni, supra note 834, at 91.} Such consensus seems to be based on a simplified version of the benefits theory – even if a taxpayer does not receive any obvious benefits from the government’s legal, economic or physical infrastructure or services (which could be the case, for example, in offshore oil and gas drilling), it is clear that the taxpayer enjoys the benefits of exploiting assets that belong to the country. Exploitation of personal information of individuals residing in a given jurisdiction is comparable to the exploitation and extraction of natural resources from such jurisdiction. Although personal information of users is not an actual asset of the jurisdiction (but rather an asset of the users themselves), it is the legal, economic and physical infrastructure and services provided by the government of such jurisdiction that give such asset its value. Without the actions of the government that would allow for the existence of a functioning society and an effective economic market, the personal information of users would be worthless for advertising purposes. In that sense, personal information of users is an “asset” that belongs to the jurisdiction more than natural resources are – while countries get the luck of the draw with respect to the natural resources that exist within their borders (and the economic potential from exploiting such resources), the same is not correct with respect to personal information of residents; the economic potential embedded in the personal information of the users within a given jurisdiction is directly affected by the manner and extent to which the government invests in its population.
and in developing its economy. Personal information is thus much more of an acquired asset, attributable to the actions of the government, than natural resource.\footnote{\textsuperscript{888}}

Therefore, it is reasonable to determine the source rule for income from mining and exploiting personal data by analogizing from the source rule for exploitation of natural resources. To apply the analogy method in that manner, we must first explore the source rule for income from natural resource and understand how that source rule operates.

\subsection*{10.2.1.1. The Source Rule for Income from Natural Resources Under U.S. Tax Law}

Under Treasury Regulations Section 1.863-1(b), promulgated in 1957, income derived from the ownership or operation of a farm, mine, oil or gas well, other natural deposit, or timber which were located within the U.S., and from the sale by the producer of the natural resources within or without the U.S., was considered income from sources within the U.S.\footnote{\textsuperscript{889}} However, the regulations also provided that the income would be bifurcated to sources within and without the U.S. if (1) the taxpayer was able to show, to the satisfaction of the IRS, that due to “peculiar conditions of production and sale in a specific case or for other reasons” the income should be apportioned within and without the U.S., or (2) the IRS determined, in its discretion, that sourcing all the income within the U.S. did not reflect the proper source of the income.\footnote{\textsuperscript{890}} The same rule applied, \textit{mutatis mutandis}, with respect to income derived from the extraction of natural resources located in a foreign jurisdiction and the sale of such resources in the U.S.\footnote{\textsuperscript{891}}

\footnote{\textsuperscript{888} This conclusion is also supported by the fact that the government of a given (democratic) country is the representative of the people of such country. In that sense, natural resources located within a given country actually belong to the people of the country. Therefore, if there is a general consensus that a country has a right to tax the exploitation of natural resources that in essence belong to the people of such country, that country should also have an equal right to tax the exploitation of other assets that belong to the people of that country, such as their personal information.}

\footnote{\textsuperscript{889} Former Treas. Reg. § 1.863-1(b), as promulgated by T.D. 6258, 10-23-57 (Amended by T.D. 6348, 12-21-58).}

\footnote{\textsuperscript{890} \textit{Id.}}

\footnote{\textsuperscript{891} Treas. Reg. § 1.863-6 provides that the principles applied, \textit{inter alia}, in section 1.861-1 of the regulations, for determining the gross and the taxable income from sources within and without the U.S. are generally applied in determining the gross and the taxable income from sources within and without a foreign country, or within and without a possession of the United States.}
Therefore, the income was generally sourced to the jurisdiction where the natural resources were located and extracted.\(^{892}\)

However, in *Phillips Petroleum v. C.I.R.*\(^{893}\), the tax court held that Treasury Regulation section 1.863-1(b) conflicts with Code section 863(b)(2)\(^{894}\) and therefore the former is invalid. Code section 863(b)(2) provided that the source of income derived from the sale of personal property produced within and sold without the U.S. is subject to apportionment (within and without the U.S.). According to the court, this rule may apply to income from natural resources (the court gave an example that natural gas, when extracted, is considered “personal property”).\(^{895}\) At the same time, the rule under regulation section 1.863-1(b), as described above, provides that such income will be solely from sources within the U.S. The conflict between the code and the regulations is evident. Based on the principle that congressional statute must always take precedence over an administrative regulation, the court held that Treasury Regulation section 1.863-1(b) is invalid.

Treasury Regulations issued in 1996 significantly changed the sourcing rules for income derived from natural resources when the exploitation and sale occur in different jurisdictions.\(^{896}\) The regulations now provide that income from the sale outside the U.S.\(^{897}\) of products derived from the ownership or operations of farm, mine, oil or gas well, other natural deposit or timber within the U.S. must be allocated to sources within and without the U.S. based on the fair market value.

\(^{892}\) See also Rev. Rul. 67-194, 1967-1 C.B. 183 (1967) (a foreign corporation’s income derived from mining and processing of ore in a foreign country and the sale of the product in the U.S., without further treatment or processing in the U.S., was gross income the source of which was solely within the foreign country); and Rev. Rul. 71-198, 1971-1 C.B. 210 (1971) (a Puerto Rican corporation’s income derived from the sale of raw tuna fish caught in international waters to tuna canners in the U.S. was gross income the source of which was outside the U.S.).

\(^{893}\) Phillips Petroleum Co. & Affiliated Subsidiaries v. C.I.R., 97 T.C. 30 (1991) aff’d sub nom. 70 F.3d 1282 (10th Cir. 1995).

\(^{894}\) As in effect during the years at issue – 1975, 1976, 1977, and 1978.


\(^{896}\) T.D. 8687, 11-27-96.

\(^{897}\) The place of sale is determined according to the title passage rule under Treas. Reg. § 1.861-7(c). The title passage rule has three layers: (1) under the general rule, applicable whenever neither of the below exceptions apply, the place of sale is where the rights, title and interest of the seller in the property are transferred to the buyer; (2) if the bare legal title is retained by the seller, the place of sale is where beneficial ownership and the risk of loss pass to the buyer; and (3) if the sale is arranged in a particular manner for the primary purpose of tax avoidance, the general rule and the bare legal exception do not apply and the place of sale is where the substance of the sale occurred (after taking into consideration all relevant facts and circumstances, such as location of property, place of payment etc.)
of the product at the “export terminal.” The term “export terminal” is defined as the final point from which the goods are shipped to the U.S. in case the natural resources are located outside the U.S., and the final point from which the goods are shipped from the U.S. if the natural resources are extracted in the U.S.

The source rule depends on whether the taxpayer was engaged in “additional production activities” (i.e., any substantial processing or manufacturing activity in addition to the activities involved in the mining and excavation of the natural resource) and the location of such activities, if any, as follows: (i) if no additional production activities are performed, the part of the gross receipts that is equal to the fair market value of the goods at the export terminal is sourced to the jurisdiction in which the natural resources are located, and the excess is sourced to the country of sale; (ii) if additional production activities are performed after shipment in the country of sale, the same rule applies as in the prior scenario, and if such production activities are performed outside the country of sale, the same rule again applies yet the excess gross receipts is sourced based on one of the three methods used for the apportionment of gross income between production and sales activities of inventory; and (iii) if additional production activities are performed before shipment, the part of the gross receipts that is equal to the fair market value of the goods immediately prior to the performance of the additional production activities is sourced to the jurisdiction in which the natural resources are located, and the excess

899 Id. at § 1.863-1(b)(3)(iii).
900 Id. at §§ 1.863-1(b)(3)(i) and (ii).
901 Id. at §§ 1.863-1(b)(1) and 1.863-1(b)(1)(ii).
902 Id. at § 1.863-1(b)(1)(ii).
903 Id. at § 1.863-1(b)(1)(i). Under the default method for apportioning income between production and sales activities, 50% of the income is attributable to production activity and 50% is attributable to sales activity (id. § 1.863-3(b)(1)(i)). A taxpayer may elect to use the independent factory price (IFP) method (id. § 1.863-3(b)(2)). A taxpayer can use the IFP method only if the taxpayer regularly sells part of her inventory to independent distributors in a way that can reasonably reflect the income earned from production activity (id. § 1.863-3(b)(2)(i)). Under that method, the amount of the gross sales price that equals the IFP is attributable to the production activity, and the excess is attributable to sales activity (id. § 1.863-3(b)(2)(ii)). Such amounts are then reduced by the cost of goods that is attributable to the production and sales activities, respectively, to reflect gross income (id. at § 1.863-3(b)(2)(iii)). Finally, a taxpayer may also elect to apportion income between production and sales activities based on taxpayer’s books and records, provided that taxpayer received permission from the IRS in advance (id. at § 1.863-3(b)(3)).
gross receipts is sourced based on one of the three methods used for the apportionment of gross income between production and sales activities of inventory.\footnote{904}

In summary, under the U.S. source rule for income derived from natural resources, the fair market value of such resources is always sourced to the jurisdiction where the natural resources are located. Any additional value created by processing the natural resources or by any manufacturing activities is sourced based on the regular allocation rules for the sale of inventory (by allocating portion of the income to the manufacturing activities and the other portion to the sales activities). Thus, despite the seemingly convoluted rule, the basic premise for the sourcing of income from natural resources is that the income from the “taking” of the resource itself, prior to any processing, is attributed to the jurisdiction where the resource is located. The source rule for income from natural resources is a special exception to the general rule that applies to the sale of personal property.\footnote{905} The law acknowledges the fundamental claim that jurisdictions have with respect to natural resources located within their territorial borders.\footnote{906}

\footnote{904} \textit{Id.}

\footnote{905} The IRS acknowledged such difference between natural resources and other personal property in the preamble to the 1996 regulations that introduced the source rule for income from natural resources. There, the IRS said that “Treasury and the IRS also believe longstanding distinctions have been made in the tax treatment of natural resources and other property, both in our tax laws and in our tax treaties” (61 FR 60540, 60551, TD 8687 (Nov. 1996)).

\footnote{906} The fundamental claim of a country to the natural resources that are located within its borders has also been extended by international law to include natural resources located on the continental shelf adjacent to the territorial borders of each country. The international recognition of this claim is based on the fact that the continental shelf is nothing but an underwater extension of the continent and thus natural resources located therein should also be considered as belonging to the sovereign of the adjacent territory. Accordingly, the United Nations Convention on the Law of the Sea recognizes an exclusive economic zone that extends up to 200 nautical miles from the shore in which countries have sovereign rights with respect to the exploitation of the natural resources but no territorial sovereignty (United Nations Convention on the Law of the Sea, \textit{supra} note 436, at Part V.). Given that natural resources located on the continental shelf are effectively treated as belonging to the country adjacent to the continental shelf, it so no surprise that income from exploitation of natural resources from such area are sourced to that country, in accordance with the general principle discussed above. Section 638 of the Code extends the geographical territory of the U.S., foreign countries and U.S. possessions to include their respective continental shelf, for all tax purposes under Chapter 1 of the Code, including for purpose of determining the source of income, but only with respect to income that is related to the exploration and exploitation of natural resources. Accordingly, income derived from activities that are related to the exploration and exploitation of natural resources on the continental shelf of the U.S. is considered income from sources within the U.S. If such related activities take place on the continental shelf of a foreign country, the income is treated as derived from sources within that foreign country, for U.S. tax purposes, but only if that foreign country exercises taxing jurisdiction with respect to such exploration and exploitation (I.R.C. §§ 638(1) and (2); Examples of activities that are considered related to the exploration and exploitation of natural resources include a physician conducting routine physical examinations of employees working on an offshore drilling rig

\textit{Continued on the next page...}
10.2.1.2. The Source Rule for Income from Natural Resources Under Tax Treaties

Unlike the seemingly intricate source rule under U.S. law, the rule adopted by most tax treaties for sourcing income from the exploitation and extraction of natural resources is more straightforward. Most tax treaties grant a primary right to tax such income to the country where the natural resources are located.\textsuperscript{907}

This right is included in two articles of the U.S., OECD and U.N. Treaty Models. First, Article 6, gives the primary right to tax income from real property (immoveable property) to the country in which the property producing such income is located. All three Treaty Models apply this right to income derived from agriculture or forestry. The OECD Commentaries explain that this right is granted to the country where the property is located because “there is always a very close economic connection between the source of this income and the State of source.”\textsuperscript{908} The second place in the Treaty Models that applies to the sourcing and taxation of income from natural resource is the definition of PE under Article 5 and the operative language of Article 7 (business profits). Article 5(2) in all three Treaty Models contains a list of examples that can be regarded, \textit{prima facie}, as constituting a permanent establishment. The relevant example in this case is the one included in subsection (f) – “a mine, an oil or gas well, a quarry, or any other place of extraction of natural resources.” According to the OECD Commentaries, the term “any other place of extraction of natural resources” should be interpreted broadly.\textsuperscript{909} Because a place where natural resources are extracted is generally considered as a PE, the income generated from the extraction of that natural resource is subject to taxation by the country in which the natural resource (and the PE) is located under Article 7(1) of the Treaty Models.

As the above review shows, the general rule under U.S. tax law and income tax treaties determines the source of income from the exploitation of natural resource in accordance with the location of such resources. Applying this source rule to determine the source of income from the exploitation of personal data is a theoretically-sound application of the analogy method. It is true

\textsuperscript{907} 61 FR 60540, 60551, TD 8687 (Nov. 1996).
\textsuperscript{908} ID. at C(5)-9 and 10.

(Treas. Reg. § 1-638(f), Ex. 3), and a cook on an oil exploration vessel whose duty is cooking meals for personnel aboard that ship (\textit{id. Ex. 4}).
that in order to apply the analogy method in these circumstances one must make a conceptual leap from the tangible to the intangible and recognize that personal data should be treated similarly to tangible natural resources in this context.\textsuperscript{910} I also understand that this is not an obvious application of the analogy method in its classic form and that there is no precedent in which a court applied the method in such extreme circumstances and to such two seemingly different types of income. As explained in the previous sections, I believe these two types of income are in fact very similar in essence, at least for purposes of sourcing. Therefore, based on the discussion up to this point, applying the analogy method in this case is appropriate, theoretically justified and leads to economically-sound results – the sourcing of income from the exploitation of personal data to the country in which the users are located.

In addition, an apportionment of the source of income from the exploitation of personal data can be appropriate when such exploitation is conduced or facilitated by technology that was developed in another jurisdiction. Although I think that the significant part of the value generated from online advertising is based on the exploitation of personal data, I also accept the argument that some of that value should be attributed to the research and development efforts that ultimately facilitate the exploitation of personal data on the online publisher’s platform. In such a case, an analogy from the source rule for income from natural resources can again yield a proper result – the income from the exploitation of personal data would be apportioned between the country where the users are located and the country in which the research and development was conducted. Similar to the rule for apportioning the source of income from natural resources under Treas. Reg. section 1.863-1(b), the apportionment should be based on the fair market value of the personal data, which would be allocated to the jurisdiction of the users, and any excess value would be allocated to the jurisdictions where the technology was developed. This method obviously creates valuation challenges that will complicate and burden the administration and collection of taxes by the jurisdiction of the users. Therefore, this method of apportionment is best avoided, if possible. Accordingly, the framework for taxing income from online advertising

\textsuperscript{910} From a technical point of view, it should be noted that the list included in the definition of natural resource (“mine, oil or gas well, other natural deposit, or timber”) is not a closed list, and thus could theoretically be expanded to include additional resources not included in the list. See Rev. Rul. 71-198, 1971-1 C.B. 210 (1971), where the IRS held the operation of catching tuna fish in international waters is like operation of a farm or other natural deposit for purposes of section 1.863-1(b) of the regulations, and applied the sourcing income rule for income derived from natural resources.
that I propose and discuss below takes this issue into account and does not necessitate the apportionment of the income based on market values. More on this will be discussed in the next part of this chapter.

10.2.2. Crossing the PE Threshold

After suggesting that the income of the online publisher from the cross-border exploitation of personal data should be sourced to the jurisdiction of the users, the next step in setting up a framework of the taxation of online advertising is to determine under what circumstances the jurisdiction of the users will have a legitimate claim to tax the income of the online publisher. As a reminder, under existing international tax norms, the jurisdiction of source can tax cross-border business profits of a foreign person only if the business activity of such foreign person is significant enough to have crossed the PE threshold.\textsuperscript{911} In that case, the jurisdiction of source can tax only the business profits that are attributable to the PE, and the rules of attribution effectively serve as source rules that determine what portion of the income will be taxed at source.

The PE concept (as well as the domestic example of the U.S. trade or business concept) traditionally applies to activities that have some level of physical presence in the jurisdiction of source. Because the online publisher can generate income without having any physical presence at the jurisdiction of the users, the online publisher is not considered as having a PE at the jurisdiction of the users under such circumstances, and is therefore not subject to tax in such jurisdiction for the advertising revenues generated by the users.\textsuperscript{912} Even when the online publisher has employees and equipment in certain jurisdictions existing international tax norms and treaty rules allow the online publisher to avoid being taxed by such jurisdictions on the advertising revenues generated by the users in those jurisdictions. In such cases, the online publisher sets up a local subsidiary which in and of itself does not create a PE for the foreign parent in that jurisdiction.\textsuperscript{913} That local entity provides services to the foreign parent company, which in turn pays the subsidiary for such services on a cost-plus basis. Because all advertising contracts are signed outside the jurisdictions of the users, none of that revenue is booked by the

\textsuperscript{911} See OECD Commentaries, supra note 390, at C-5(1).
\textsuperscript{912} See chapters 8.6. and 9.3.5 above.
\textsuperscript{913} Google, for example, has 70 offices in 37 countries. Google.com, supra note 860.
\textsuperscript{914} See Article 5(7) in the OECD and U.S. Treaty Models and Article 5(8) in the U.N. Treaty Model.
local subsidiaries, which end up paying taxes only for the service fee received from the parent company, after deducting significant salaries, rent and other expenses, resulting in a relatively low tax bill in the jurisdiction of the users.

Therefore, any framework that advocates for the taxation of online publishers by the jurisdictions of the users necessarily must tackle the issue of PE as the threshold (and in our case, the barrier) for the taxation of the online publisher at source.

10.2.2.1. Proposing an Additional PE Threshold

Because the concept of PE, under all existing interpretations, requires some level of physical presence in the jurisdiction of source, any cross-border digital-based business activity that does not require the taxpayer to have physical presence in the foreign jurisdiction will not create a PE for the taxpayer. This result is clearly inconsistent with the conclusions reached in prior parts of this dissertation, saying that taxation of online publishers by the jurisdiction of the users is economically justified.

To the best of the author’s knowledge and research, to this day there has not been any final court decision holding that a nonresident that has no physical presence whatsoever in a jurisdiction is deemed to have a PE in such jurisdiction based on online activity. One case that is often cited as an example for such a “virtual PE” decision is the decision by the Spanish Central Economic-Administrative Court from 2012 regarding Dell Products. In that case, Dell Ireland was held as having a PE in Spain with respect to the sale of computers (manufactured in Ireland) that were marketed and sold in Spain via a website that was targeting the Spanish market. The court reached this decision even though Dell Ireland did not have any employees or facilities in Spain and the website was stored on servers outside Spain. However, a key issue that was crucial to the court’s decision was the reliance by Dell Ireland on the facilities and employees of its subsidiary, Dell Spain (the court concluded that Dell Ireland used Dell Spain’s facilities and that employees of Dell Spain were involved in the maintenance of the website). Therefore, the court concluded

that Dell Spain constituted a Spanish PE of Dell Ireland, based on both Article 5(1) of the income tax treaty between the countries (holding that Dell Ireland had a fixed place of business because of the use it made of Dell Spain’s facilities) and Article 5(5) of the treaty (holding that because Dell Spain had authority to enter into contracts in the name of Dell Ireland, the former was a dependent agent of the latter). Therefore, although the Spanish court did consider the fact that the sales and deliveries made by Dell Products via the website activity was economically significant, that was not the fact that led to the finding of a PE. The involvement of Dell Spain (whose employees and facilities were physically located in Spain) was a major factor in the decision, and thus most of the decision relies on traditional analysis of the PE concept, which requires some form of physical presence.

The digital economy proves that nonresidents can have significant cross-border economic activity without physical presence. The fact that such activity cannot create a PE creates a de facto distinction between the traditional “physical” economy and the digital economy. Such distinction is without merit. To resolve the discrepancy, a change must be made to the PE definition. This change can come about in two forms: (1) removing the physical presence requirement from the existing definition and accompanying commentaries and interpretations; or (2) adding a new threshold to the PE concept that is not based on physical presence. The latter seems to be the better approach, as it will minimize disruption to the existing norms and will nonetheless level the playing field between physical and non-physical businesses with respect to the application of the PE concept.

10.2.2.2. Review of Prior and Existing Proposals for a Digital PE

Before discussing the proposal for a new economic-presence-based PE threshold, it is helpful to review some of the prior and current “digital” PE concepts that have been proposed by various forums to solve the inapplicability of the current PE definition to pure digital business activity. The review will provide context for the next part of the chapter and will show the state of mind of governments with respect to their attempts to tax nonresidents that conduct business activities in the jurisdiction without a physical presence.
**10.2.2.1. OECD – Taxation of E-Commerce**

In January 1999, the OECD Committee on Fiscal Affairs appointed the Technical Advisory Group (“TAG”) on Monitoring the Application of Existing Treaty Norms for Taxing Business Profits. In 2004, the TAG submitted its final report titled “Are the Current Treaty Rules for Taxing Business Profits Appropriate for E-Commerce?” The TAG considered the pros and cons of the application of existing treaty rules with respect to e-commerce and assessed these rules against several criteria for the evaluation of the existing rules and possible alternatives. The TAG presented 11 alternatives to the existing rules for taxing business profits. Some of these alternatives required only minor changes to existing rules and some involved fundamental changes to the rules. Among the latter group of alternatives, the TAG considered an option that would add a new nexus of “electronic (virtual) permanent establishment.”

The TAG suggested three versions of the virtual PE nexus: (1) expanding the PE definition to cover a virtual place of business; (2) expanding the definition to cover a “virtual agency” scenario (the digital equivalent of dependent agent), or (3) expanding the definition to include “on-site business presence,” that will include “virtual presence.”

Under the first option, a foreign enterprise that maintains or carries on a business via a website that is hosted on servers of another enterprise located in the jurisdiction, will have a PE in that jurisdiction. This is a very limited version of virtual PE, because it still requires the basic principles of the PE definition to exist (i.e., a fixed place through which the business is conducted – in this case, servers within the jurisdiction). Accordingly, under this option, a foreign enterprise that operates a website which is hosted on servers outside a given jurisdiction will not have a PE in that jurisdiction, because the business will not be considered as existing at a fixed location within the jurisdiction. The second option is also limited in scope. Under that option, the definition of PE would be extended to scenarios where foreign persons habitually

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916 OECD, supra note 615.
917 The criteria used by the TAG were based on the principles adopted by the OECD’s Committee on Fiscal Affairs for the evaluation of tax issues arising from electronic commerce, as presented to and endorsed by the OECD Ministerial Conference in Ottawa in 1998 (the “Ottawa Framework”), which are further discussed in part 10.2.6 in this chapter. See OECD, supra note 253.
918 OECD, supra note 615, at 65.
919 Id. at 65–66.
920 Id. at 66.
enter into contracts with persons located in the jurisdiction via electronic means (such as a website), regardless of the location of the servers.\textsuperscript{921} The third option (of virtual on-site business presence) introduces a PE threshold that does not require any physical presence in the jurisdiction. This approach is based on the concept of economic presence. I.e., a foreign enterprise could be considered as having a PE in a jurisdiction if such person provides “on-site services or other business interface (which could be a computer or phone interaction) at the customer’s location.”\textsuperscript{922} The TAG noted that this alternative would require setting a threshold of economic activity so that only foreign persons with significant activity could be considered as having a PE.

The TAG then discussed some of the challenges that these proposed changes pose for the PE definition, based on the Ottawa Framework criteria and other considerations. First, the TAG noted that implementing options 1 or 3 would create significant difficulties with respect to the attribution of profits to such PEs. According to the TAG, under a conventional application of the attribution rules, which are based on functions performed by people and assets located in the jurisdiction of the PE, no substantial profits (if any) would be attributed to such virtual PEs.\textsuperscript{923} Second, the TAG noted that to the extent that the virtual PE definition would result in different tax outcomes for conventional and electronic forms of businesses, then the result would violate the neutrality principle.\textsuperscript{924} Third, with respect to the efficiency principle, the TAG argued that adopting a virtual PE definition would create additional compliance burden for taxpayers that would have new tax obligations in jurisdictions where they have no presence at all.\textsuperscript{925} Fourth, the new virtual PE definition would add a certain level of uncertainty to the existing regime.\textsuperscript{926} Fifth, the TAG argued that the first option (virtual place of business PE) would not be effective because it could be easily circumvented by taxpayers, who would have their websites hosted on servers located in low-tax jurisdictions, and the third option (the virtual presence PE) could be avoided as well, by splitting the activity based on the specific threshold adopted for purpose of

\textsuperscript{921} Id.
\textsuperscript{922} Id.
\textsuperscript{923} Id.
\textsuperscript{924} Id. at 68.
\textsuperscript{925} Id.
\textsuperscript{926} Id. at 67.
finding significant economic presence. Sixth, according to the TAG, the proposed definitions would generally add flexibility to the PE concept, and provided such amendments to the definition are drafted based on concepts rather than rules, they should be able to accommodate new types of business models and remain relevant. Seventh, none of the options should raise discrimination concerns as to their compatibility with the World Trade Organization rules. Finally, the TAG noted that because all three options would allow source countries to tax business profits of foreign enterprises that they would not have been able to tax absent such changes, such change, even if agreed to by source and residence countries, would trigger a debate as to the proper division of the right to tax between such countries. The TAG predicted that a quick an easy global consensus would not be the likely result of such a debate.

The TAG concluded the review by stating that none of the options that require fundamental changes to the PE concept (including the virtual PE proposals) should be adopted. According to the TAG, e-commerce and other technology-based business models do not, by themselves, justify significant changes from the existing regime (yet the TAG recognized the need to continue monitoring the effect of new technology-based business models on tax revenues). This conclusion was in line with the approach that the OECD adopted several years earlier in one of its initial reports on the taxation of e-commerce, where the OECD Committee on Fiscal Affairs concluded that the principles that apply to taxation of conventional commerce (neutrality, efficiency, certainty and simplicity, effectiveness and fairness and flexibility) should apply equally to e-commerce, and that “…existing taxation rules can implement these principles.”

10.2.2.2. The French Proposal

One of the interesting proposals for a digital PE, and one that specifically applies to online advertising, originated in France a few years before the BEPS Project published its

927 Id. at 70.
928 Id.
929 Id. at 71.
930 Id. at 72.
932 Id. at 11.
The proposal originated from a government-commissioned report on the taxation of the digital economy, published in January 2013. The report, drafted by two prominent French government officials (Pierre Collin from the Conseil d’Etat and Nicolas Colin from the Inspection Générale des Finances, thus giving the report its common nickname – the Collin-Colin report) evaluated the growth of the digital economy and proposed a new way to tax multinational companies that exploit users’ data.

The report notes that personal data constitutes the key resource of the digital economy and it is used as leverage by digital companies to scale their business and increase profitability. The report describes the users as providing free labor for the digital companies (by generating personal data that is mined and exploited by the digital companies) that creates significant value. The report argues that companies need to contribute tax revenues to countries where their users “work” for them for free and create such added value. The report suggested that the traditional PE definition be revised to account for the central role that users have in the creation of value for online publishers and capture the “free labor” that users provide to the digital companies. The authors acknowledge that existing international law must be changed in order to introduced this new PE definition and that bilateral tax treaties must to be renegotiated for this new concept to apply. Until such long-term goals could be achieved, the authors suggest adopting a tax on personal data that is derived from the “free labor” of users who participate in the value-creation process of companies. The proposed tax would have applied only if the

933 One of the earliest proposals to tax online advertising was promoted in France in 2010. According to the French proposed legislation, a tax of 1% were to apply to the purchase of online advertising space starting July 1, 2011 (see Ulrika Lomas, *France Adopts 2011 Finance Bill*, TAX-NEWS.COM (Dec. 17, 2010), http://www.tax-news.com/news/France_Adopts_2011_Finance_Bill____46853.html). The tax, which would have been borne by the purchasers (the advertisers) and not the online publishers, was eventually not adopted (see Eric Pfanner, *France Drops Plans for ‘Google Tax’*, NEW YORK TIMES (June 23, 2011), http://www.nytimes.com/2011/06/24/technology/24iht-google24.html).


935 *Id.* at 2.

936 *Id.* at 49–50.

937 *Id.* at 2.

938 *Id.* at 114–15.

939 *Id.* at 115.

940 *Id.* at 123.
company had crossed a threshold of a minimum number of users and the tax would be a per-user charge.\textsuperscript{941} The authors suggested a progressive charge that would provide an incentive for companies to adopt practices that are supportive of public interest objectives.\textsuperscript{942}

The Collin-Colin report encountered substantial criticism from various French political and business organizations. In September 2013, the French Digital Council (Counseil National du Numérique)—an independent advisory committee appointed by the French President to explore and provide recommendations with respect to the impact of digital on the French society and economy—\textsuperscript{943} issued an opinion with respect to the Collin-Colin report.\textsuperscript{944} According to the opinion, the introduction of a unilateral “digital tax” would be “unrealistic and economically devastating.”\textsuperscript{945} The opinion noted that efforts should be made to prevent abusive tax planning undertaken by multinational companies, and that such efforts should be made in a coordinated and concerted matter between governments. Thus, the French Digital Council recommended that at this stage new national taxes that would undermined France’s position in any international negotiation efforts should not introduced, including any taxes based on the “predator pays” principle suggested by the Collin-Colin report.\textsuperscript{946} According to the Council, caution must be taken with respect to the introducing new sector-specific taxes which, the Council believed, would impeded the competitiveness of the French digital market.\textsuperscript{947} That being said, the Council recognized the importance of the role of users in the creation of value and thus recommended that additional research be conducted.\textsuperscript{948}

Another example of the criticism directed at the Collin-Colin report came from GenerationLibre, a French think tank aimed at promoting freedoms in France. The organization issued a statement following the publication of the Collin-Colin report, saying that the report was “wrong and

\textsuperscript{941} Id. at 123.
\textsuperscript{942} Id. at 128.
\textsuperscript{945} Id. at 7.
\textsuperscript{946} Id. at 8.
\textsuperscript{947} Id. at 13.
\textsuperscript{948} Id. at 9.
dangerous.” The statement accused the Collin-Colin report as lacking credible economic analysis, and argued that the taxes proposed by the report would eventually be borne by French companies and web users and would disincentive investments in the French digital economy.

Although the digital tax proposed by the Collin-Colin report were not adopted, French legislators continue to push for new tax measures that would apply to the digital economy. These measures are discussed in part 10.3 of this chapter.

10.2.2.2.3. The OECD Base Erosion and Profit Shifting Project

Almost a decade after the publication of the 2004 TAG report, the OECD launched the Base Erosion and Profit Shifting (“BEPS”) Project. The problem of BEPS was initially recognized by the OECD in a report issued in February 2013 (shortly after the Collin-Colin report was published in France), which later, with the endorsement of the G20, evolved into the ambitious BEPS Project.

The term BEPS was described by the OECD as follows:

“BEPS relates chiefly to instances where the interaction of different tax rules leads to double non-taxation or less than single taxation. It also relates to arrangements that achieve no or low taxation by shifting profits away from the jurisdictions where the activities creating those profits take place. No or low

951 In 2012, the G20 reiterated the need to prevent base erosion and profit shifting and endorsed the ongoing work of the OECD on this matter (see G20, Leaders Declaration, Los Cabos, Mexico (2012), at 48 http://www.consilium.europa.eu/uedocs/cms_Data/docs/pressdata/en/ec/131069.pdf) and in 2013 the G20 specifically endorsed the BEPS Project (see supra note 882).
taxation is not per se a cause of concern, but it becomes so when it is associated with practices that artificially segregate taxable income from the activities that generate it. In other words, what creates tax policy concerns is that, due to gaps in the interaction of different tax systems, and in some cases because of the application of bilateral tax treaties, income from cross-border activities may go untaxed anywhere, or be only unduly lowly taxed.”

The OECD ultimately concluded that the net global corporate tax revenues lost from BEPS are estimated as 4–10% of global corporate tax revenues, or $100–240 billion at 2014 levels. In address this problem, the teams working in the BEPS Project were to explore the weaknesses in the current international tax rules and recommend new actions and measures that, once implemented, would “ensure that profits are taxed where economic activities take place and value is created.”

The BEPS action plan specifically noted that the spread of the digital economy poses challenges for international taxation and that it is important to study how digital businesses generate profits in order to determine if and to what extent the existing rules should be revised in order to properly apply to the digital economy and prevent BEPS in that context. Amongst the 15 action plans that were covered by the BEPS Project, two are of specific relevance to the issue of digital PE and online advertising – Action 1 (addressing the tax challenges of the digital economy) (“Action 1”) and Action 7 (preventing the artificial avoidance of permanent establishment status) (“Action 7”). The recommendations of each of these action plans are discussed below.

953 OECD, supra note 406, at 10.
956 OECD, supra note 406, at 10.
957 The other actions explored by the BEPS Project were: Action 2 (neutralising the effects of hybrid mismatch arrangements), Action 3 (designing effective controlled foreign company rules), Action 4 (limiting base erosion involving interest deductions and other financial payments), Action 5 (countering harmful tax practices more effectively, taking into account transparency and substance), Action 6 (preventing the granting of treaty benefits in inappropriate circumstances), Actions 8–10 (aligning transfer pricing outcomes with value creation), Action 11 (measuring and monitoring BEPS), Action 12 (mandatory disclosure rules), Action 13 (guidance on transfer pricing documentation and country-by-country reporting), Action 14 (making dispute resolution mechanisms more effective), and Action 15 (developing a
**Action 1 – Addressing the Tax Challenges of the Digital Economy**

The BEPS action defined the goals of Action 1 as follows:

“Identify the main difficulties that the digital economy poses for the application of existing international tax rules and develop detailed options to address these difficulties, taking a holistic approach and considering both direct and indirect taxation. Issues to be examined include, but are not limited to, the ability of a company to have a significant digital presence in the economy of another country without being liable to taxation due to the lack of nexus under current international rules, the attribution of value created from the generation of marketable location-relevant data through the use of digital products and services, the characterisation of income derived from new business models, the application of related source rules, and how to ensure the effective collection of VAT/GST with respect to the cross-border supply of digital goods and services. Such work will require a thorough analysis of the various business models in this sector.”

The main conclusion presented in the OECD Task Force on the Digital Economy (“TFDE”) in the final report of Action 1 is that “the digital economy is increasingly becoming the economy itself” and therefore “it would be difficult, if not impossible, to ring-fence the digital economy from the rest of the economy” when it comes to taxation. This conclusion significantly affected the ultimate recommendations presented in the final report of Action 1, as well as the manner in which the report’s recommendations were accepted by countries world-wide, as will be further discussed below.

The first few chapters of the final report of Action 1 provide an extensive overview of the fundamental principles of international taxation, the evolution of information and communication technology, the development of the digital economy and the emergence of technology-based business models (including online advertising). The report than dedicates a chapter to discuss, in broad terms, features of tax planning structures that are common in the multilateral instrument to modify bilateral tax treaties). For the final report of all BEPS actions see OECD, BEPS 2015 Final Reports, http://www.oecd.org/ctp/beps-2015-final-reports.htm.

959 OECD, *supra* note 818, at 54.
960 *Id.* at chapters 2-4.
digital economy and that result in BEPS, including an explanation of the Double Irish Sandwich tax structure.

The report identifies three main categories of policy challenges raised by the digital economy: nexus, data, and characterization. With respect to nexus, the report notes that the development of technology has made it possible for entities to be heavily involved in the economic life of another country (i.e., generate significant revenues from that country) without having a physical place of business in such country, and this possibility raises questions as to whether the current rules, and specifically the PE definition, are appropriate for the digital economy. The report explains that the increased collection, storage and use of users’ data and the expanding role of such data in the digital economy raise questions about whether the existing nexus rules continue to be appropriate in this context or whether revenues generated from data collection ought to be taxed by the jurisdiction from which such data was collected. The increased importance of data also raises issues of valuation and characterization. Finally, the report notes that the many new business models in the digital economy raise questions about how to properly characterize transactions and revenues.

To address these tax challenges, the TFDE discussed and analyzed several proposals and eventually presented three options: (i) a new nexus based on significant economic presence, (ii) a withholding tax on certain types of digital transactions, and (iii) an equalization levy.

(i) Significant-Economic-Presence Nexus:

Under this option, a nonresident that has significant economic presence in a country would be considered as having taxable presence in such country. Significant economic presence would be established when the nonresident has a “purposeful and sustained interaction with the economy

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961 Id. at chapter 5.
962 Id. at Annex B, Section B.2.
963 Id. at 100–101.
964 Id. at 102.
965 Id.
966 Id. at 104.
967 The Task Force also discussed possible changes to the exceptions from PE status and such changes were proposed in Action 7, as discussed below.
of that country via technology and other automated tools."\textsuperscript{968} Such “purposeful and sustained interaction” would be evidenced by one or more objective factors. The report identifies three groups of factors that could be applied in this context.

(1) \textit{Revenue-based factors}: when the users and customers of the digital enterprise are located in the same country, the value of the users and the users’ data would generally be reflected in the revenues generated from that country. The revenues earned from such a jurisdiction could be a potential factor for establishing significant economic nexus.\textsuperscript{969} The report states that revenues alone are not sufficient to create such nexus, but they could be considered a basic factor when combined with other digital- or user-based factors, as discussed below.\textsuperscript{970} Any revenue-based threshold would be assessed against revenues generated from transactions concluded only with customers from within the jurisdiction. Setting a high-enough threshold level would help minimize compliance burden for taxpayers and administrative burden for tax administrators.\textsuperscript{971}

(2) \textit{Digital factors}: the report suggests a range of digital-based factors that could be used as part of the significant-economic-presence test. For example, a local domain name, a website or digital platform that have been localized and adjusted to account for language and cultural norms, and local payment options embedded in the website or digital platform (i.e., prices are reflected in local currency, local taxes and fees are included in the price, and local forms of payments are accepted).\textsuperscript{972}

(3) \textit{User-based factors}: because of the importance of users and data for the business models in the digital economy, the report suggests that user- and data-based inputs may also serve as valuable indicators of significant economic presence. Such factors may include the number of monthly active users on the digital platform, the regular conclusion of contracts

\textsuperscript{968} OECD, \textit{supra} note 818, at 107.
\textsuperscript{969} \textit{Id}. at 107.
\textsuperscript{970} \textit{Id}.
\textsuperscript{971} \textit{Id}. at 108.
\textsuperscript{972} \textit{Id}. at 109.
on the digital platform, and the volume of data collected on the digital platform from users who reside within the specific country during the taxable year.\textsuperscript{973}

The TFDE also considered what changes would be required to the profit attribution rule in case significant-economic-presence nexus were to be adopted. The report notes that because a nexus established based solely on significant economic presence would likely not involve carrying on of any functions of the enterprise in the traditional sense, the existing profit allocation rules (which are based on a functions-assets-risks analysis) would not allocate any profit to jurisdictions in which the enterprise has significant economic presence.\textsuperscript{974} The TFDE considered several adjustments to the existing rules, including a proposal to treat customers and users as performing certain functions on behalf of the enterprise, but ultimately rejected all such proposal because they would require making significant changes to the existing profit allocation rules, which is an endeavor that was not contemplated at that point.\textsuperscript{975} The report considered a “deemed profit” method, under which a ratio of presumed expenses would be applied to the nonresident’s revenue derived from transactions concluded with in-country customers.\textsuperscript{976} Although easy to administer, such method would ignore different cost structures and might result in tax liability even when no actual profits are generated. The report notes that one possible way to mitigate these concerns would be to consider the deemed profit as a rebuttable presumption that would not be applied to taxpayers that can show that their activity resulted in a loss.\textsuperscript{977}

Although the two other proposals considered by the report (withholding tax on digital transactions and equalization levy) do not concern the issue of nexus or the creation of a “digital PE” (which is the issue we are considering in this part of the chapter), such proposals are relevant to parts of the discussion to follow, and thus will be reviewed here.

\textsuperscript{973} Id. at 110.
\textsuperscript{974} Id. at 111–12.
\textsuperscript{975} Id. at 112.
\textsuperscript{976} Id.
\textsuperscript{977} Id. at 113.
(ii) **Withholding Tax on Digital Transactions:**

The TFDE considered a withholding tax on payments made by residents (and local PEs) for goods and services purchased from a nonresident. The report suggested that such a tax could be considered as a stand-alone gross-basis tax or as a collection mechanism and enforcement that will be combined with a net-basis tax triggered by a significant economic presence nexus. To provide clarity as to which transactions are subject to the tax, specific types of transactions would need to be identified. This, the report argues, would likely result in disputes about characterization of transactions and could also lead to unequal tax treatment of economically equivalent transactions. Therefore, the report concludes that a more general definition of the covered transactions would be appropriate, such as “all transactions for goods and services ordered online.”

The report recognizes that applying a final withholding tax on the gross revenues of an online business that has ongoing expenses would yield a result that would not be a perfect proxy for tax on net income. To mitigate this problem, the report suggests setting a withholding rate that is relatively low and that would reflect typical profit margins (that could be based on statistical analysis of actual margins of local taxpayers). Another drawback of this proposal is that a final withholding tax based on gross-revenue is likely to raise significant conflicts with trade obligations under EU law.

Given these difficulties, the report ultimately takes the position that using the withholding mechanism as a tool to enforce collection of net-income tax liability (triggered by significant economic presence) would be a more viable approach.

(iii) **Equalization Levy:**

Under the third and final option considered by the TFDE, an equalization levy would be applied to revenues generated by nonresident that have a significant economic presence in the country. According to the report, the levy would be imposed on the gross value of goods and services.

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978 *Id.*
979 *Id.* at 113.
980 *Id.* at 114–15.
981 *Id.* at 116.
provided to customers and users in a given country, which are paid by customers and users in such country to a nonresident (who was found to have a taxable presence by way of significant economic nexus).\textsuperscript{982}

As with the withholding tax proposal, an equalization levy applied to gross revenues would likely create trade conflicts under EU law. One option to mitigate this difficulty would be to apply the levy to residents and nonresidents alike. In either way, consideration must be given to ways to mitigate the impact of exposing nonresidents (and possibly residents) to both the equalization levy and to corporate income tax. In this context, the report notes that the levy would likely not be a tax for which the nonresident would be able to get a tax credit in the country of residence, and thus the report argues that the levy should be applied only in instances where the revenues is not taxed by the country of residence (or taxed at a very low tax rate).\textsuperscript{983}

Ultimately, with the exception of the changes to the PE definitions (discussed below, under Action 7), the TFDE did not recommend any of the options discussed in the final report of Action 1. The TFDE refrained from endorsing any of these proposals because it was expected that the measures developed in the BEPS Project as a whole would significantly impact and mitigate the BEPS issues related to the digital economy.\textsuperscript{984} In addition, the TFDE recognized that adopting any of the three options discussed above would require making substantial changes to the existing international tax standards, and such changes would require additional work (an endeavor that the TFDE apparently was not prepared to pursue at this point).\textsuperscript{985} However, the report states that countries could introduce any of the above proposals in bilateral tax treaties or in their domestic tax laws “as additional safeguards against BEPS, provided they respect existing treaty obligations.”\textsuperscript{986}

Finally, the TFDE states that the conclusion presented in the report may evolve as the digital economy continues to grow and develop, and thus further monitoring of the digital economy is required, especially with respect to the emergence of new business models, the effect of the

\begin{footnotesize}
\begin{enumerate}
\item\textsuperscript{982} Id.
\item\textsuperscript{983} Id. at 117.
\item\textsuperscript{984} Id. at 137.
\item\textsuperscript{985} Id.
\item\textsuperscript{986} Id.
\end{enumerate}
\end{footnotesize}
implementation of BEPS measures on the tax challenges created by the digital economy, and actions taken by countries to implement the options discussed in the report. The TFDE recommended that a report reflecting the outcomes of such developments should be released by the year 2020.

**Action 7 – Preventing the Artificial Avoidance of Permanent Establishment Status**

At the outset, it should be noted that Action 7 does not address any issues relating to digital PE, virtual PE or other forms of non-physical-based PE. The BEPS Project discussed such issues only under Action 1, as discussed above.

The BEPS action defined the goals of Action 7 as follows:

“Develop changes to the definition of PE to prevent the artificial avoidance of PE status in relation to BEPS, including through the use of commissionaire arrangements and the specific activity exemptions. Work on these issues will also address related profit attribution issues.”

The BEPS action plan recognized that the definition of PE is lacking and that taxpayers are taking advantage of the definition in various ways to artificially avoid a PE status in jurisdictions where such taxpayers have significant presence nonetheless, thus resulting in BEPS. Action 7 was focused on proposing changes to the PE definition that would prevent this problem. Action 7 identified two main issues that contributed to the artificial avoidance of PE status – the use of *commissionaire* and similar arrangements and the specific activity exemption under the PE definition.

A *commissionaire* arrangement is “an arrangement through which a person sells products in a given State in its own name but on behalf of a foreign enterprise that is the owner of these products.” Under such arrangement, the profits of a foreign seller would not be subject to tax in the market jurisdiction because the person that conducts the sale does not own the products and thus only the commission is attributable to him. Action 7 explains that taxpayers are using

987 Id. at 138.  
commissionaire arrangements to artificially avoid PE status and therefore Action 7 proposed changes to Articles 5(5) and 5(6) of the PE definition to address such arrangements (and similar strategies).

Article 5(4) of the OECD Model provides an exception from PE status. Under such exception, a person is deemed not to have a PE if such person has a place of business that is used solely for one of the activities listed in the Article. When the list of activities was drafted, such activities were generally considered as preparatory or auxiliary in nature. Due to the significant changes to the way businesses are being conducted (especially in connection with the digital economy), in certain circumstances activities listed under Article 5(4) could now be conducted as a core business activity. Absent a change in the PE definition, foreign persons can conduct core business activities in a country without having a PE. Therefore, to ensure that the exception is available only to activities that are in fact preparatory or auxiliary in nature, Action 7 proposed changes to Article 5(4) and the accompanying commentary. In addition, Action 7 introduced a new rule intended to prevent enterprises from fragmenting their business activity into smaller “auxiliary” activities among related entities in order to benefit from the PE “preparatory or auxiliary” exception.

10.2.2.4. Why the BEPS Project Will Not Solve the Problem

Before moving on to the final part of the review of digital PE proposals, a few words of criticism with respect to the OECD’s BEPS Project are in order.

Under different circumstances, the recommendations of the BEPS Project could have made this dissertation redundant, yet the final proposals of Action 1 and 7 are far from providing a comprehensive solution to the taxation of online advertising and other digital types of businesses. The first and most significant problem with the BEPS Project is that it refrained from making a much-needed fundamental reform in the rules of international taxation.

990 Id. at 10.
991 Id.
992 Id. at 28.
993 Id. at 39.
The proposals of the BEPS Project are explicitly limited to addressing flaws in the existing international taxation system. The proposals do not discuss fundamental changes to the basic principles of the system. This approach legitimizes the existing tax norms and rules and only creates new “bright lines” for taxpayers to work around. This line of criticism was recently presented (in a very direct manner) by the U.K. All-Party Parliamentary Group (APPG) on Responsible Tax. In August 2016, the APPG on Responsible Tax issued a report in which the APPG examined the BEPS Project’s recommendations. In the report, the APPG argues that the proposals of the BEPS Project are likely to add to an already-complicated global tax system, thus creating new opportunities for taxpayers to exploit. According to the GAAP, the OECD failed to explore or challenge the fundamental principles of the international tax system (such as the basic concepts of residence and source), and merely attempted to fix the immediate harmful results arising from the existing rules. Therefore, the APPG argues, the proposals of the BEPS Project are only a ‘sticking plaster’ on a struggling global tax system, and “while it may improve existing rules in the short term, in the long term it will fail to stamp out corporate tax avoidance.” The APPG takes the position that the BEPS Project should be the first step in a

994 For example, the Explanatory Statement of the final BEPS report notes that OECD and G20 countries have agreed to monitor development related to the digital economy, and based on such monitoring work, a determination will be made as to whether additional work will be needed with respect to the three options presented to address the tax challenges raised by the digital economy. According to the Explanatory Statement, such determination “should be based on a broad look at the ability of existing international tax standards to deal with the tax challenges raised by developments in the digital economy” (see OECD, supra note 955, at 8–9 (emphasis added)).

995 In the context of bright line rules the U.S. Supreme Court has said that “the very meaning of a line in the law is that you intentionally may go as close to it as you can if you do not pass it” (Superior Oil Co. v. Mississippi ex rel. Knox, 280 U.S. 390, 395–96 (1930)). The U.S. Supreme Court expressed a similar view in the context of minimizing tax liability in Gregory v. Helvering (supra note 608, at 469), saying that “[t]he legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted.”


998 Id. at 9.

999 Id. at 5.

1000 Id. at 9.
much longer process of radical reform of the existing tax system.\textsuperscript{1001} Similar criticism of the BEPS Project was also adopted by tax scholars and experts.\textsuperscript{1002}

Another aspect that contributes to the low expectations from the BEPS Project’s proposals is the fact that the project does not enjoy an across-the-board support from the global community. The project is led by OECD member countries and additional countries from the G20, but countries that are not members in these groups (a large portion of which are “source” countries) have not showed full support in the project.\textsuperscript{1003} It is thus not surprising that in January 2017 China and the Group of 77 (currently including 134 developing countries) have called on the United Nations to create a new tax agency that would develop proposals that are better suited for the needs of developing countries than those included in the final reports of the BEPS Project.\textsuperscript{1004}

Because many countries doubt the ability of the BEPS Project’s proposals to fundamentally reform the existing international tax systems, such countries (including members of the OECD and the G20) have started to implement unilateral measures to prevent BEPS within their own jurisdiction and try to put their hands on as much tax revenue as they can. The adoption of such unilateral solutions (such as the diverted profits tax in the U.K. and Australia) seem to be an admission of the BEPS Project’s failure by the OECD’s own members.\textsuperscript{1005} In addition, the implementation of unilateral measure in itself increases the (already high) chances that the BEPS Project will not be able to create a radical, coherent and long-lasting reform in the international tax system. These outcomes (and expectations) are also reflected in the results of a recent survey, showing that the BEPS Project had only a low impact on corporations. According to the survey,

\textsuperscript{1001} Id. at 5.
\textsuperscript{1002} See, e.g., Kristen A. Parillo, A Destination-Based Corporate Tax: An Alternative to BEPS, 78 TAX NOTES INT. 315, 315 (April 27, 2015) (quoting Rita de la Feria, professor of tax law at the Durham University Law School who said: “No Matter how well drafted they are, anti-avoidance measures eventually be out of date. Which means that the tax authorities will always be playing catch-up. Anti-avoidance measures have a last-resort purpose, but if we want to fix the underlying sources of BEPS, we need to reexamine the fundamentals of our system”).
\textsuperscript{1003} See Mindy Herzfeld, Who will Solve the Problem of Double Taxation, 76 TAX NOTES INT. 398, 399 (Nov. 3, 2014).
conducted amongst 2,600 businesses across 36 countries nearly a year after the final reports of
the BEPS Project were published, 78% of companies did not change their approach to taxes.1006

The final report of Action 1 with respect to the tax challenges raised by the digital economy is
independently subject to criticism. The report of Action 1 takes the position that the digital
economy is the economy itself, and thus it would be in appropriate to provide ring-fenced
solutions to the tax challenges raised by that industry.1007 Thus, Action 1 refrained from
proposing (or even reviewing) industry-specific rules that would apply only to revenues derived
from digital activity. Pascal Saint-Amans, head of the OECD Centre for Tax Policy and
Administration, went so far as to say that “[t]he findings are that there is no such things as digital
companies rather than digitization of the economy”, giving as an example the use of digital
means by remote sellers to conduct business.1008 But what are Google, Facebook and Yahoo if
not digital companies? The BEPS Project failed to recognize the difference between companies
that exist entirely online (like the major online publishers) and companies that are involved in
online retailing, and therefor also engage in delivery of goods. The latter are indeed not digital
companies in the pure sense of the word, but the former are. Because of the failure of the TFDE
to recognize the difference between these types of companies, some of the options discussed
under Action 1 could also lead to unwanted results. For example, the significant economic
presence nexus, as described in the report, could lead to a nonresident having taxable presence in
a country based on “market demand” alone (i.e., remote sales).1009 The traditional view of the
benefits theory does not justify taxing a remote seller only because he has significant amount of
sales into a jurisdiction and a local website. While an argument could be made as to why remote

1007 OECD, supra note 955, at 8.
1008 Lee A. Sheppard, OECD BEPS Project Unlikely to Endorse Digital PE, TAX NOTES 384, 384 (January 27, 2014).
1009 OECD, supra note 818, at 111 (“If a non-resident enterprise generates gross revenues above the threshold
from transactions with in-country customers concluded electronically through a localised digital platform
where the customer is required to create a personalised account and utilise the local payment options
offered on the site to execute the purchase, it could be considered that there is a link between the revenue
generated from that country and the digital and/or user-based factors evidencing a significant economic
presence in that country”); see also id. at 113–14 (the TFDE suggested that the option of withholding tax
on digital transactions “could be applied, for example, to transactions for goods or services ordered online
(i.e. digital sales transactions), or to all sales operations concluded remotely with non-residents”).
sellers should be taxed by the jurisdiction of the purchaser, such scenario is entirely different than a purely-digital company deriving income from online advertising for which users are a core “resource” in the revenue-generation process. The economic presence of these two types of companies in the jurisdiction of the purchaser/user is different and warrants a separate discussion, which is something that Action 1 failed to undertake.

Even before the final report of Action 1 was submitted, practitioners warned that the inability of the BEPS Project to reach a consensus regarding the manner in which the digital economy should be taxed would encourage countries to take unilateral action.\(^\text{1010}\) As evidence by the myriad of domestic laws and regulations recently adopted around the world (as discussed in the third part of this chapter), that prediction came true. Furthermore, the U.S., which undoubtedly must be supportive of any global tax initiative that hopes to make a difference, did not support an introduction of an economic presence PE because that would have allowed other countries to tax the digital multinational, most of whom are headquartered in the U.S., resulting in an erosion of the U.S. tax base.\(^\text{1011}\) The lack of global consensus as to the proper taxation of the digital economy, combined with the unilateral actions adopted by many countries even before the final BEPS conclusions were submitted, are key reasons as to why the BEPS Project is not likely to result in a much-needed fundamental reform of the international tax system to allow for proper taxation of the digital economy.

Finally, although the concept of PE (and more broadly, the allocation of rights to tax business profits between source and residence countries) is a core concept in the international tax system, the initial scope of the BEPS Project’s inquiry with respect to this concept was limited from the get go. From the early days of the BEPS Project, no fundamental changes were planned for the PE concept. The BEPS action plan clearly took this position when it stated that “these actions are not directly aimed at changing the existing international standards on the allocation of taxing rights on cross-border income.”\(^\text{1012}\) Therefore, it was not surprising that the final report of Action

\(^{1010}\) Margaret Burow, *OECD Digital Economy Discussion Draft May Encourage Unilateral Actions*, Tax Notes: Highlights & Documents 2823 (April 7, 2014).


\(^{1012}\) OECD, *supra* note 406, at 11.
7 did not make any fundamental changes to the PE concept. Action 7 was not about reconsidering the concept of jurisdiction to tax and whether new types of activities merit the creation of a sufficient nexus with the source country, but it was rather limited to reviewing the existing definition of PE, the exceptions to the definition, and certain arrangements that were used to circumvent the existing definition (such as *commissionaire* arrangements). Thus, Action 7 was rightfully criticized as being “an ad hoc, hole-closing approach rather than principled reform.” Presumably, the limited scope of the recommendations under Action 7 should have made it easier for countries to adopt them, but even under those circumstance some countries have been reluctant to do so, which further reflects the problems with Action 7 and the BEPS Project more generally.

10.2.2.3. Economic Nexus under U.S. State Tax Laws

One field of taxation that has been in the forefront of debating and implementing new rules with respect to non-physical nexus and economic presence is the state sales tax regime in the U.S. For several years, state governments have been working effortlessly in an attempt to promote state and federal legislation that would allow states to require out-of-state retailers to collect sales tax from sales they make to customers in the state, even when such out-of-state retailers have no physical presence in such state.

How is a discussion on state taxation relevant to the international taxation issues that we have been discussing so far? On the one hand, from the viewpoint of international tax, state taxation is an entirely domestic matter and issues of U.S. state taxation are often subject to U.S. tax law. However, state tax laws can have an impact on international trade and investment as potential barriers to entry and as a component of the overall tax burden.

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1013 See Yariv Brauner, *Prevent the Artificial Avoidance of PE Status, in U.S. STATE TAX CONSIDERATIONS FOR INTERNATIONAL TAX REFORM*, 123 (Laura Breech ed., 2014) (explaining that the BEPS Project focuses on tackling aggressive tax planning of multinational entities, such as shifting income to tax havens, yet such tax planning involved a relatively minor use of taxable presence planning, and thus it is not surprising that the 2013 BEPS report did not focus on reforming the PE rules).

1014 OECD, *ACTION PLAN ON BASE EROSION AND PROFIT SHIFTING*, 19 (2013) (defining the purpose and scope of Action 7 as “[d]evelop[ing] changes to the definition of PE to prevent the artificial avoidance of PE status in relation to BEPS, including through the use of commissionaire arrangements and the specific activity exemptions…”).

1015 Yariv Brauner, *supra* note 1013, at 125.

1016 See Ben Stupples, *U.K. Won’t Adopt OECD’s Permanent Establishment Definition*, BLOOMBERG (Dec. 20, 2016) (reporting that the U.K. will not adopt the Action 7 recommended changes to the PE definition).

1017 In this part of the chapter, the use of the words “state” or “states” refer to the 50 political entities that constitute the United States of America.
constitutional constraints which are irrelevant in the international context. However, because state taxes are jurisdiction-specific and because nearly all states collect sales tax, the sphere of state sales taxation has become a “miniature model” that resembles (or at least has similar characteristics to) the international taxation sphere with respect to issues of cross-border digital transactions. Therefore, a review of the recent development in state taxation with respect to out-of-state persons would be a good source of comparison to the international discussion regarding the taxation of nonresidents that lack physical presence, and will thus prove helpful for the development of the framework for the taxation of online publishers.

To understand the major developments in this field of tax law, we must first explore some basic concepts in U.S. constitutional law. The Commerce Clause under the U.S. Constitution grants Congress the power to “regulate Commerce… among the several States.” Based on this power, U.S. courts have inferred a limit on the ability of the states to adopt legislation that burdens or discriminates against out-of-state businesses only for purpose of favoring local businesses. Such limitation is referred to as the Dormant Commerce Clause. In the case of Complete Auto Transit, Inc. v. Brady, the U.S. Supreme Court had set a four-prong test for evaluating and sustaining state taxes under the Dormant Commerce Clause. Under the test (which have become known as the Complete Auto Test): (1) the tax must be applied to an activity that has substantial nexus with the taxing state, (2) the tax must be fairly apportioned, (3) the tax must not discriminate against interstate commerce, and (4) the tax must be fairly related to the services provided by the State.

The issue of “substantial nexus”, as required by the first prong of the Complete Auto Test, was the main subject in the U.S. Supreme Court case of Quill Corp. v. N. Dakota By & Through Heitkamp. In Quill, the state government of North Dakota, required the Quill Corporation, an

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1019 U.S. CONST. art. I, § 8 cl. 3.
1022 Id. at 279.
1023 Supra note 851.
out-of-state mail-order house with neither outlets nor sales representatives in the state, to collect and pay use tax on goods purchased for use in the state. The question that came before the court was whether the North Dakota tax, as it applies to such out-of-state seller, which had no physical presence in the state, meets the “substantial nexus” requirement and could be sustained under the Dormant Commerce Clause. In its decision, the Supreme Court cited to the 1967 case of National Bellas Hess, Inc. v. Department of Revenue of State of Illinois,\footnote{386 U.S. 753 (1967).} which was the first Supreme Court decision to discuss the physical presence requirement. In Bellas Hess, the Supreme Court held that physical presence is required to establish substantial nexus under the Dormant Commerce Clause.\footnote{Id. at 756–57.} The court in Quill upheld the Bellas Hess decision with this respect and held that vendors who have no physical presence in a state (and whose only contact with the state is by mail or common carrier) did not have the “substantial nexus with the taxing state” necessary to impose tax-collection duties for purpose of the Dormant Commerce Clause.\footnote{Quill, supra note 851, at 311–13.}

The Quill decision was decided in 1992, only a year after the World Wide Web was developed.\footnote{See supra note 39.} At that time, the only way out-of-state sellers could reach customers within a state was either by mail catalogues or by phone. Therefore, the Supreme Court could not have predicted the far-reaching effect of its decision once e-commerce was developed. The effect was indeed significant. According to the earliest data available, during the fourth quarter of 1999, U.S. retail e-commerce sales were estimated at $5.4 billion, which accounted for 0.64% of the total U.S. retail sales estimate.\footnote{See U.S. DEPARTMENT OF COMMERCE NEWS, supra note 80.} Since then, the estimated U.S. e-commerce sales has multiplied by a factor of 19(!), and the percentage of e-commerce out of total retail sales has risen to 8.4%.\footnote{U.S. CENSUS BUREAU NEWS, supra note 80.} Because most states rely on sales taxes as one of their most significant sources of revenue,\footnote{In 2013, the average percentage of the states’ revenues that came from sales taxes was 22.5%. See Tax Foundation, supra note 1018, Table 8 – Sources of State & Local Tax Collections, Percentage of Total from Each Source, Fiscal Year 2013.} it is no surprise that the growing e-commerce economy, combined with the “physical presence” limitation that was set by the Quill decision, resulted in significant tax losses
to the states. According to a University of Tennessee study conducted in 2009, the total sales tax that the states were expected to lose in 2012 alone due to e-commerce was estimated to be $11.4 billion.\footnote{Donald Bruce, William F. Fox, William B. Stokely & LeAnn Luna, \textit{State and Local Government Sales Tax Revenue Losses from Electronic Commerce} (2009), http://cber.utk.edu/ecom/ecom0409.pdf} This profound impact explains why states have effectively declared war against the \textit{Quill} decision and have pursued a variety of legislative initiatives intended to allow the states to collect taxes from out-of-state sellers.

Having to conform to the physical presence requirement under \textit{Quill}, the states’ first attempt to reclaim their share of sales taxes was through affiliate nexus rules (also known as click-through nexus rules or Amazon laws). These rules target out-of-state sellers that have affiliate programs. Under such programs, sellers pay other website owners a commission for referring users to the sellers’ websites to buy goods or services.\footnote{See ALAN CHARLESWORTH, supra note 43, at 8.} The referral usually must result in a sale of a product or a service for the affiliate to receive payment for the referral, which is typically a percentage of the sale.\footnote{See, e.g., the affiliate program of Amazon (which is known as Amazon Associates), which offers up to 10% commission on qualified purchases made through affiliate referrals. Amazon.com, supra note 166.}

The affiliate nexus rules treat affiliates that have presence in the state as if they were part of the workforce of the out-of-state seller (i.e., the “long-arm” of the seller within the state), therefore creating nexus for the out-of-state seller in the state and requiring the seller to collect sales tax from sales made by residents of the state. These rules apply only to out-of-state sellers that have a sales volume higher than a certain \textit{de minimis} threshold (most commonly $10,000 per year). The rules generally create a rebuttable presumption of nexus, and the out-of-state seller can prove that the in-state affiliate did not engage in any in-state solicitation on behalf of the out-of-state seller, and therefore the seller is not required to collect sales tax. This type of legislation is a limited version of what the states would have liked to do (absent the \textit{Quill} decision) – require out-of-state sellers to collect sales tax even if they do not have a click-through affiliate program.

The first state to enact an affiliate nexus rule was New York.\footnote{See N.Y. Tax Law § 1101(b)(8)(vi) (McKinney) (a person making sales of tangible personal property or services “shall be presumed to be soliciting business through an independent contractor or other} The New York Court of Appeals upheld the law and the U.S. Supreme court denied certiorari.\footnote{In upholding the law,}
the New York Court of Appeals stated that websites owned by New York residents meet the physical presence requirement of *Bellas Hess* and *Quill*.\(^{1036}\) Since the New York law was enacted, nearly twenty other states have followed suit and enacted similar laws, including South Carolina, Michigan, Tennessee, Washington, Nevada, and Vermont, to name a few.\(^{1037}\) As a result of these laws, Amazon has decided to terminate its affiliate program in at least 7 states that introduced affiliate nexus laws (Vermont, Rhode Island, Maine, Missouri, Colorado, Arkansas and Louisiana).\(^{1038}\)

Frustrated by their inability to require out-of-state sellers to collect sales tax, and in light of the declining sales tax revenues, states have urged the federal government to intervene and enact a federal law that would circumvent the physical presence requirement under *Quill*. The first significant federal proposal was the Marketplace Fairness Act of 2013.\(^{1039}\) The Act would allow states to require out-of-state online sellers to collect sales tax according to the tax rate of the location of the buyer, even if the seller does not have physical presence in the state (provided the seller’s remote sales are in excess of an annual threshold and the state either joined the


\(\text{Overstock.com, Inc. v. N.Y. State Dep’t of Taxation & Fin., id. at 595.}\)

\(\text{See David Sawyer, } Senator Introduces Click-Through Nexus Bill, 75 STATE TAX NOTES 140 (Jan. 19, 2015); Maria Koklanaris, Michigan Governor Signs ’Amazon’ Law, 75 STATE TAX NOTES 125 (Jan. 19, 2015); Eric Yauch, Nexus Bill Sent to Governor, 76 STATE TAX NOTES 280 (Apr. 27, 2015); Paul Jones, Click-Through Nexus Bills Introduced in Washington and Nevada, 76 STATE TAX NOTES (April 13, 2015); for a complete list see Mark Faggiano, Which States Require Sales Tax Based on Click-Through Nexus? TAXJAR.COM (Aug 22, 2016), http://blog.taxjar.com/states-sales-tax-click-thru-nexus.}\)

\(\text{See Jennifer DePaul, } Amazon Ends Associates Program Over Online Sales Tax Law, 75 STATE TAX NOTES 87 (Jan. 12, 2015); and Eric Yauch, Amazon Halts Louisiana Associates Program Following Click-Through Nexus Law, 80 STATE TAX NOTES 99 (April 11, 2016). During a several-month period starting at the end of 2016, Amazon announced that it will be collecting sales tax in several states, even though Amazon currently has no apparent physical presence in such states (including states in which Amazon previously cancelled its affiliate program specifically in order to avoid having to collect sales taxes). This is likely due to Amazon’s change in business model, that requires it to have presence in more states in order to provide fast delivery times. See Paul Jones, Amazon’s Sales Tax Collection Deals Show Shift in Strategy, Legal Landscape, 83 STATE TAX NOTES 496 (Feb. 6, 2017). Effective March 1, 2017, Hawaii, Idaho, Maine and New Mexico are the only states (with sales tax) in which Amazon does not collect such tax. See Paul Stinson, Amazon to Start Collecting Sales Tax in Oklahoma, BLOOMBERG DAILY TAX REPORT (Feb. 7, 2017) and Andrew DeMillo, Amazon Will Add Arkansas to Sales Tax List, PORTLAND PRESS HERALD (February 10, 2017), http://www.pressherald.com/2017/02/10/amazon-will-add-arkansas-to-tax-list.}\)

\(\text{S. 734 H.R. 684.}\)
Streamlined Sales and Use Tax Agreement or provides the sellers adequate software to determine the tax to be collected). The Act passed the Senate in May 2013 but was not approved by Congress. In March 2015 a similar version of the original act was introduced in the Senate. A similar bill was introduced in Congress shortly thereafter. An updated version of the bill (in draft form) was again submitted in 2016, titled the Online Sales Simplification Act of 2016. Under that revised version, an “origin state” (the state in which the seller has the most employees) would be able to require sellers within that state to collect sales tax with respect to sales to out-of-state buyers, using the tax base of the origin state and the tax rate of the destination state (i.e., the state where the buyer is located) (a hybrid origin- and destination-based sales tax). The funds collected from such tax would then be distributed to the destination states via a federal clearinghouse.

Despite the flurry of legislative proposals, the fact is that in the past several years Congress has abstained from following through on any of these proposals. Not only that, but in July 2016, a counter legislative proposal has been suggested under the name No Regulation Without Representation Act of 2016. If enacted, the act would codify the Quill decision by creating a physical presence requirement for sales tax purposes (the act even clarifies that a seller that delivers goods to an address in another state using a third-party courier will not be considered as having physical presence in the other state). The result of such act would be that states could not require remote sellers to collect sales tax from sales within the state unless such remote sellers have physical presence in the state.

The inaction on the part of Congress has motivated states to take unilateral measures and enact laws that stretch the definition of nexus to new limits. Some state laws try to work around the Quill limitation, while others directly defy Quill in the hope that a lawsuit filed by out-of-state

1044 H.R. 5893.
retailers would provide the Supreme Court with an opportunity to rethink the *Quill* holding. The three most significant state laws on this matter are from Colorado, Alabama and South Dakota. These are briefly described below.

In 2010 Colorado enacted a new use tax notification and reporting regime.\(^{1045}\) Under this law, remote sellers that are not required to collect Colorado sales tax (i.e., sellers that do not have physical presence in the Colorado) and who have annual gross sales to Colorado residents of more than $100,000, are required to notify their Colorado purchasers that sales or use tax is due on certain purchases made from the remote seller, and to report specific information about these sales to the state of Colorado. Remote sellers are also required to send an annual report to purchasers with $500 or more in purchases. Failure to comply with these notifications and reporting requirements may subject the remote seller to penalties.\(^ {1046}\)

In March 2015, the U.S. Supreme Court upheld the Colorado law, saying that the notice and reporting requirement is not a tax or collection obligation, and therefore *Quill* does not apply.\(^ {1047}\) One interesting aspect of the decision was the concurring opinion of Justice Kennedy, who criticized the *Quill* decision (saying it was a “case questionable even when decided,” even though he himself concurred with the majority opinion at the time), and called for reexamination of the case. Justice Kennedy said that “[t]here is a powerful case to be made that a retailer doing extensive business within a State has a sufficiently “substantial nexus” to justify imposing some minor tax-collection duty, even if that business is done through mail or the Internet… This argument has grown stronger, and the cause more urgent, with time.”\(^ {1048}\) With respect the effect of technology on the physical presence requirement, Justice Kennedy said that “[t]oday buyers have almost instant access to most retailers via cell phones, tablets, and laptops. As a result, a


\(^{1046}\) Louisiana adopted a law similar to the Colorado notification and reporting regime, which will go into effect on July 1, 2017 (HB 1121 (Act 569), 2016 Leg., Reg. Sess. (La. 2016)). In Oklahoma, the Retail Protection Act of 2016 (HB 2531, 55th Leg., 2nd Reg. Sess., (Okla. 2016)) asks out-of-state sellers that maintain a place of business in Oklahoma, including “marketplace providers”, to collect sales tax. The term “marketplace providers” includes any entity that facilitates a sale by a retail vendor by listing or advertising tangible personal property or services for sale in any forum, including websites. Collection and remittance is not mandatory (unlike in the original proposed version of the law), but out-of-state sellers that do not collect and remit are required to send an annual notice to buyers with respect to their Oklahoma tax liability, as under the Colorado law. The Oklahoma law became effective November 1, 2016.


\(^{1048}\) *Id.* at 1135.
business may be present in a State in a meaningful way without that presence being physical in the traditional sense of the term.” Justice Kennedy concluded that “[g]iven these changes in technology and consumer sophistication, it is unwise to delay any longer a reconsideration of the Court’s holding in Quill...”

Following the U.S. Supreme Court decision, the 10th Circuit remanded its decision. Then, in August 2016, the Direct Marketing Association petitioned the U.S. Supreme Court with respect to the decision of the 10th Circuit. In October 2016, Colorado filed a cross-petition urging the Supreme Court to overturn Quill, and in November 2016 eleven other states filed an amici brief in support of Colorado’s call to overturn Quill. All such requests were denied.

A few words of analysis with respect to the Colorado law are in order. The law effectively expanded Colorado’s jurisdiction to nonresidents of the state that could be operating their business from anywhere in the world, despite the fact that they have no presence whatsoever in Colorado, and they only sell to customers who reside within the state. This is definitely a radical approach. That being said, requiring out-of-state sellers to report their sales (to the taxpayer and the tax authorities) is a solution that is only available with respect to sales tax because of the matching use tax. Purchasers must report and pay use tax on their annual state tax return, and therefore a purchaser who did not pay sales tax at the time of sale is required to pay that tax (in the form of sales or use tax) when the annual tax return is filed. Thus, the reporting obligation increases taxpayers’ incentive to self-report and gives authorities better information to collect if taxpayers fails to self-report. This back-stop mechanism does not exist in the case of online publishers, that have no tax return filing obligation in the jurisdiction of the users.

The second example of a “Quill-defying” rule was set in regulations promulgated in Alabama, which was the first to directly challenge Quill following Justice Kennedy’s opinion in DMA v. Brohl. Under the regulations, if an out-of-state seller has annual sales of tangible personal property into the state in excess of $250,000 and the seller conducts certain business activities in

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1049 Id. (emphasis added)
1050 Id.
1051 Direct Mktg. Ass’n v. Brohl, 814 F.3d 1129 (10th Cir. 2016)
the state,\textsuperscript{1053} including solicitation by means of advertising, then the out-of-state seller is considered as having substantial economic presence in Alabama for sales tax purposes and is thus required to register, collect and remit sales tax.\textsuperscript{1054} The regulations became effective on January 1, 2016.\textsuperscript{1055} Unlike the affiliate program laws that rely on the affiliate’s physical presence in the state in order to meet the \textit{Quill} requirement, the Alabama regulations do not require any physical presence, and thus directly contradict \textit{Quill}.

South Dakota is the third state that enacted legislation that directly goes against the \textit{Quill} decision. Under the South Dakota sales tax nexus law, out-of-state sellers are required to register, collect and remit sales tax if they meet one of the following criteria: (1) generate annual gross revenue of more than $100,000 from sales of tangible property, sale of products delivered electronically, or services delivered into South Dakota, or (2) have 200 or more separate sale transactions into South Dakota in a given calendar year.\textsuperscript{1056} This law, which clearly does not meet the physical presence requirement of \textit{Quill}, went into effect on May 1, 2016.

As of the end of January 2017, at least 17 other states have introduced bills that, if enacted, would require out-of-state sellers with no physical presence to collect and remit sales tax.\textsuperscript{1057} Even though all these legislative proposals do not pass muster under \textit{Quill}, it seems that the political pressure from the states (motivated by true economic pressure suffered by the states) will eventually lead the U.S. Supreme Court to change the \textit{Quill} decision and forego the physical presence requirement with respect to the ability of states to require out-of-state sellers to collect sales tax. At this point we must remember, though, that \textit{Quill}, \textit{DMA v. Brohl}, and all the laws discussed above are with respect to the seller’s obligation to collect sales tax and not the income tax liability of the seller itself. The difference between the two is significant. Justice Kennedy, in \textit{DMA v. Brohl}, noted that the activity of an out-of-state seller justifies “imposing some \textit{minor}\textsuperscript{1055}"

\textsuperscript{1053} For a list of the business activities see Section 40-23-68, Code of Alabama 1975 (http://alisondb.legislature.state.al.us/alison/codeofalabama/1975/coatoc.htm).

\textsuperscript{1054} Ala. Admin. Code 810-6-2-.90.03, § 1.

\textsuperscript{1055} Id. § 3.

\textsuperscript{1056} S.D. Codified Laws § 10-64-2 (Certain Sellers Located Outside of State Required to Collect and Remit Sales Taxes—Criteria). As proposed and approved on March 22, 2016 in SD LEGIS 70 (2016), 2016 South Dakota Laws Ch. 70 (SB 106).

\textsuperscript{1057} Eric Yauch, More State Legislatures Considering Sales Tax Economic Nexus Laws, 83 STATE TAX NOTES 494, 494 (Feb. 6, 2017).
tax-collection duty,"1058 and imposing an actual tax liability on the income of such sellers could hardly be considered as a minor matter. It is therefore interesting to see that some states have indeed enacted laws that impose tax on the income (and sometime gross revenue) of out-of-state persons based on such persons’ economic presence within the state. The ability of a state to impose such tax obligation was confirmed in Geoffrey, Inc. v. S.C. Tax Comm’n,1059 in which the court held that “[t]he nexus requirement of the Due Process Clause can be satisfied even where the corporation has no physical presence in the taxing state if the corporation has purposefully directed its activity at the state’s economic forum.”1060

One of the leading examples of such tax is the Ohio Commercial Activity Tax, that applies to gross receipts of taxpayers that have a nexus in the state. A taxpayer will have nexus in Ohio for purpose of this tax if he has more than $500,000 in sales to customers in Ohio.1061 Ohio was recently on the defense for the rationale behind this nexus rule, after three non-Ohio based e-commerce companies challenged it in court. The three cases were joined under Cruchfield Corp. v. Testa.1062 In this case, the taxpayers argue that the controlling precedent is Tyler Pipe Industries Inc. v. Washington Department of Revenue,1063 where the court held that a taxpayer has substantial economic nexus in a state only if it engages in activities in that state, either directly or through agents acting on its behalf. On the issue of psychical presence, Ohio is arguing that the out-of-state retailers store software in the state (in the form of cookies which are saved on the users’ browsers), and software is tangible personal property which thus creates physical presence for the retailers in the state. The retailers’ counter argument is that (1) they are not targeting users based on their geographic location, (2) the cached cookies are subject to complete control by the users, who can delete them, and that (3) electronically transmitted information is not tangible personal property.1064

1058 DMA v. Brohl, supra note 1047, at 1135.
1060 Id. at 19.
1061 Ohio Rev. Code Ann. § 5751.01(H), (I) (West).
1062 Cruchfield Corp. v. Testa, Dkt. No. 2015-0386, Ohio Sup. Ct.
In November 2016, the Supreme Court of Ohio dismissed the taxpayers’ appeal, in an opinion that did not include any discussion with respect to the above “nexus via cookies” argument. The court held that “although a physical presence in the state may furnish a sufficient basis for finding a substantial nexus, Quill’s holding that physical presence is a necessary condition for imposing the tax obligation does not apply to a business-privilege tax such as the [Ohio Commercial Activity Tax], as long as the privilege tax is imposed with an adequate quantitative standard that ensures that the taxpayer’s nexus with the state is substantial.”¹⁰⁶⁵ The court then cited a handful of cases that have explicitly rejected the Quill physical-presence standard to taxes on, or that are measured by, income.¹⁰⁶⁶ The court also said that Tyler Pipe stands for the proposition that physical presence is a sufficient condition for imposing tax, but not a required one.¹⁰⁶⁷ I.e., the court held that a nonresident of the state can have substantial nexus that would subject him to tax in the state even in the absence of physical presence, provided such substantial nexus exists. In this case, the court held that the $500,000 sales-receipts threshold complies with the substantial-nexus requirement.¹⁰⁶⁸

Another leading example of a state that has adopted the economic nexus for income tax purposes is Oregon. Under Oregon regulations, a person can have “substantial nexus” for purpose of Oregon income tax without having physical presence in the state.¹⁰⁶⁹ The Oregon law states that “[s]ubstantial nexus exists where a taxpayer regularly takes advantage of Oregon’s economy to produce income for the taxpayer and may be established through the significant economic presence of a taxpayer in the state.”¹⁰⁷⁰ In determining whether a taxpayer has substantial nexus, several factor may be considered, including whether he taxpayer: (1) maintains continuous and systematic contacts with Oregon’s economy or market; (2) conducts deliberate marketing to or solicitation of Oregon customers; (3) receives significant gross receipts attributable to customers

¹⁰⁶⁵ Cruchfield Corp. v. Testa, 2016-Ohio-7760, at ¶ 42 (emphasis added).
¹⁰⁶⁶ Id. at ¶ 47.
¹⁰⁶⁷ Id. at ¶ 50.
¹⁰⁶⁸ Id. at ¶ 52.
¹⁰⁶⁹ Or. Admin. R. § 150-317-0020(2) (December 1, 2016).
¹⁰⁷⁰ Id. § 150-317-0020(2) (December 1, 2016) (emphasis added).
in Oregon; (4) receives significant gross receipts attributable to the use of taxpayer’s intangible property in Oregon; and more. ¹⁰⁷¹

Other states that have economic nexus rules with respect to income/gross receipts are Washington and South Carolina. In Washington, a person with more than $250,000 of gross receipts from certain activities in the state is considered as having substantial nexus with the state for purposes of the business and occupation tax. ¹⁰⁷² South Carolina published a list of activities that create nexus for state income tax purposes. Under the list, having a substantial number of customers with billing address in South Carolina or earning a substantial amount of revenue from South Carolina customers will create nexus for an out-of-state corporation that has no physical presence in the state and only provides access to its software to South Carolina customers. ¹⁰⁷³

In summary, the above review of the various state tax initiatives that impose obligations on out-of-state persons (either to collect sales tax or actual tax liabilities) shows that the concept of economic presence of foreign persons is spreading rapidly and is being adopted by more and more governments as a necessary mean to address the shortfall in tax revenues and to address the challenges tax administrators are facing when confronted with new technology-based business models that allow nonresidents to conduct significant business activity in the state without having any physical presence. Countries around the world are facing similar challenges in the international arena and share the same concerns and difficulties. Therefore, the expansion of the nexus definitions under state laws and the implementation of the economic presence test in this context are likely an indication for what would be expected in the international arena as well (as already evidenced by several unilateral measures adopted by certain countries, as discussed in the last part of this chapter).

10.2.2.4. Proposal for an Economic-presence-based PE Threshold

The common denominator of all the initiatives and reports discussed in the previous section is that they all consider (although not necessarily recommend) the possibility of creating a taxable

¹⁰⁷¹ Id. § 150-317-0020(3) (December 1, 2016).
presence for a nonresident based on various indicia of economic presence. One resembling feature of all these initiatives is that they all failed to achieve this goal. This part of the chapter will present a proposal for an economic-presence-based PE threshold that would apply to online publishers and would hopefully lead to the intended outcome – creating a taxable presence for online publishers in the jurisdictions of users (under certain circumstances), thus allowing such jurisdictions to tax the online publishers.

According to the PE threshold proposed below, a nonresident is considered having a taxable presence in a jurisdiction if: (1) the nonresident exploited an economic resource or enjoyed an economic benefit from within the jurisdiction, (2) the resource and/or benefit enjoyed/exploited by the nonresident is a material factor in the realization of the nonresident’s income, and (3) the nonresident’s activity has crossed the de-minimis threshold. Each of these three prongs is discussed below.

10.2.2.4.1. Prong I – Exploitation of Economic Resources or Enjoyment of Economic Benefits

The existing definition of the PE concept is intended to create a taxable presence to a nonresident only when such nonresident has a connection with the economy of the jurisdiction that is more than negligible and such connection is manifested in some fixed physical presence in the jurisdiction. The connection between the nonresident and the jurisdiction must involve some core aspect of the business, because the PE definition specifically excludes auxiliary and preparatory activities for purpose of creating a taxable presence.

As was discussed in prior chapters, in the digital age a nonresident can have significant economic connection with a jurisdiction (thus theoretically justifying the finding of a PE) even without having any physical presence in the jurisdiction. Such economic connection is created when the nonresident is able, by means of technology, to exploit economic resources that are located within the jurisdiction and/or enjoy economic benefits that are conferred by the jurisdiction. Therefore, the first prong of the proposed PE threshold is that the nonresident exploit an economic resource and/or enjoy an economic benefit from the jurisdiction. In essence, this prong is looking for anything from within the jurisdiction that the nonresident is enjoying and that contributes to the creation of value. This prong does not require the nonresident to have physical
presence in the jurisdiction because such requirement is not indicative of the ability of the nonresident to generate value from the jurisdiction.

One example of a scenario to which this prong applies is mining of personal data. When nonresidents mine, collect and process personal data of users located in a given jurisdiction, such nonresidents are exploiting an economic resource that is located within that jurisdiction. At this point of the discussion it must be clear why and how such personal data is exploited and that this is an extremely valuable economic resource. Another example could be that of a nonresident harnessing the processing power of computers located within a jurisdiction.

This prong of the proposed PE threshold also ensures that a nonresident is not treated as having an economic connection with a jurisdiction solely based on market demand. I.e., the proposed PE threshold would not create a taxable presence for remote sellers whose only connection with the jurisdiction is by remotely selling goods or services to customers within the jurisdiction. That type of activity has traditionally been recognized as creating only a weak economic connection, if any.\textsuperscript{1074} I agree with that view and I argue that such activity should not create taxable presence for the nonresident because a sale of goods or services into a jurisdiction (absent specific targeting of that market) does not contribute to the creation of value for the seller. Although the price that a purchaser agrees to pay to purchase a product reflects the value of the goods, the payment does not, in and of itself, create value. Value is created by the efforts and actions of the seller, such as research and development, procurement of resources, manufacturing, marketing and sales efforts, or making the products available in new markets. The ultimate sale is only a barter transaction where the parties exchange a product for currency in an amount equal to the value of the product in the eyes of the purchaser. The actual sale materializes the value already embedded in the product, but it does not create the value. Therefore, the traditional “market demand” view, under which a connection with a jurisdiction that is based solely on market demand should not create a nexus for a nonresident, is justified and is followed by this prong of the proposed PE threshold.

\textsuperscript{1074} See supra note 615. See also OECD, supra note 818, at 101 (saying that “while having a market in a country is clearly valuable to a seller, this condition by itself has not created a taxing right in the area of direct taxation to this point”).
10.2.2.4.2. Prong II – Material Factor Test

The material factor test is borrowed from the U.S. Treasury Regulations, where such test is used to determine whether income is attributable to an office or a fixed place of business under certain circumstances. One of the applications of the material factor test in connection with the source rule for the sale of inventory property.\textsuperscript{1075} Under the general rule, income from sale of inventory property that was purchased within the U.S. and sold outside the U.S. (or purchased outside the U.S. and sold in the U.S.) is based on the place of sale,\textsuperscript{1076} which is determined according to the title passage rule.\textsuperscript{1077} However, under one of the exceptions to the general source rule, when a nonresident (who is engaged in a trade or business in the U.S.) derives income from the sale of personal property (including inventory) for use, consumption or disposition in the U.S., and that income is attributable to an office or other fixed place of business (“FPB”) that the nonresident maintains in the U.S., the income is sourced within the U.S. (regardless of the place of sale).\textsuperscript{1078} For purpose of this exception, income is attributable to the office or FPB of the nonresident in the U.S. only if such office or FPB is a material factor in the realization of the income.\textsuperscript{1079} Activities will not be considered a material factor unless they “provide a significant contribution to, by being an essential economic element in, the realization of the income, gain, or loss.”\textsuperscript{1080} However, the activities of the office or FPB in the U.S. do not have to be a major factor in the realization of the income, gain, or loss.\textsuperscript{1081} The regulations explain that in the context of the sale of goods, an office or a FPB is considered a material factor in the realization of income if the office or FPB actively participates in soliciting the order, negotiating the contract of sale, or performing other significant services necessary for the consummation of the sale which are not the subject of a separate agreement between the seller and the buyer.\textsuperscript{1082}

\textsuperscript{1075} The material factor test also applies for purpose of determining whether certain types of foreign-source income of a Foreign Person (namely, income from intangibles, income from banking or securities business and income from sales of inventory) is attributable to such Foreign Person’s U.S. office or fixed place of business, in which case the income would be subject to U.S. tax (I.R.C. § 864(c)(4)(B)).

\textsuperscript{1076} Id. §§ 861(a)(6) and 862(a)(6).

\textsuperscript{1077} See supra note 897.

\textsuperscript{1078} I.R.C. §§ 865(e)(2) and 864(c)(4)(B)(iii).

\textsuperscript{1079} Treas. Reg. § 1.864-6(b)(1).

\textsuperscript{1080} Id. (emphasis added).

\textsuperscript{1081} Id.

\textsuperscript{1082} Id. § 1.864-6(b)(2)(iii) (emphasis added).
In an analogy from the above test, the second prong of the proposed PE threshold requires that the economic benefits and/or resources from which the nonresident is enjoying are a material factor in the realization of income by the nonresident. The economic benefits or resources will be considered a material factor if they significantly contribute to, or serve as an essential economic element in, the realization of the income. The benefits or resources enjoyed by the nonresident do not have to be the most significant factor contributing to the realization of income. A benefit or resource that are a necessary element in the consummation of a transaction or the realization of the income would thus be considered as a material factor under this test.

The material factor test under the regulations is essentially used to identify income that is sufficiently connected to the U.S. office of the foreign person, thus justifying the sourcing of such income in the U.S. (and therefore the taxation of the income in the U.S.). The material factor test is adopted in the second prong of the proposed PE threshold for similar reasons – to ensure that taxable presence would be created for a foreign person only when such person enjoys economic benefits or resources that are sufficiently connected to the income realized by the foreign person.

This prong is somewhat similar to the “preparatory or auxiliary” exception under the existing PE definition, which serves as an indicator to whether the foreign person has sufficient involvement in the economic life of the jurisdiction in order to justify taxation at source. The exception considers certain preparatory or auxiliary activities as being insufficient to create such taxable presence and subject the foreign person to tax at source.

10.2.2.4.3. **Prong III – De-Minimis Exception**

In connection with the significant economic presence nexus option discussed in the BEPS Action 1 report, the TFDE suggested that a revenue-based factor, based on gross revenues received from the jurisdiction, be included as one indicator of the existence of significant economic presence in such jurisdiction.\(^\text{1083}\) It was suggested that such factor would also serve as a threshold for triggering significant economic presence in order to minimize administrative burden for tax

\(^{1083}\) OECD, *supra* note 818, at 107.
administrators and compliance burden for taxpayers, under the assumption that nexus is less likely to be created when only a small amount of revenue is received from a jurisdiction.\textsuperscript{1084}

The substantive test of the proposed PE threshold, as described in prongs I and II above, does not include a revenue factor as an indication for the creation of nexus. Including such a factor could preclude foreign persons from having a taxable presence in jurisdictions where they exploit economic resources in situations where the revenues realized in connection with exploitation of such resources are received partly or wholly from another jurisdiction. That would be the case in online advertising, where the location of the customer (advertisers) and the location of the economic resource used to realize the income from the customer (users, whose personal data is exploited), does not necessarily correlate – the advertisers could be located in jurisdictions that are different from the users that trigger the advertising revenue.

A revenue-based threshold could still be used to relive administrative burden for tax administrators and compliance burden for taxpayers. However, this raises the question of how to set a revenue threshold when the administrators of a given jurisdiction do not know how much revenue was triggered to the nonresident from the exploitation of economic resources from within the jurisdiction (because, as described in the previous paragraph, the revenues could be realized from other jurisdictions). In order to answer this question, we must get ahead of ourselves and explain that the following parts of this chapter will include a proposal for the tax (and means to collect that tax) that should be applied to nonresidents that have a PE (in the context of online advertising) based on the proposed PE threshold discussed herein. The proposal suggests both a multilateral and a unilateral solution. In either case, each jurisdiction could set its own revenue threshold based on such jurisdiction’s considerations and audit efficiency (i.e., its revenue-collected to cost-of-audit ratio). If the multilateral collection instrument proposed in part 10.2.5 of this chapter is adopted, the threshold could be applied based on the overall global revenues of the online publisher, whereas if the unilateral option is adopted the threshold could only be applied to the revenues generated by the online publisher from the jurisdiction conducting the audit. That limitation should be taken into account by each jurisdiction when setting the threshold.

\textsuperscript{1084} \textit{Id.} at 108.
In addition, a revenue-based threshold that will exclude small and medium online publishers may be necessary because of the possible effects that the flat-rate tax on gross revenues which is proposed below could have on such publishers. Although the proposed tax rate is low (3-4% of gross revenues), it is based on the high net income margins of the large online publishers (Google and Facebook). Online publishers with lower profit margins could be negatively affected by such gross revenue tax, that could unintentionally benefit the large online publishers by preventing competition from small and medium publishers.

Finally, the de-minimis threshold should also include a “trade or business” requirement, such that a nonresident could not have a PE under the proposed PE threshold unless such nonresident regularly carries on activities of the type from which the revenues (realized due to the exploitation of economic resources in the jurisdiction) are derived.

10.2.2.5. Application of the Proposed PE Threshold to Online Advertising

After reviewing the components of the proposed PE threshold, its application in the case of online publishers seems clear. With respect to the first prong of the threshold, a foreign online publisher that mines personal data of users and targets such users with specific ads, is exploiting an economic resource from within the jurisdiction. As we have extensively discussed in previous chapters, the personal information of users, which the online publisher harvests, is an economic resource in much the same way as natural resources. The personal information, data and content of users have enormous economic value (as evidenced by the market size of companies that mine, exploit and trade in this data), which is attributed to the jurisdiction in which the users reside. This prong of the threshold does not require that the foreign online publisher has any physical presence in the jurisdiction of the users in order for the PE threshold to be crossed.1085

1085 Although not required, one could also argue that the online publisher does indeed have a physical presence in the jurisdiction of the users, or at least a deemed presence for purposes of the PE test. According to the 2005 report of the OECD’s TAG on the taxation of e-commerce, “physical activity somewhere, as reflected by an entrepreneur’s risk assumption, labour deployment, and property investments, remains a necessary component to an enterprise’s creation of products and services” (OECD, supra note 615, at 15–16). This argument is based on the fact that income cannot be derived “on the internet” because the internet is not a separate and distinct place. Unlike the high-seas or space, which are actual places where people can engage in trade and commerce, the internet is only a medium of communication between people, that have a very physical presence in their respective jurisdictions (see Jack L. Goldsmith, supra note 803, at 476 (arguing that the internet is only a medium of communication between people that reside within a territory, and thus

Continued on the next page...
The second prong of the proposed PE threshold is also met with respect to online publishers because the economic resource being exploited (the users and their personal data) is a material factor in the realization of income. The users’ personal data and the actions of the users (viewing, clicking or acting upon an ad) are an essential economic element in the realization of the income. Although other elements also contribute to the realization of the income (namely the work of employees who develop and maintain the online platform, support the computer servers that to operate the platform, and engaged in sales and service activities), the users are a necessary element in the consummation of the online advertising transaction and the realization of the income. Therefore, the users and their personal data are considered a material factor under this prong of the test.

The \textit{de-minimis} threshold includes two aspects. First, it requires that the online publisher realize revenues in excess of a threshold set by the relevant jurisdiction. Because the revenue factor is not a substantive requirement for the creation of taxable presence, but is rather only used as a convenient tool to alleviate administrative burden, a discussion of this aspect is not required for purpose of this theoretical application of the proposed PE threshold. The second aspect of the \textit{de-minimis} threshold, that requires that the online publisher regularly carry activities of the type from which the revenues are derived, is also met.

Based on this analysis, the application of the proposed PE threshold in the case of online publishers would result in online publishers having a taxable presence in the jurisdiction of the users, thus providing such jurisdictions with a legitimate claim to tax online publishers.

\textbf{10.2.2.6. The Proposed PE Threshold – a Standard for Closing the Gap}

As was discussed in chapter 5 above, good tax laws aim to tax the true economic reality of transactions. Tax rules that are not able to fully comprehend the business and economic
outcomes of a transaction create a gap between such economic and tax results. The gap creates an opportunity for taxpayers to avoid paying taxes with respect to the accurate economic benefits of their actions. Taxpayers can take advantage of this gap by “planning into it,” thus structuring their business models and transactions in order to fall into the gap, but taxpayers can also enjoy the tax benefits of the gap in a passive way. Such passive avoidance is not a result of tax planning but rather a result of the inability of tax rules to fully encompass the economic consequences of the taxpayer’s activities. That is the case of online advertising – the existing PE rules do not recognize the users and the mining of the users’ personal data as a factor that should be considered when determining whether a foreign person should have a taxable presence in a jurisdiction. Online publishers have been passively enjoying this gap in the tax laws.

In order to solve the problem and close the gap the PE rules must be changed. The rules could be changed either by adding to or modifying the existing rules, or by adding a standard that would set criteria against which varying circumstances would be compared when the existing rules fail to apply.

The main factor influencing the decision between rules and standards is the frequency with which the law will be applied to a certain conduct. When the conduct (and in the case of tax law, an income-generating transaction) is expected to be frequent and have recurring characteristics, designing a rule would be more efficient, because the savings from the frequent application of the rule would exceed the higher costs of designing a complex rule. However, when the conduct is infrequent and subject to a large number of variations, a standard is generally preferable, because drafting a rule that would cover all possible transactions becomes too complicated a task.

In our case, although the digital economy has grown exponentially in the last decade, the number of unique types of transactions is not significantly large. In addition, the possible variations of

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1086 See Louis Kaplow, supra note 274, at 621.
1087 Id. at 621.
1088 Id. at 621–22. See also David A. Weisbach, supra note 274, at 886.
1089 For example, the TFDE identified and discussed a handful of business models that have arisen from the digital economy, such as e-commerce, app stores, online advertising, cloud computing, participative networked platforms, high speed trading, and online payment services. OECD, supra note 818, at 54. In
future types of transactions arising from the digital economy is practically infinite. We cannot know today what new types of technology will be developed in the future and what new types of transactions such technology would allow. These facts suggest that a standard-based solution for the PE threshold is the proper choice. Although tax administrators would presumably need to apply the standard to a large number of taxpayers, the relatively small number of different types of transactions mean that decisions made with respect to such transactions could be transformed into rules by the power of precedent, thus providing greater efficiency and predictability to taxpayers and tax administrators alike.

The proposals made by Action 1 and Action 7 of the BEPS project adopted a rule-based solution to the PE problem. This is evidenced by the changes to the PE rules proposed in Action 7 and by the multiple objective factors that were proposed for the “significant economic presence” nexus option in Action 1. These additional rules add complexity to an already-complex tax system, which in turn creates additional “bright lines” that taxpayers can plan around. In addition, rules, unlike standards, are not able to adequately deal with unforeseen scenarios, and that would likely be the case when the BEPS Project’s proposed rules would encounter a new type of business transaction made possible by a new technology that does not adhere to objective factors such as number of users or volume of data (as suggested by the Action 1 report). Therefore, attempting to solve the problem of the PE concept with more rules would eventually lead us back to the same spot we are in today – a PE definition that cannot coherently apply to new types of business models, thus creating a gap between the economic and tax results of the transaction.

On the other hand, the PE threshold proposed above is a standard-based solution. It is an open-ended standard that could be interpreted and applied to countless unique transactions that may develop in the future. The terms “benefit,” “realization,” and “material,” used in the first two prongs of the proposed PE threshold, are susceptible to interpretation, thus providing the proposed PE threshold (and the courts that will interpret it) sufficient flexibility that will allow

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1090 See Stanley S. Surrey & William C. Warren, The Income Tax Project of the American Law Institute: Gross Income, Deductions, Accounting, Gains and Losses, Cancellation of Indebtedness, 66 HARVARD LAW REVIEW 761, 775 (1953) (“In the income tax, as in other complex legislation, the need is for a standard which will project our present aims into the future and serve as the vehicle for solving the unforeseen cases as they arise”).
this concept to maintain its validity as future types of transactions and income develop. At the same time, the overall goal of the proposed threshold is clear – give jurisdictions the right to tax income generated by nonresidents that exploit the economy of such jurisdictions, even when the exploitation takes place in completely virtual realms. This goal is widely shared amongst most countries. Given this generally-broad consensus, the proposed PE threshold seems like an appropriate solution for one of the main problem in the international tax system. The strongest opposition to this proposed PE threshold is expected to come from the U.S., who has been reluctant to adopt changes that would give source countries more taxing rights, and has opposed attempts by foreign countries to tax U.S. multinationals. However, such opposition is not based on a legal argument but rather only on the (understandable) interest of the U.S. to preserve its tax base. Although a decision of the U.S. not to adopt the proposed PE threshold could hinder its global adoption, the U.S.’s blessing is not required for a successful implementation of this proposal, that could be achieved by a multinational initiative (even one that excludes the U.S.) or by unilateral legislation.

10.2.3. Flat-Rate Tax on Gross Revenues

Once the jurisdictions of the users have a right to tax the income of online publishers, the next question to consider is what part of the online publisher’s income would be taxed by such jurisdictions and what taxes would apply.

Under the existing rules, once a foreign person is found to have a PE in a jurisdiction, the business profits attributable to such PE could be taxed by such jurisdiction. The business profits that are attributable to a PE are such profits that the PE might be expected to make if it

1091 But see part 10.2.6 of this chapter regarding the effect that the proposed PE threshold would have on the issue of certainty and predictability.

1092 See Alice G. Abreu and Richard K. Greenstein, supra note 255, at 331–32 (suggesting that when there is a widely shared understanding of the goals and values that underlie the relevant field of law, then a standard that reflects those values will be apt).

1093 See supra notes 634 and 1011.

1094 See Article 7(1) of the OECD and U.S. Treaty Models. The U.N. Treaty Model includes a similar provision yet amplifies it with a limited force-of-attraction rule. Under that rule, the country in which the PE is located can tax not only the profits attributable to the PE but also other business profits derived by the foreign person in that country not through the PE (but only if such other profits are derived from the same or similar type of activities that are separately performed by the PE). See Article 7(1) of the U.N. Treaty Model and UNITED NATIONS, supra note 475, at 142–43.
were a separate and independent enterprise engaged in similar transactions under similar conditions (i.e., the arm’s length principle).

An initial question that must be addressed is whether the income that the online publisher generates should at all be apportioned, or rather it should be considered as arising entirely from the jurisdictions of the users. In chapter 9.1.1 we concluded that there are two categories of communities the economic life of which make it possible for the online publishers to generate income – the communities where the employees and users are located. These are the jurisdictions that most significantly contribute to the creation of value for the online publisher. Therefore, it would be improper to ignore the jurisdiction of the employees (where the online platform is developed and maintained) for purpose of attributing the income of the online publisher. The jurisdiction where most of the research and development efforts took place (which is usually, but not necessarily, also the jurisdiction of residence) has a legitimate claim to tax at least part of the income. Therefore, if we were to apply the existing PE rules, the income of online publishers would need to be apportioned between the jurisdiction of residence (assumed for this purpose to be the jurisdiction in which the R&D activity takes place) and all jurisdictions in which the online publisher has a PE due to the exploitation of personal data.

In practice, the method for determining the portion of income that should be attributable to a PE is quite complicated and subject to intensive debates. The difficulties in dividing taxing rights between multiple jurisdictions was identified by the 1923 Double Taxation Report. One of the methods that the four economists considered as a possible solution for double taxation was the “method of division of tax.” This method suggested dividing the right to tax between the countries of source and residence based on the economic contribution carried in each. The economists believed that adopting this method could provide a good practical outcome, even thought it would not be the most accurate application of the economic allegiance theory because the division of the income would be arbitrary and imprecise. The report eventually rejected this method due to difficulties of application. The report noted that “it is not possible on the

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1095 See Article 7(2) of the Treaty Models.
1096 1923 Double Taxation Report, supra note 348, at 42.
1097 See id. at 45–46.
1098 See id. at 46.
The report further explains that the “division of tax” method would require the country of residence to give relief to a portion of the income, yet determining that portion would be impracticable in a multinational setting, where each country has its own income tax rules and rates. With this respect, the report noted that “[t]o allocate the exact proportion of economic allegiance to origin or domicile in each particular category is well-nigh impossible. Such an attempt would savour too much of the arbitrary.” Therefore, the report concluded that the division of tax method is not the most desirable method for resolving double taxation.

This method of division of tax is essentially what the rules for attribution of income to a PE attempt to achieve. During the century that has passed since the 1923 Double Taxation Report was published, the role of multinational entities in the global economy has only grown, yet the task of dividing income to various jurisdictions remained equally complicated, and the need to allocate income to jurisdictions in which taxpayers do not have physical presence only complicates things even further. Even alternative methods for attributing income, such as the formulary apportionment method, do not alleviate the complexity or income attribution.

One of the key difficulties when determining the business profits (i.e., net income) attributable to a PE is the attribution of expenses and costs. Entities that have a PE in a foreign jurisdiction typically incur costs that are associated with the realization of income by the PE but are not incurred in the jurisdiction of the PE. These are commonly overhead costs related to the administration of the business (for example, the cost of the main office, salary of the CEO, etc.)
but also the cost of research and development of the products sold through the PE, marketing and sale costs, etc. Such costs would need to be allocated amongst all the PEs (and non-PE related entities) of the foreign persons that have benefited from the costs in the realization of income. This turns out to be an extremely complicated task, as evidenced, for example, by the highly technical and convoluted regulations for the allocation and apportionment of research and experimental expenditures under U.S. tax law.

The digital economy exacerbates this problem even further. First, companies that operate mostly or entirely online will have a more centralized cost structure with less (or no) direct costs associated with the PEs. The result is that there are more indirect costs to allocate to the various PEs, some of which do not even have physical presence in the relevant jurisdiction. In addition, the digital economy increased the use of inter-company royalty payments, which are paid by the operating entities (and could equally be allocated to PEs) for the right to use the intangibles, usually developed by the parent company. As we have seen in the Double-Irish Sandwich tax structure, a well-designed inter-company royalty payment agreement can significantly minimize a company’s (or a PE’s) net income, which would undermine any attempt to properly allocate expenses to a PE and leave the jurisdiction of the PE with practically no tax revenues. The use of royalties to minimize tax liability at source is subject to limitations, and could be further restricted with additional rules, but that would only further complicate the task of allocating expenses.

The above discussion shows that the task of attributing income and expenses to a PE is a complicated one, it increases the costs of compliance and audit, and eventually is likely to yield an inaccurate result. These conclusions are even stronger with respect to the attribution of income to a PE of a digital company that has no physical presence in the jurisdiction of the PE. Under these circumstance, a flat-rate tax on gross revenues, rather than corporate tax on net income, could be a more appropriate solution. Such flat-rate tax would eliminate the need to allocate expenses and thus significantly minimize compliance and audit complications and costs.

1104 See American Law Institute, supra note 688, at 13 (stating that “[i]n the nature of things, it is at best difficult for a source country to verify the deductions necessary to determine the net income of a foreign person…”).

A flat-rate tax on gross revenues would still require allocation of revenues to the PE, but at least in the case of online advertising that seems to be a straightforward task – if an online publisher is found to have a PE in a given jurisdiction, the revenues attributed to that PE would be revenues generated by the users in such jurisdiction. Because every view, click or action that users take is recorded in the systems of the online publisher (for purpose of billing the advertisers), all the data required to attribute the revenues to the PE already exists and determining the amounts to be attributed to each PE should be a simple calculation.

However, attributing the revenues entirely based on the location of the users that generated it would mean that all the revenues of the online publisher would be allocated to the various user-jurisdictions but none would be allocated to the jurisdiction of residence (where the R&D and maintenance of the online platform is conducted). That result undermines the conclusion reached above, whereby the country of residence also has a legitimate claim to tax at least a portion of the income. That problem could be solved by setting the flat tax at a low-enough rate, and thus, when the jurisdiction of residence taxes the entire global net income of the online publisher it can collect a portion of the tax (even after giving credit to the taxes paid to the source jurisdictions). However, in order to prevent a situation where the online publisher enjoys the lower flat tax rate but is ultimately not taxed by the country of residence (either because of tax planning or because the country of residence exempts foreign source income), the online publisher should be required to prove that the income was taxed by the country of residence (or by the country of residence of the ultimate parent, in case the entity that is considered as having a PE is only a subsidiary in the multinational group) at a rate that is equal to or higher than a certain threshold (that could be set to a fixed rate, the average OECD corporate tax rate or other benchmark rates). If the online publisher is not able to show that the income was ultimately taxed at residence at an adequate rate, the flat-rate tax that would apply to the gross revenues attributed to the PE would be higher.

The results of such flat-rate tax would likely be no less arbitrary than the results arising from allocation of revenues and expenses to a PE. However, a flat tax on gross revenues significantly decreases compliance and audit costs, and the arbitrariness of the results could be somewhat mitigated if the customary level of expenses that one can expect the find in companies that operate online would be taken into consideration in determining the rate of the tax.
According to their public financial reports, Google has a net income (before taxes) margin of approximately 26% of revenues, and Facebook operates at an average margin of 40%. Under such margins, a flat-rate tax of 3% to 4% would be appropriate. A tax of 3% on gross revenues would be equivalent to a tax rate of 11% on net income in the case of Google and 7.5% in the case of Facebook. Such rates seem more than reasonable (they are less than the 12.5% corporate tax rate in Ireland, which is the lowest rate in the OECD). These rates also leave room for the residence country to tax the net income of the online publisher while maintaining a relatively reasonable overall effective tax rate of the online publisher. Provided that the residence country grants a tax credit for the taxes paid to the jurisdiction of the users, the residence country can still collect tax at an effective residual rate of more than 10% (assuming a corporate tax rate in the low twenties) and even more than that in the case a more profitable company, like Facebook. Applying a 4% rate would be the equivalent of a 15% tax rate on net income in Google’s case and 10% in the case of Facebook – still in the reasonable range. That being said, such tax rates would apply only if the online publisher can show that the revenue is in fact subject to tax by the country or residence. Otherwise, a higher rate should apply. A rate of 6–7% would be equivalent to a rate in the mid-twenties for Google or in the high teens for Facebook. Such rates would be significantly higher than the effective tax rate that such internet giants currently pay on their non-U.S. income.\footnote{1107}

\footnote{1106} Google revenues (in millions) for 2014, 2015 and 2016 was $66,001, $74,989, and $90,272, respectively, and its income before income taxes for such years (in millions) was $17,259, $19,651, and $24,150, respectively. See Alphabet Inc., Annual Report (Form 10-K) for the year ended December 31, 2016. Facebook’s revenues (in millions) during such years was $12,466, $17,928, and $27,638, respectively, and its income before income taxes (in millions) for these years was $4,910, $6,194, and $12,518, respectively. See Facebook, Inc., Quarterly Earnings, Q4 2016 – Income Statement (Feb. 1, 2017).

\footnote{1107} In addition, in order to prevent cash flow problems for small and medium online publishers (assuming such publishers were not excluded from the PE definition under the \textit{de minimis} threshold), the flat-rate tax could be set at a 0% rate for such publishers that demonstrate that their net income margin (for this purpose, excluding any inter-company royalty payments) is less than a certain threshold. Applying a 3% flat rate tax to a publisher with an 8.5% net income margin would reflect a net income tax of 35%, which is the current corporate tax rate in the U.S. and is considered high. Therefore, an 8.5–10% profitability threshold would seem reasonable. Alternatively, a graduated tax rate could be applied to each online publisher based on the average net income margin of such publisher in the three preceding years. That would be a more burdensome system to administer, but it would be possible to implement, especially in the context of the multilateral withholding proposal discussed below.
10.2.3.1. Double Taxation

The first concern that comes to mind with respect to the above proposal is double taxation. If the jurisdiction of residence does not allow the online publisher a foreign tax credit for the taxes paid at source, the income of the online publisher would be subject to double taxation. That is a valid concern because there is a great likelihood that a flat tax on gross income paid to the source jurisdiction would be disallowed as a foreign tax credit in the country of residence.\textsuperscript{1108}

This issue should be solved by applying a foreign tax credit or an exemption in tax treaties and domestic laws of the residence country. In cases where the residence country has an exemption system in place there would not be any concern of double taxation, assuming the country of residence adopts the source rule discussed in part 10.2.1 of this chapter, under which the income of the online publisher is sourced to the jurisdiction of the users. In that case, because the country of residence will not tax the income at all, the higher flat-rate tax would apply.

Regarding foreign tax credits, there is a valid argument that a foreign tax credit should be allowed with respect to the proposed flat-rate tax, at least under U.S. tax law.\textsuperscript{1109} As noted in supra note 1108, a foreign tax must meet several requirements for a U.S. Person to be allowed a foreign tax credit with respect to the payment of such tax. The main hurdle in our case is the “net income” requirement, under which the foreign tax must permit the recovery of significant costs and expenses.\textsuperscript{1110} Therefore, generally, a foreign tax based on gross receipts or gross income does not satisfy the “net income” requirement. However, treasury regulations say that a gross income tax could satisfy this requirement:

\textsuperscript{1108} For example, a U.S. person is allowed a foreign tax credit only for taxes imposed on “income, war profits or excess profits.” I.R.C. § 901(b)(1). A foreign levy comes within this definition only if it is a tax the predominant character of which is that of an income tax in the U.S. sense (Treas. Reg. § 1.901-2(a)(1)). The “predominant character” test is met if the foreign tax is likely to reach net gain in the normal circumstances (id. § 1.901-2(a)(3)(i)). One of the requirements that a tax must meet in order to satisfy the “net gain” test is that such tax permits the recovery of significant costs and expenses (id. § 1.901-2(b)(4)), thus generally excluding taxes based on gross receipts. \textit{See also} OECD, supra note 818, at 117 (the TFDE recognized that the Equalization Levy proposed under Action 1 of the BEPS Project would likely not be credited by the jurisdiction of residence).

\textsuperscript{1109} Because most major online publishers are U.S. companies, the analysis under U.S. law is of high importance in this case. In addition, the U.S. Code and Treasury Regulation provisions on the issue of foreign tax credits form one of the more comprehensive fields in U.S. tax law, and thus it would be reasonable to think that arguments made with respect to this set of rules could be applicable to the foreign tax credit rules in other countries as well.

\textsuperscript{1110} Treas. Reg. § 1.901-2(b)(4).
"In the rare situation where that tax is *almost certain to reach some net gain in the normal circumstances in which it applies* because costs and expenses will almost never be so high as to offset gross receipts or gross income, respectively, and the rate of the tax is such that after the tax is paid persons subject to the tax are almost certain to have net gain. Thus, *a tax on the gross receipts or gross income of businesses can satisfy the net income requirement only if businesses subject to the tax are almost certain never to incur a loss (after payment of the tax)*.\(^{1111}\)

Because of the cost structure of online publishers and the high net income margins, and because of the low tax rate, it is almost certain that the proposed tax would result in some net gain for the online publisher in the normal circumstances.\(^ {1112}\) Therefore, the flat-rate tax on gross revenues of online publishers would meet this exception and the online publisher should be allowed a foreign tax credit (provided all other requirements are met).\(^ {1113}\)

Finally, even if the online publisher is not allowed a foreign tax credit for the amounts paid to the jurisdictions of the users, one must evaluate this result against the existing state of the world. The fact is that under the Double-Irish Sandwich tax structure the consequence of Ireland not giving a foreign tax credit for the flat-rate tax paid to the jurisdictions of the users will have little impact on the online publisher. Because the online publisher is able to minimize its taxable income in Ireland (by using inter-company royalty payments), it has little use of the foreign tax credit, and any double taxation resulting from the denial of such credit is minimal. Furthermore, even if the online publisher would no longer be able to minimize its tax liability in Ireland and would in fact be subject to double taxation on all of its global income, the result would still be reasonable. In such a scenario, the online publisher would be subject to a 3% gross revenue tax, which is the equivalent of 7.5–11% rate on net income (depending on the publishers’ profit margin), and would also be subject to 12.5% of corporate tax in Ireland, resulting in an overall tax rate between 20% and 23.5%. For comparison, the average corporate tax rate amongst OECD

\(^{1111}\) *Id.* § 1.901-2(b)(4)(i)(B) (emphases added).

\(^{1112}\) That would “almost certainly” be the case if small and medium online publishers are not subject to this tax because of the de-minimis threshold or because of the measures discussed in *supra* note 1107.

\(^{1113}\) The U.S. foreign tax credit rules are elaborate and include multiple requirements. This issue is beyond the scope of this dissertation.
countries is 22.6%, and thus even under a full-blown double taxation scenario, the online publisher would end up paying taxes at a reasonable rate.

Finally, even if the online publisher was subject to a more significant effective tax rate because of double taxation, such result would likely not affect the incentives of the online publisher to “invest” in the source countries, which is the main concern with respect to double taxation. Because the online publisher has relatively low incremental costs for “entering” into a market (i.e., making its products available to users in a given jurisdiction), the fact that it will generate less profits than the current high profit margins would likely not prevent the publisher from “entering” into that jurisdiction. That would be a real concern only if the double taxation is so significant that it erodes the profitability of the online publisher to unsustainable levels. Because of the relatively low rate of the proposed tax, such a scenario is highly unlikely.

10.2.3.2. Discrimination and Subsidy

Shay, Fleming, and Peroni argue that a low-rate tax on gross revenues of foreign persons can be a discriminatory market entry barrier in some cases and a subsidy of foreign persons (on the account of residents) in other cases. Using a 35% corporate tax rate that applies to residents and a 5% fixed-rate tax on gross revenues that applies to nonresidents, the authors show that a point of equilibrium is achieved when the net income (pre-tax) margin is at 14.29%. Meaning that two businesses, one a resident and one a nonresident, that have the same profit margin of 14.29% would be taxed equally under the 35% and 5% tax rates. When the profit margin is higher than 14.29%, the nonresident has a lower effective tax rate which is essentially subsidized by the higher effective rate on residents, and when the profit margin is less than 14.29%, it is the residents that have a lower effective tax rate, which could have the effect of a discriminatory market entry barrier.

1114 See OECD.Stat, supra note 633.
1115 See 1923 Double Taxation Report, supra note 348, at 5–6.
1117 Id. at 100.
Neither of these concerns exist in our case. First, in the case of online publishers the profit margin is significantly higher than 14.29%. As noted above, the average profit margin of Google is 26% and that of Facebook is around 40%. Therefore, the more likely scenario is that foreign online publishers would have a lower effective tax rate than residents, giving rise to the subsidy argument. However, that argument loses its relevance when comparing the effective tax rates of residents and nonresidents in the absence of the proposed flat-rate tax. Under the current international tax system, nonresident online publishers pay no tax to the jurisdiction of the users with respect to the revenues generated from the exploitation of personal data of such users and from the actions of such users. On the other hand, resident online publishers pay corporate tax in their country of residence. There is a complete disparity between the two. Once the proposed PE threshold and the proposed flat-rate tax on gross revenues are introduced, the tax liability of the nonresident online publisher rises exponentially. Creating a tax liability for the nonresident in the source country is itself a reduction of the subsidy that was embedded in the existing rules. Therefore, arguing that a flat-rate tax creates a subsidy for nonresidents seems irrelevant when the adoption of the tax helps minimize an already existing subsidy.

Furthermore, even if the profit margins of online publishers were lower than the equilibrium threshold (thus resulting in a higher effective tax rate on nonresidents), that would not have created a real market-entry barrier. That is because the online publisher is already present in the market by the mere fact that his online platforms are accessible to users in any market without the publisher having to make significant efforts (assuming the online platform is already developed and working). In such a case, an online publisher can easily generate more revenues from new markets, even if its effective tax rate is higher than that of residents. One could argue that such a disparity in tax rates would allow resident publishers to offer advertisers lower prices, which could be a market-entry barrier. However, even this argument is irrelevant in the business of online advertising, where competition is not based solely on price but rather on the effectiveness of the advertising budget. I.e., a reduced price is irrelevant if the online platform has a low exposure to users. Therefore, the ability of resident publishers to offer lower prices

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1118 When applying the same methodology with a lower corporate tax rate of 22% (the average corporate rate in OECD countries) and a flat rate of 3%, the point of equilibrium is reached at a profit margin of 13.64%.
would be an ineffective market barrier because it could be overcome by a nonresident publisher that has a better online platform with a higher rate of exposure.

10.2.4. Adoption of the Proposal

A global adoption of the proposed PE threshold and flat-rate tax on gross revenues will require making changes to the tax treaty models and to all the bilateral treaties based on such models. Making such changes would require countries to renegotiate all of their tax treaties, which, given the total number of treaties (more than 3000), would make the process of implementing these measures extremely burdensome and lengthy. Alternatively, countries could agree to enter into a multilateral instrument that will implement the proposed measures across multiple tax treaties by modifying their application, similar to the convention signed with respect to the anti-BEPS measures proposed by the BEPS Project, schedule to be signed in June 2017.1119

Adopting such a multilateral instrument will require a broad international consensus. Until such consensus is reached, countries can achieve similar results by (1) adopting the proposed PE threshold in their domestic law as a test for creating taxable presence, and (2) enacting a tax in the form of the proposed flat-rate tax on gross revenues of foreign persons found to have a PE under the proposed PE threshold. Adopting such a tax is not likely to conflict with existing treaty obligations because this would be a new tax that, under the customary terms of tax treaties, should not be subject to the provisions of existing treaties.1120 In this scenario, of unilateral implementation of the proposed measures, the multinational solution for collection of the tax, as suggested in the next part, would not be available, and thus the collection by countries that adopt the proposed PE threshold and the flat-rate tax would be limited to collection only from local advertisers (and local PEs).


1120 See Article 2(4) of the Treaty Models, providing that the treaty will apply to any tax that is identical or substantially similar to the taxes that were subject to the treaty at the time the treaty was signed. Thus, a new tax, enacted after the conclusion of the treaty, which is not identical or substantially similar to taxes that were subject to the treaty at the time the treaty was entered into, would not be subject to the treaty. That is the case with respect to the proposed flat-rate tax on gross revenues. In addition, such new tax could arguably be considered as an anti-abuse measure that should not be treated as contradicting existing treaty obligations.
10.2.5. Enforcement and Collection

As a matter of international law, countries do not assist each other in the collection of tax claims. Consequently, one of the main issues arising from the allocation of taxing rights between source and residence countries is the ability of such counties to collect and enforce the tax that was allocated to each.

In the context of the measures proposed in this chapter, the issue is whether the source countries (i.e., the countries of the users) would be able to collect the proposed tax. Under the proposed measures, the source jurisdictions would be entitled to collect tax from revenues of the foreign online publisher based on the location of the users whose personal information was exploited and whose actions triggered the receipt of revenue, and irrespective of the location of the paying advertiser. This creates two separate challenges: first, the jurisdiction of the users has to determine what part of the revenue is attributable to the exploitation of personal data of users located within the jurisdiction. Then, the jurisdiction of the users has to be able to collect the tax from the revenues, which could be paid to the online publishers by advertisers located within the jurisdiction but also by advertisers located outside the jurisdiction.

A possible solution for these challenges would be to establish a multinational clearing house, where all revenues will flow through and all withholding and remittance will be conducted in a centralized manner. Local law would require advertisers to remit payments for online advertising expenses (whether paid to a resident or a nonresident) only through the clearing house, and online publishers would be required to accept revenues only via the clearing house. Online publishers would provide the clearing house with the data required to apportion the revenues to the various jurisdictions (i.e., what revenue was triggered by users from each jurisdiction – data that is already available to the online publishers), the clearing house would collect the flat-rate


1122 See Thomas S. Adams, Interstate and International Double Taxation, in LECTURES ON TAXATION 101, 112 (Roswell Magill ed., 1932) (“In agreements allocating tax sources for the purpose of preventing double taxation, the tax should not be assigned to a jurisdiction which cannot effectively administer and collect the tax”), as quoted in Michael J. Graetz & Michael M. O’Hear, The “Original Intent” of U.S. International Taxation, 46 DUKE LAW JOURNAL 1021, 1101 (1997). See also Martin Norr, supra note 805, at 432 (“However lawful an assertion of tax jurisdiction may be, power to make the assertion effective is nevertheless required”).
tax from the revenues and remit the collected tax to the appropriate jurisdictions and would pay the remainder to the online publishers. The clearing house would also know which countries have adopted a revenue-based de minimis rule and would be able to apply that rule to each online publisher.

All taxpayer information delivered to the clearing house would be subject to customary confidentially obligations of tax administrators. The costs of operating the clearing house would be paid using a proportionate share of the tax collected by each participating jurisdiction. A country that would not participate in the clearing house would not be entitled to receive its share of the collected taxes (i.e., the revenues attributed to countries that do not participate in the clearing house would be remitted to the online publisher free of tax). Participating jurisdictions would also agree not to independently audit the online publisher (with respect to revenues received via the clearing house). This would also make participation in the clearing house appealing to online publishers, who will be subject to a single streamlined tax collection process and reduced audit risk and costs.

Only time will tell if this clearing house is nothing but a utopic dream, but it is a fact that the world is gradually adopting more multinational solutions, including with respect to exchange of information and administrative assistance, in an effort to tackle the tax challenges of the twenty-first century.1123 Countries have realized that they have to share information and assist each other with collection and enforcement of taxes if they wish to level the playing field with multinational companies that take advantage of the segregated nature of tax administration. The problem of tax collection from cross border activity is yet another aspect of the dichotomy between the single-jurisdictional nature of tax (and tax administration) and the global nature of the modern

economy. The only way for governments to tackle these challenges is by joining forces, or at least by assisting each other.\textsuperscript{1124}

Until a multinational clearing house is established, countries that adopt the proposed measures would have to collect tax independently. Absent a permissive rule of international law, a state has no executive jurisdiction in the territory of another state.\textsuperscript{1125} However, international law does not prohibit states from exercising jurisdiction in their own territories, with respect to matters that relate to acts that have taken place abroad.\textsuperscript{1126} When it comes to the enforcement of the tax measures proposed above, countries have an even stronger normative justification to impose tax collection measures, because the acts with respect to which a country is exercising its taxing power have taken place within that country’s own territory (the mining of personal data and the actions of users that realized the revenue) and the results of such acts (the payment of revenue) could take place either within or without the territory of such country.

Theoretically, each country could enforce the proposed PE threshold and collect the flat-rate tax independently. A country that chooses to adopt these measures within its domestic tax laws can require an online publisher that is found to have a PE in such country to provide all the data required to determine which portions of the online publisher’s revenues should be subject to tax by that country. In order to collect the tax, a country can impose a withholding obligation on any resident that makes a payment for online advertising expenses and enforce such withholding requirement by imposing a joint-and-several liability standard on the withholding agent.\textsuperscript{1127} Although a country cannot impose a withholding obligations on any nonresident advertiser, it

\begin{footnotesize}


\textsuperscript{1126} Id. at paragraph 46.

\textsuperscript{1127} See, e.g., I.R.C. § 1461 (holding that any person required to deduct and withhold taxes from nonresident aliens and foreign corporations is liable for such tax).
\end{footnotesize}
can assess the tax ex post facto based on the information provided from the online publisher during an audit.\textsuperscript{1128}

It is highly unlikely that an online publisher would refuse to cooperate with the tax administration and not provide the information required to assess the tax. An online publisher would be able to do so only if it has no assets in the jurisdiction and thus would not be deterred by enforcement measures. However, an online publisher would likely have assets in any jurisdiction in which it has users simply because it will have the rights to receive payments from advertisers residing in such jurisdiction, and those rights would be subject to the enforcement power of the tax administration. In addition, even in the rare situation where an online publisher has only users but no advertisers in a given jurisdiction, such jurisdiction can undertake more extreme enforcement measures to compel cooperation and payment of the tax, such as blocking online publishers or reduce the internet bandwidth used by such publishers.\textsuperscript{1129}


There are several tax policy considerations that have traditionally been used to guide the development of tax systems. Such considerations include neutrality, efficiency, certainty and simplicity, effectiveness and fairness, and flexibility.\textsuperscript{1130} In 1998, the Committee on Fiscal Affairs of the OECD suggested that these considerations be applied for purpose of evaluating tax issues arising from electronic commerce,\textsuperscript{1131} and this suggestion was adopted in 2001.\textsuperscript{1132} Since then, the OECD has referred to these considerations each time it had considered tax policy issues

\textsuperscript{1128} The final report of Action 1 under the BEPS Project stated that “the location of advertising customers and the location of users are frequently aligned in practice, such that the value of the user data is reflected in the advertising revenue generated in a country.” OECD, supra note 818, at 104. If this assertion is accurate, the fact that a country cannot impose a withholding tax on nonresident advertisers is not expected to significantly impact a country’s ability to collect the tax. However, the digital economy and the continued trend of globalization will likely weaken the alignment between users and revenues and make collection from nonresidents a more significant part of a country’s enforcement efforts.

\textsuperscript{1129} Such means are technologically feasible. See, e.g., Google.com, KNOWN DISRUPTIONS OF TRAFFIC TO GOOGLE PRODUCTS AND SERVICES, https://www.google.com/transparencyreport/traffic/disruptions/#group=REGION (last visited Feb 24, 2017) (showing a list of countries that block access to Google’s products and services from within their territory).

\textsuperscript{1130} See OECD, supra note 954, at 20.

\textsuperscript{1131} See OECD, supra note 253, at 4.

\textsuperscript{1132} See OECD, supra note 931, at 230.
and proposals relating to e-commerce and, recently, also the digital economy in general. The next several paragraphs include an evaluation of the measures proposed in this chapter against these policy considerations.

(i) Neutrality

According to this consideration, “[t]axation should seek to be neutral and equitable between forms of electronic commerce and between conventional and electronic forms of commerce. Business decisions should be motivated by economic rather than tax considerations. Taxpayers in similar situations carrying out similar transactions should be subject to similar levels of taxation.”

The proposed framework of taxation of online publishers meets all the prongs of this consideration. The above consideration requires that traditional and electronic forms of commerce be taxed in a neutral and equitable manner. The inability of the existing international tax rules to apply to digital businesses has led to non-neutral taxation of digital and traditional businesses. The reliance of the existing PE definition on the physical presence requirement has generally limited the PE definition to traditional types of businesses, and has allowed digital businesses to avoid having a taxable presence despite having significant economic presence at a given jurisdiction. Therefore, the position of the OECD, that “…it would not be appropriate, nor possible, to design one set of nexus rules for “e-commerce” companies, and another for non-e-commerce companies” is surprising, because that the exactly the outcome achieved by applying the existing rules. Accordingly, any measure that could minimize this disparity should not be considered non-neutral, because in fact it would be decreasing the level of non-neutrality that already exists within the framework of the existing rules. The proposed PE threshold does just that, by allowing source countries to claim a right to tax foreign digital businesses that exploit such countries’ resources. It is therefore also an equitable result. Second, online publishers are currently under-taxed due to the gap created between the economic results of their activity and the (in)ability of the existing tax rules to fully tax such economic activity. Closing

1133 See OECD, supra note 615, at 9–30; OECD, supra note 818, at 20–21, 134–38.
1134 OECD, supra note 931, at 230.
1135 OECD, supra note 615, at 18.
that gap, at least partly, will decrease the motivation of online publishers to rely on elaborate tax planning structures, that are very common under the existing rules. Finally, the fact that online publishers would be taxed differently than traditional means of publishing (TV, radio, etc.) is irrelevant, because these two industries and significantly different from one another and thus do not merit similar tax treatment.

(ii) **Efficiency**

According to this consideration, “[c]ompliance costs for taxpayers and administrative costs for the tax authorities should be minimized as far as possible.”\(^{1136}\)

The proposed multinational clearing house for the administration of the flat-rate tax would comply with this consideration. Such a collaboration between countries would significantly minimize both compliance and audit costs, would make use of software to efficiently allocate and remit the tax, and would be a centralized administrative tool that would increase enforcement efficiency. Although setting up and maintaining this clearing house would require additional costs not currently incurred, yet such costs would be paid for by additional tax which is currently not collected. Although the flat-rate tax on gross revenues is naturally inefficient because it fails to take into account the specific costs of each taxpayer,\(^{1137}\) the net effect of the new tax should be positive which would make it more efficient than the current state of events, where a significant amount of tax is not collected.

(iii) **Certainty and Simplicity**

According to this consideration, “[t]he tax rules should be clear and simple to understand so that taxpayers can anticipate the tax consequences in advance of a transaction, including knowing when, where and how the tax is to be accounted.”\(^{1138}\)

Because the proposed PE threshold is drafted as a standard rather than as a rule, taxpayers would not have a high level of certainty as to whether the proposed PE threshold would apply in their specific circumstances. That is the tradeoff involved in adopting a standard based measure – less

\(^{1136}\) OECD, *supra* note 931, at 230.

\(^{1137}\) See OECD, *supra* note 615, at 52.

\(^{1138}\) OECD, *supra* note 931, at 230.
certainty but also less tax planning opportunities for taxpayers. That said, once the application of
the standard would turn into a rule with respect to a certain type of transaction (by the power of
precedent, set by court or administrative decisions), the level of certainty would increase
significantly with respect to similar transactions. Furthermore, the proposed flat-rate tax is very
simple and it relieves source jurisdictions from the complex and inaccurate task of allocating
expenses to the PE.

(iv) Effectiveness and Fairness

According to this consideration, “[t]axation should produce the right amount of tax at the right
time. The potential for tax evasion and avoidance should be minimised while keeping counter-
acting measures proportionate to the risks involved.”

The tax results arising from the taxation of digital companies under the current international tax
system are not fair. This position has been forcefully expressed by law makers around the world.
For example, during a public hearing of the U.K. Parliament’s Committee of Public Accounts
from February 2016 regarding the tax agreement that Google has entered into with HMRC with
respect to Google’s tax liability in the U.K., the committee chair, Ms. Meg Hillier, had asked Mr.
Matt Brittin, the head of Google Europe, Middle East and Africa, whether can he “hear the
anger and frustration out there, because for those figures [referring to Google’s revenues from
the U.K. that amount to billions of dollars] you settled for £130 million [in tax]?” This is but
one example that reflects a growing global agenda regarding the unfair tax treatment of the
internet giants.

Therefore, when it comes to fairness, any tax measures that would allow source jurisdictions to
impose and collect taxes from foreign persons that exploit resources and enjoy benefits from
such jurisdictions, would be achieving a result that is more fair than the current state of affairs.
The proposed measures will increase the sense of fairness, as well as minimize the potential for
tax avoidance by online publishers. Although a flat-rate tax on gross revenues could be

1139 Id. at 230.
1140 U.K. PARLIAMENT, PUBLIC ACCOUNTS COMMITTEE, supra note 885, at question 9.
1141 See also chapter 10.3 below.
considered unfair because it applies regardless of profitability, the low proposed-rate should partly relieve this concern.

(v) Flexibility

According to this consideration, “[t]he systems for the taxation should be flexible and dynamic to ensure that they keep pace with technological and commercial developments.”¹¹⁴²

The fact that the proposed PE threshold is standard-based creates a high level of flexibility and would allow the proposed threshold to encompass new types of income and transactions that could arise as technology continues to develop in the future. As noted by the TFDE in the final report of Action 1, as long as the PE definition is drafted in terms of concept rather than specific examples, the PE definition “should remain relevant and flexible.”¹¹⁴³

Based on the above evaluation, the measures proposed in this chapter for taxing online publishers (and other taxpayers that digitally exploit resources in foreign jurisdictions) seem to be adequate and reasonable, especially when compared to the way such taxpayers are taxed under the current international tax rules.

10.3. What are Countries Doing? A Review of Unilateral Measures to Tax Digital Companies

In recent years, many governments around the world have proposed, and some have already adopted, new tax laws the purpose of which is to expand such countries’ tax jurisdiction and improve their ability to tax the income of multinational entities, especially ones operating in the digital economy. Many of such new laws were specifically ‘targeted’ to apply to the major online publishers, and several of these laws were even nicknamed ‘Google taxes.’ This part of the chapter will review and discuss the most significant of these laws.

At the outset, it is worth noting that many of the laws discussed below have come to fruition as a result of increased public dismay with the ability of multinational companies (including the online publishers) to take advantage of the existing tax rules in order to minimize their tax

¹¹⁴² OECD, supra note 931, at 230.
¹¹⁴³ OECD, supra note 615, at 70.
liability. The extremely low tax rates paid by some multinationals in source countries have led to increased scrutiny from legislators that often expressed a feeling that the actions of such multinationals (to structure their activity in the most tax efficient way permitted by law) are unfair and even immoral, even though such actions are entirely within the boundaries of the law. For example, during a 2012 public hearing of the U.K. Parliament’s Public Accounts Committee on the issue of tax avoidance by multinational corporation, the following words were exchanged between the committee’s chair and Mr. Matt Brittin (who at the time of the hearing was Google’s Vice President for Sales and Operations, Northern and Central Europe):

“Chair: So you are minimising your tax even though it is unfair to British taxpayers. Matt Brittin: It is not unfair to British taxpayers. We pay all the tax you require us to pay in the UK. We paid £6 million of tax last year- Chair: We are not accusing you of being illegal; we are accusing you of being immoral.”1144

One of the committee members had even (indirectly) accused Google of being evil:

“Q: Am I right in thinking that your tag line is “Do no evil”? Matt Brittin: That is a phrase that is used to crystallise the values of Google and how we try to operate. Correct. Q: It seems to me that, if I can just put it very gently, you are not matching up to that.”1145

Google’s response to these assertions was concisely summarized in one of Mr. Brittin’s responses during the hearing, when he said that “[t]ax is not a matter of personal choice, but a matter of following the law and the rules, which is what we do.”1146

Similar accusations about the immorality of Google’s choices and actions were raised during a 2015 public hearing of the Australian Parliament’s Economics References Committee about corporate tax avoidance. In that hearing, the committee’s chairman stated that:

Q:… the Australian public do not accept that the structures that have been created by these companies are necessarily genuine, and there is a strong sense out there that companies such as yours [referring to Google, Apple and Microsoft], which do incredible work in terms of employment, which create fantastic jobs, which

1144 U.K. PARLIAMENT, PUBLIC ACCOUNTS COMMITTEE, supra note 629, at questions 484–85 (emphasis added).
1145 Id. at question 523 (emphasis added).
1146 Id. at question 613.
create innovative new products, also have a greater moral and social responsibility to give more back to this community and that the structures that have been created within your firms, be it through Ireland, through Singapore, through the US or through wherever, have been designed to minimise your tax obligation in this country… In saying that, I am not implying or saying that any of this is necessarily illegal behaviour. If it is tax evasion, it is a matter for the Tax Office, but the question is—and I am sure this has been put to you before—more about the morality of having these structures and whether your companies have a greater corporate and social responsibility that you are not meeting.1147

Ms. Maile Carnegie, Managing Director at Google Australia, responded to these arguments by saying that:

“When I think about the morality of it, I think the people who need to give the right number are, quite frankly, the people sitting on your side of the room. What we need to do is to make sure that we are living up to that.”1148

Finally, in February 2016 the U.K. Parliament’s Committee of Public Accounts conducted a public hearing regarding the tax agreement that Google has entered into with HMRC with respect to Google’s tax liability in the U.K. Under the agreement (as disclosed by Google in January 2016),1149 Google has agreed to pay an additional £130 million1150 for the period between January 2005 and June 2015, bringing the total taxes paid by Google in the U.K. for that period to £196.4, which is undoubtedly a small amount when considering the fact that the U.K. is Google’s second largest market in the world which has contributed $7 billion to Google’s revenues in 2015 alone.1151

1147 PARLIAMENT OF AUSTRALIA, ECONOMICS REFERENCES COMMITTEE, supra note 632, at 45 (emphases added)
1148 Id. at 45.
1150 As noted during the hearing by Mr. Tom Hutchinson, Vice President of Finance in Google, £18 million out of £130 million that Google paid under the agreement with HMRC was for interest, bringing the actual tax payment to only £112 million. See U.K. PARLIAMENT, PUBLIC ACCOUNTS COMMITTEE, supra note 885, at question 21.
At the beginning of the hearing, the committee chair, Ms. Meg Hillier, asked Mr. Matt Brittin (by now the head of Google Europe, Middle East and Africa) whether he could “hear the anger and frustration out there, because for those huge [revenue] figures you settled for a figure of £130 million [of tax]?” Mr. Brittin explained that Google U.K. is paying accurate taxes, which were determined, after an intensive 6-year audit of HMRC, based on the taxable profits of Google U.K. He also noted that Google U.K.’s revenues included only the commission for services that it received from Google Ireland (in an amount of £1.178 billion), and none of the online advertising revenues that originated from the U.K. (of more than $7 billion, all of which were recorded in Google Ireland) because that is not what the tax system requires. Although the existing international tax rules support Mr. Brittin’s argument, the committee members did not accept it, and in their final report they stated that:

“Google told us that international tax rules are complex and that it just follows them. This is disingenuous. There is nothing in the rules that says you must set up two companies in Ireland and send large royalty payments, via the Netherlands, to a company that is tax resident in Bermuda.”

This criticism of Google’s legal tax planning directly contradicts the traditional view (at least under U.S. tax law) that taxpayers have no moral obligation to maximize their tax liability beyond what the law requires. The normative question of whether multinational companies should have moral and social responsibilities with respect to the taxes they pay to the communities within which they operate is beyond the scope of this dissertation, but if the current trend of criticism continues, the traditional standard may be facing a change. Either way, the public’s reaction to the aggressive tax planning of multinational corporations and the new legislative measures that followed are a fascinating example of how non-economic factors can have a direct effect on tax legislation.

1152 U.K. PARLIAMENT, PUBLIC ACCOUNTS COMMITTEE, supra note 885, at question 9.
1153 Id. at question 47.
1154 Id. at questions 28 and 46.
1155 HOUSE OF COMMONS – COMMITTEE OF PUBLIC AFFAIRS, supra note 1151, at 6 (emphasis added).
1156 See supra notes 305–306 and the accompanying text.
10.3.1. United Kingdom – Diverted Profits Tax

In March 2015 the U.K. enacted the Diverted Profits Tax (“DPT”), which became effective on April 1, 2015. The DPT is intended to deter diversion of profits from the U.K. by large multinationals that either: (i) avoid creating a U.K. permanent establishment, or (ii) use arrangements or entities which lack economic substance to exploit tax mismatches.\footnote{HM Revenue and Customs, Diverted Profits Tax: Guidance DPT1000 (2015), https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/480318/Diverted_Profits_Tax.pdf.} The first case is of more interest in our context.

The DPT would apply in the case of avoidance of U.K. taxable presence if the following conditions are met:

1) A foreign company (which is not a U.K. resident) (the “foreign company”) carries on a trade;

2) A person (the “avoided PE”) is carrying on an activity in the U.K. in connection with the supplies of services, goods or other property by the foreign company in the course of its trade. It does not matter if that person is a U.K. resident or not;

3) It is reasonable to assume that the activity of the avoided PE or the foreign company (or both) is designed so as to ensure the foreign company is not treated as carrying on a trade through a U.K. PE; and

4) Either the mismatch condition or the tax avoidance condition are met.\footnote{Id. at DPT1140.}

The tax avoidance condition is met if in connection with the supply of the goods or services, arrangements are in place one of the main purposes of which is to avoid or reduce a charge to corporate tax in the U.K.\footnote{Id. at DPT1150.} HMRC noted that the rule would be applied in cases when the foreign company has put in place arrangements that separate the substance of its activities from where the business is formally done (PE avoidance in particular).\footnote{Id. at DPT1151.}
The mismatch condition is met under the following cumulative conditions:

1) In connection with the supplies of the goods or services, a provision (the “material provision”) is made between the foreign company and the avoided PE;

2) The foreign company or the avoided PE is directly or indirectly participating in the management, control or capital of the other, or a third person is participating in the management, control or capital of both;¹¹⁶¹

3) the material provision results in an effective tax mismatch outcome as between the foreign company and the avoided PE. Such outcome exists when a reduction in one party’s tax liability is greater than any resulting increase in tax liability of the other party, unless the increased tax liability amounts to at least 80% of the reduction in tax liability of the first party.¹¹⁶² This condition is intended to cover a situation where a U.K. subsidiary pays royalties to a parent or affiliate and the decrease in taxes in the U.K. resulting from such payments is significantly greater than the increase in tax for the parent or affiliate from the receipt of the royalties; and

4) It is reasonable to assume that the transaction or involvement of a person in the transaction was designed to secure the tax reduction described in the previous condition.¹¹⁶³

The DPT does not apply if (1) the foreign company’s total U.K.-related sales revenues during a given tax year are no greater than £10 million, or (2) if the foreign company’s total U.K.-related expenses during a given tax year are no greater than £1 million.¹¹⁶⁴ In addition, the DPT does not apply if the avoided PE or the foreign company are small or medium sized enterprises.¹¹⁶⁵

¹¹⁶¹ Id. at DPT1172.
¹¹⁶² Id. at DPT1180.
¹¹⁶³ Id. at DPT1191.
¹¹⁶⁴ Id. at DPT1142.
¹¹⁶⁵ Id. at DPT1140. The terms small and medium sized enterprises are defined in the Annex to EU Commission Recommendation 2003/361/EC of 6 May 2003, as modified by Section 172 of the Taxation (International and Other Provisions) Act 2010. Very broadly speaking, an entity falls within such definitions if it employs fewer than 250 persons and has either an annual turnover not exceeding €50 million or an annual balance sheet total not exceeding €43 million (see EUROPEAN COMMISSION, USER GUIDE TO THE SME DEFINITION 11 (2015), http://ec.europa.eu/DocsRoom/documents/15582/attachments/1/transl
If the DPT is applicable in the case of an avoided PE, a 25% penalizing tax rate (compared to the normal 20% corporate tax rate) would generally apply to the profits that would have risen to the avoided PE. Companies are required to notify HMRC within 3 months of the end of the tax year if they are potentially within the scope of the tax. If a DPT charge is issued, the taxpayer must pay the tax within 30 days (a deadline that may not be postponed under any circumstances). The charge may then be reviewed by HMRC.\textsuperscript{1166}

The DPT was intended to address, among other tax schemes, the Double Irish Sandwich structure.\textsuperscript{1167} To explain how this would work let us assume that Subsidiary 2 (the entity used in the explanation of the Double Irish Sandwich structure in chapter 9.1.2 above) has a U.K. subsidiary (which is also the case in reality with respect to Google, for example). Such U.K. subsidiary is carrying on activities in the U.K. in connection with the supply of goods or services by its Irish parent, Subsidiary 2. It is reasonable to assume that the activity of Subsidiary 2 or of the U.K. subsidiary (or both) was designed to ensure that Subsidiary 2 is not treated as carrying on a trade through a U.K. PE, and the tax avoidance condition is thus met (one of the main purposes of the scheme is to avoid or reduce a charge to U.K. corporate tax). Therefore, a 25% tax would apply to the profits that would have been the chargeable profits of Subsidiary 2, attributable to the avoided U.K. PE, had the avoided U.K. PE been a permanent establishment through which Subsidiary 2 carried on its trade in the U.K.\textsuperscript{1168}

However, the HMRC guidance to the DTP also includes an example of a scenario in which the DPT would not apply to a Double Irish Sandwich structure. According to the guidance (as applied to our example), the DPT would not apply if, after thorough review of HMRC it is established that:

1) Subsidiary 2 had a large staff of qualified people who carry on material activities where the contracts are contracted (in our case, Ireland). Such material activities may include: having regular contact with the U.K. sales support staff and providing regular input into

\textsuperscript{1166}HM REVENUE AND CUSTOMS, supra note 1157, at DPT1140.
\textsuperscript{1167}Id. at DPT1310 and DPT1140.
their activities; having regular contact and authority to negotiate the terms of sale contracts with U.K. and other European customers and actually performing this function; orchestrating sales across Europe by various product promotions, advertising campaigns and sport sponsorship; managing relations with major customers who have a presence in several European countries including the U.K.; or actively managing the local European sales support companies;

2) It is not reasonable to assume that the activities of Subsidiary 2 or the U.K. sales support company, in particular the signing of sale contracts by Subsidiary 2, was designed to ensure that Subsidiary 2 did not have a U.K. PE. Rather, the activities of the two companies support their commercial roles within the group; and

3) The allocation of profit between Subsidiary 2 and the U.K. sales support company reflect their contribution to the generation of profits from activities in the U.K.\textsuperscript{1169}

This guidance provides Google (and other online publishers) a way to avoid the DPT, provided they arrange their business according to HMRC’s guidelines. That seems to be the case, because during the 2016 hearing of the U.K. Parliament’s Committee of Public Accounts, Google’s Vice President of Finance explained that the DPT is a regime that is intended to apply to taxpayers that do not pay their tax under the regular corporate tax law, and because of Google’s settlement with HMRC, Google is paying the right amount of tax and thus would not be subject to the DPT.\textsuperscript{1170} It was further states that, going forward, if Google would pay the right amount of tax according to the normal rules in the U.K. then DPT would not apply to it.\textsuperscript{1171}

Furthermore, because the DPT requires some presence in the U.K., online publishers (and other digital companies) could also avoid the DPT by not having any person carry any activity in the U.K. in connection with U.K. sales.\textsuperscript{1172} Therefore, if an online publisher handles all sale and

\textsuperscript{1169} HM Revenue and Customs, supra note 1157, at DPT1310, Example 2.

\textsuperscript{1170} U.K. Parliament, Public Accounts Committee, supra note 885, at question 36.

\textsuperscript{1171} Id. at question 37.

\textsuperscript{1172} There is evidence to show that online publishers can in fact generate significant sales from a country without having any presence in that country. See Kolkata v. Right Florists Pvt Ltd., Income Tax Officer, Ward 12 (2), 1336/ Kol. / 2011 (Income Tax Appellate Tribunal, Kolkata ‘B’ Bench, Kolkata) (April 12, 2013), http://itatonline.org/archives/?dl_id=981 (holding that nothing in the factual record of the case demonstrates or suggests that Yahoo’s advertising revenues generated in India were supported by, serviced by or connected with any entity based in India). This conclusion is further supported by the testimony of Matt Brittin, one of Google’s top executives, who said that Google “... is an internet-based business, so

Continued on the next page...
support activity from outside the U.K., and thus has no risk of having a PE to begin with, the concept of “avoided PE” is irrelevant and the DPT would not apply.\textsuperscript{1173} As noted initially, the DPT also applies when a U.K. company (or a PE of a non-U.K. company) makes use of arrangements or entities that lack economic substance to exploit tax mismatches. This option requires, \textit{inter alia}, that an effective tax mismatch outcome exist in order for the DPT to apply.\textsuperscript{1174} Such outcome would exist, for example, if a U.K. company would pay royalties to an affiliate in a low-tax jurisdiction, resulting in an increase in the tax liability of the foreign affiliate that is less than 80\% of the decrease in the tax liability of the U.K. company. However, that is not the case under the tax structure used by Google. Google U.K. does not pay any royalties to Google Ireland. In fact, no payments are made in that direction at all. It is Google Ireland that makes cost-plus payments to Google U.K. for the services that the latter provides to the former.\textsuperscript{1175} Because none of the advertising revenue is recorder by the U.K. company, no royalties are paid by that company for the use of the technology. All that revenue is recorder in Ireland and all royalties are paid by the Irish company to the Bermuda company.\textsuperscript{1176}

Finally, it is worth noting that in March of 2016 Facebook announced that it will start recording revenues from sales made to large U.K. advertisers in its U.K. entity, rather than recording all revenues in its Irish entity (as it had done until that point under its Double Irish Sandwich structure).\textsuperscript{1177} It has been suggested, but not confirmed, that Facebook’s announcement was

\textsuperscript{1173} See Luca Cerioni, \textit{The New “Google Tax”: The “Beginning of the End” for Tax Residence as a Connecting Factor for Tax Jurisdiction?}, 55 EUROPEAN TAXATION 185, 191 (2015) (stating that “[p]aradoxically, the DPT, although often referred to as “Google tax”, would risk being avoided exactly by those multinationals whose digital presence can make the creation of a PE (and the presence of “the avoided PE”) really unnecessary, but whose high volumes of sales to local clients drove the idea for its introduction”).

\textsuperscript{1174} HM REVENUE AND CUSTOMS, supra note 1157, at DPT1110.

\textsuperscript{1175} See supra notes 1153–1154.

\textsuperscript{1176} See chapter 9.1.2.

influenced by the DPT. This change would also mean that Facebook’s U.K. entity will start paying royalties to its Irish affiliate for the right to use the technology that enabled the sales recorded in the U.K. entity. Assuming such royalty payments would not trigger an ‘effective tax mismatch outcome’ (as defined above) and thus would not expose Facebook to the DPT, Facebook would still be able to shift certain profits from the U.K. to Ireland. It should also be noted that Facebook will continue to book all revenues from small advertisers through its Irish entity, and it is not clear what percentage of its U.K. revenues come from such small advertisers.

10.3.2. Australia – Multinational Anti-Avoidance Law & Diverted Profits Tax

10.3.2.1. Multinational Anti-Avoidance Law

In May 2015, the Australian government released a proposal for a Multinational Anti-Avoidance Law (“MAAL”). The MAAL, which is effective starting January 1, 2016, is an amendment to the existing anti-avoidance rule under Australian corporate tax. The law is intended to prevent multinationals from having significant sales activity in Australia while recording their revenues outside of Australia and thus paying little or no tax in Australia.

The MAAL is generally intended to apply to a scheme that meets the following description: (i) a foreign entity derives income from supplying goods or services to Australian customers, (ii) an Australian entity (that is an associate of, or is commercially dependent on, the foreign entity) undertakes activities in Australia directly in connection with the supply of the goods or services, (iii) some or all of the income derived by the foreign entity is not attributable to an Australian permanent establishment, and (iv) the principal purpose, or one of the principal purposes of the

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scheme, is to obtain an Australian tax benefit or to obtain both an Australian and foreign tax benefit.\textsuperscript{1181}

The MAAL would apply to a global parent entity with an annual global income exceeding AUD 1 billion, or to an entity that is a member of the consolidated group of which such global entity is the parent.\textsuperscript{1182}

As with the U.K. DPT, the MAAL applies only when some activity is undertaken by an Australian entity in connection with the sales. In this context, the explanatory memorandum discusses a ‘Fly-in, fly-out’ arrangement as an example to a scenario to which the MAAL would not apply. Under that example, a foreign entity sells mechanical products in Australia but does not have a PE. The foreign entity flies two of its employees to Australia for a week to meet with and understand the needs of Australian customers. The foreign entity’s personnel then fly back to the foreign country to incorporate the information obtained from the meetings in Australia into the development of their product and offer. There is no other connection with Australia in relation to the sale. Because there is no Australian entity or entity in Australia assisting with the sale, the MAAL will not apply.\textsuperscript{1183} Based on this requirement of the MAAL and the above example, the MAAL would not apply to an online publisher (or other digital company) that handles all sales from outside Australia, without any local assistance with the sales. As noted earlier, such \textit{modus operandi} is possible in the context of online advertising.\textsuperscript{1184}

With respect to Google, unless it adopts the above \textit{modus operandi} it will likely not be able to avoid the MAAL because Google has significant presence in Australia, with more than a 1,000 employees, 500 of whom are highly-skilled engineers.\textsuperscript{1185} This might explain why it was reported that in its 2015 Australian tax returns Google had said that “Effective 1 January, 2016,

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{1182} \textit{Id. at \textsuperscript{¶} 2.9–2.10.}
\item \textsuperscript{1183} \textit{Id. at \textsuperscript{¶} 3.41.}
\item \textsuperscript{1184} See supra note 1172.
\item \textsuperscript{1185} See Google Australia, Submission to Senate Economics References Committee, Inquiry into Corporate Tax, Submission No. 57 (Feb. 2, 2015), http://www.aph.gov.au/Parliamentary_Business/Committees/Senate/Economics/Corporate_Tax_Avoidance/Submissions.
\end{itemize}
\end{footnotesize}
Google Australia Pty Limited restructured its business such that it will recognise revenue from the marketing and selling of certain services and products to Australian based customers” instead of booking such revenues in Singapore under Google Asia Pacific Pte. Ltd. (which, like the Irish entities in the Double Irish Sandwich scheme, is used as a central hub for recording revenues from the Asia-Pacific markets). It is not clear what “certain” services and products will be recorded by Google’s Australian company, and it is also not clear what would be the scope of royalties that such entity would pay to other Google affiliates for the right to use the technology that facilitates the revenue from such products and services. Also, interestingly, in May 2016 the terms and conditions for an Australian customer using the Google AdWords’ platform still showed the advertising terms for Google Asia Pacific Pte. Ltd.

According to the Australian Taxation Office, ever since MAAL has entered into effect, taxpayers are entering into “artificial and contrived arrangements in attempts to avoid the application of the MAAL.” In response, the Australian Taxation Office has issued taxpayer alerts warning against international profit shifting by multinationals. In a statement issued in September 2016, the Australian Taxation Office noted that they “continue to take a dim view of any arrangements that are designed to sidestep the MAAL and will act firmly as soon as [they] become aware of them.”

10.3.2.2. Diverted Profits Tax

On November 29, 2016, the Australian Treasury released proposed legislation that would adopt a diverted profits tax (“DPT”). The proposed DPT was introduced into the Australian Parliament on February 2017 and is intended to take effect July 1, 2017. The purpose of the

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1191 See PARLIAMENT OF AUSTRALIA, TREASURY LAWS AMENDMENT (COMBATING MULTINATIONAL TAX AVOIDANCE) BILL 2017 (Feb. 9, 2017), http://www.aph.gov.au/Parliamentary_Business/Bills_Legislation/Continued on the next page...
DPT is to ensure that Australian taxes paid by large global multinationals properly reflect the economic substance of the activities that those entities carry on in Australia and prevent those entities from reducing the amount of Australian tax they pay by diverting profits offshore through contrived arrangements.\textsuperscript{1192}

The DPT would impose a penalizing 40 percent tax rate on diverted profits of large multinationals if the Australian tax authorities reasonably conclude that such profits have been artificially diverted from Australia. The tax would apply to large global multinationals that have annual revenues of AUD 1 billion or more, with total Australian turnover of AUD 25 million or more, and that have entered into a scheme at least one of the parties of which is a foreign entity and a principal purpose of which is to provide tax benefits in Australia (or in Australia and in a foreign country).\textsuperscript{1193}

The Australian tax authorities are required to consider all facts and circumstances when determining whether a principal purpose of the scheme was to provide the tax benefits, and the existence of significant quantifiable non-tax financial benefits arising from the scheme could be a strong indicator that the purpose of the scheme was not to produce the tax benefits.\textsuperscript{1194} Thus, for example, a multinational decides to centralize the technical support functions into regional zones, resulting in the closing of a technical support center in Australia that provided services to the multinational’s subsidiary in Australia. In such a case, if the multinational can provide financial projections, prepared at the time of the restructuring, showing the expected productivity and efficiency gains from centralizing the technical support functions and lower wage costs in the chosen location, the Australian tax authorities, after considering all facts and circumstances, 


\textsuperscript{1193} Id. at ¶¶ 1.21, 1.65. The DPT will apply with respect to tax benefits for an income year that starts on or after July 1, 2017, irrespective of the date on which the scheme that gave rise to the tax benefits was entered into, or was commenced to be carried out. Id. at ¶ 1.215.

\textsuperscript{1194} Id. at ¶ 1.51.
would determine that the scheme was not entered into for a principal purpose of obtaining a tax benefit, and the DPT would not apply.\(^{1195}\)

The DPT will not apply if (1) the increase in the foreign tax liabilities of foreign entities resulting from the scheme is 80% or more of the corresponding reduction in the Australian tax liability of the relevant taxpayer,\(^ {1196}\) or (2) if the income derived by the entities involved in the scheme reasonably reflects the economic substance of the entity’s activities in connection with the scheme.\(^ {1197}\)

According to an example in the proposed legislation, an Australian company that decides to move its marketing and distribution functions abroad under a foreign entity (established in a jurisdiction with a lower tax rate), can avoid the DPT under the economic substance exception if it can demonstrate that the staff working under the foreign entity is actually carrying out the marketing and distribution functions for the Australian company and that such functions are no longer carried out in Australia. In such a case, the Australian company is able to demonstrate that the profits of the foreign entity reasonably reflect the economic substance of the functions carried out by such entity, and the DPT will not apply.\(^ {1198}\)

Unlike the U.K. DPT, which is self-assessed by the taxpayer, the Australian tax authorities can assess a DPT, in which case the taxpayer has 21 days to pay the tax.\(^ {1199}\) The amount due is not reduced by any foreign taxes paid on the diverted profits.\(^ {1200}\) The taxpayer can provide additional information to explain why the tax should be reduced (including to zero) during a review period of 12 months after the assessment was issued.\(^ {1201}\) The proposed legislation also significantly increases the administrative penalties that would apply to multinational companies. For example, the DPT would increase the penalty for a failure to file a return or other statement from a

\(^ {1195}\) Id. at ¶ 1.59, example 1.3.
\(^ {1196}\) Id. at ¶ 1.80. Based on the Australian corporate tax rate of 30%, the 80% exception would apply only if the diverted profits are subject to a foreign tax of 24%, which is a high threshold (it is higher than the average corporate tax rate amongst OECD countries).
\(^ {1197}\) Id. at ¶ 1.99. Certain special types of entities are also exempt from the DPT, such as managed investment trusts, foreign collective investment vehicles with wide membership, entities owned by a foreign government that is a foreign entity, complying superannuation entities and foreign pension funds. Id. at ¶¶ 1.67–1.68.
\(^ {1198}\) Id. at ¶ 1.136, example 1.10.
\(^ {1199}\) Id. at ¶ 1.143.
\(^ {1200}\) Id. at ¶ 1.144.
\(^ {1201}\) Id. at ¶¶ 1.165–1.166.
maximum of AUD 4,500 to AUD 450,000. These changes to the normal tax payment and assessment procedures, as well as the increased penalties, are intended to incentivize compliance and cooperation from multinational companies.

The Australian DPT will apply alongside the MAAL. Although the DPT seems to be a more powerful measure, the proposed legislation does note that the DPT is expected to apply “in only very limited circumstances” and it is anticipated that the DPT will raise only AUD 100 million annually starting 2018–19.

Finally, nothing in the proposed legislation of the Australian DPT suggests that the tax could apply to digital companies that have no presence in Australia. Therefore, online publishers that operate entirely from outside of Australia should not be caught by the DPT. Furthermore, even if the online publisher is present in Australia, the DPT will not apply if the company is able to show that the profits attributed to the Australian subsidiary are consistent with the economic substance of the entity’s activities. Therefore, online publishers could still have marketing and customer support services provided by a local subsidiary as long as such subsidiary’s profits would reflect the activities of the entity. Thus, if online publishers maintain all sales activities outside of Australia, and pay an arm’s length price to the Australian subsidiary for the marketing and customer support services, it could still charge revenues from Australian advertisers in foreign entities without triggering the DPT. All that being said, given that this is a novel legislation, it is hard to predict how the Australian tax authority and the Australian courts will interpret the principal purpose test and the economic substance test under the DPT.

It should finally be noted that under the Australian DPT, foreign multinationals can still shift profits from Australia to a foreign jurisdiction as long as the tax savings from such scheme meet the 80% exception. This 20% buffer leaves sufficient room for tax savings that could incentivize digital companies to take advantage of this exception. In the case of online publishers that generate revenues from Australian users, using the 80% exception to shift profits to a foreign jurisdiction would mean that revenues would not be taxed where the users are located, even

1202 Id. at ¶ 2.19.
1203 Id. at ¶¶ 1.157, 2.18.
1204 Id. under the headings “Regulation Impact on Business” and “Financial Impact.”
though the personal information of such users (and the actions of such users) are a significant role in the realization of the revenue.

10.3.3. India – Equalization Levy

In *Kolkata v. Right Florists Pvt Ltd*,\(^\text{1205}\) the Indian tax authority argued that foreign online publishers (Google (Ireland) and Yahoo (USA)) had a PE in India and thus payments made to them by the taxpayer (a florist that advertised its business online) should have been subject to withholding.\(^\text{1206}\)

The Income Tax Appellate Tribunal held that a website *per se*, which is the only form of presence Google had in India, cannot be a permanent establishment under domestic law (i.e., cannot be considered a business “carried out in India”).\(^\text{1207}\) Relying on the OECD Commentaries regarding PE via websites and servers, the tribunal concluded that “[a] search engine, which has only its presence through its website, cannot therefore be a permanent establishment unless its web servers are also located in the same jurisdiction.”\(^\text{1208}\) The tribunal also ruled that the revenues received by such foreign online publishers were not “deemed to accrue or arise in India” (i.e., it was not sourced in India). The tribunal reached this conclusion because the online publishers were not “supported by, serviced by or connected with any entity based in India.”\(^\text{1209}\)

Therefore, the tribunal held for the taxpayer and rejected the Indian tax authorities position.

The tribunal did note that changes to the PE concept, as is applied by domestic Indian law, are a policy matter that should be address by the legislator, thereby calling on the Indian government to take action.\(^\text{1210}\) The tribunal’s decision in *Kolkata v. Right Florists* made it clear to the Indian government that it could not tax the internet giants based on the existing legal framework.

\(^{1205}\) See *supra* note 1172.

\(^{1206}\) The term PE is used and analyzed by the court in the context of the domestic law equivalent of “trade or business” (“carrying out a business in India”), and not in the context of the PE concept under tax treaties.

\(^{1207}\) *Kolkata v. Right Florists Pvt Ltd, supra* note 1172, at 14.

\(^{1208}\) *Id.* at 17.

\(^{1209}\) *Id.* at 21.

\(^{1210}\) *Id.* at 13–14 (“It is a policy decision that Government has to take as to whether it wants to reconcile to the fact that conventional PE model has outlived its utility as an instrument of invoking taxing rights upon reaching a reasonable level of commercial activity and that it does fringe neutrality as to the form of commercial presence i.e. physical presence or virtual presence, or whether it wants to take suitable remedial measures to protect its revenue base. Any inertia in this exercise can only be at the cost of tax certainty.”)
Therefore, the Indian Ministry of Finance formed a committee, whose purpose was to review the business models under the digital economy, review the direct tax issues arising from such models, and propose an approach to deal with these issues. The committee published its report in February 2016, titled “Proposal for Equalization Levy on Specified Transactions.”  

The 120-page long report relies heavily on the BEPS Project’s final report on Action 1, significant parts of which are cited in the Indian report. Much like the Action 1 report, the Indian report reviews the growth of the digital economy and the special tax challenges that such economy raises, including source and character, allocation of taxing rights, and the effect of increased reliance on user data. The report concludes that users are a significant indicator of both nexus and the creation of value in the jurisdiction of the users, and their participation in the creation of value should contribute to the creation of a taxable presence for an online publisher in the jurisdiction of the users. The committee also noted that, at this stage, quantifying the value created by users is a difficult task and thus any tax proposal should not require the quantification of such value.

The report then reviews the three options that were discussed in the BEPS Project’s final report on Action 1 as possible solutions to these challenges – significant economic presence nexus, withholding tax and equalization levy. The committee concluded that although a nexus based on significant economic presence is justified, further study is required in order to resolve the issue of attribution of profits in way that could ensure simplicity, predictability and administrability. The committee believed that until those issues are resolved, the adoption of a simpler solution would be preferable, especially in the Indian context. The committee also rejected the ‘withholding tax’ option, saying that, though practical, it will not be effective unless adopted across all applicable tax treaties. The committee concluded that the third option proposed by Action 1—the equalization levy—is the most feasible of the three – not being a tax

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1212 Id. at 54.
1213 Id.
1214 Id. at Chapter 9.
1215 Id. at 72.
1216 Id. at 77.
on income, it could be implemented in domestic law without conflicting with existing treaty obligations. Therefore, the committee proposed that India adopted an equalization levy.

The committee considered the various aspect and characteristics of such a levy and provided detailed recommendations in the report. Such recommendations were generally followed by the Indian government, that included a proposal for a new equalization levy in the 2016 Finance Bill (in February 2016). According to the provisions of the Finance Bill (which took effect on June 1, 2016), an equalization levy at a rate of 6% would be charged on the amount of consideration for any “specific services” received by a nonresident of India from (i) a resident of India that carries on a business or profession, or (ii) a nonresident that has a PE in India. The term “specific services” was defined as “online advertisement, any provision for digital advertising space or any other facility or service for the purpose of online advertisement…”

The equalization levy would not apply under the following exceptions: (1) where the nonresident online publisher has a PE in India and the online advertising services are effectively connected with such PE (i.e., the equalization levy would apply to a foreign publisher that has a PE if the revenues from online advertising rendered to Indian residents are not effectively connected with that PE); (2) where the aggregate amount of consideration (that is otherwise subject to the levy) received by the nonresident in the previous year did not exceed one lakh rupees (approximately $1,500); or (3) where the payment for the online advertising that is otherwise subject to the levy is not for the purpose of carrying on a business or a profession.

The equalization levy is collected by withholding. A resident of India that carries on a business or profession, or a nonresident having a PE in India (which are regarded as “Assessee”) are required to deduct the levy from amounts paid to a nonresident for online advertising services (unless an exception applies) and remit the withheld amount to the Indian tax authorities by the

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1217 *Id.* at 81.
1219 *Id.* at § 162(1).
1220 *Id.* at § 161(i).
1221 *Id.* at § 162(2).
seventh day following the end of the month. An Assessee that does not withhold the levy is held liable for the levy.\textsuperscript{1222} Assessee are also required to file an annual report with respect to the equalization levy.\textsuperscript{1223}

In order to incentivize compliance, the provisions of the equalization levy impose interest and penalties on Assessee that fail to deduct, remit or report the equalization levy (subject to a reasonable cause exception).\textsuperscript{1224} Furthermore, an Assessee that fails to deduct and remit the equalization levy would not be allowed a deduction for the online advertising expenses with respect to which the levy was supposed to be withheld.\textsuperscript{1225}

In order to prevent double taxation, any income that was subject to the equalization levy is exempt from income tax in India.\textsuperscript{1226}

Although the equalization levy was initially adopted only with respect to online advertising, the base of the tax is expected to expand in the future.\textsuperscript{1227} The report that proposed the levy had originally recommended that the levy be applied to 12 different categories that broadly encompass almost all existing types of digital goods and services,\textsuperscript{1228} and there has already been reports that the levy is expected to be widened to apply to streaming video and audio in the near future.\textsuperscript{1229} If the tax base of the levy would indeed be widened in accordance with the categories proposed by the committee, the levy would eventually subject almost all digital companies to tax in India, even when the activity of such nonresident companies will not necessarily justify the

\textsuperscript{1222} \textit{Id.} at § 163.
\textsuperscript{1223} \textit{Id.} at § 164.
\textsuperscript{1224} \textit{Id.} at §§ 167–169. An Assessee who fails to deduct the levy is subject to a penalty equal to the equalization levy that was not deducted (in addition to the Assessee’s liability for the actual levy); an Assessee who fails to remit a levy that was withheld or to make an annual report will be subject to a penalty for each day of delay. An Assessee who makes a false statement related to the equalization levy is punishable by imprisonment of up to 3 years. \textit{Id.} at § 173.
\textsuperscript{1225} \textit{Id.} at § 22 (amending § 40 of the Income-tax Act, 1961-2016).
\textsuperscript{1226} \textit{Id.} at § 7(E) (amending § 10 of the Income-tax Act, 1961-2016).
\textsuperscript{1227} \textit{See} Paresh Parekh & Vishal Agarwal, \textit{Equalisation Levy – A Googly!}, 1 GLOBAL TAXATION 54, 61 (2016).
\textsuperscript{1228} \textit{Committee on Taxation of E-Commerce, supra} note 1211, at 88–89 (proposing to apply the levy to online advertising, designing, hosting and maintaining websites, uploading, storing or distributing digital content, online collection or processing of users’ data, online sale of goods and services, use or right to download online music, movies, games, books or software, online news, search and maps applications and more).
imposition of the tax. That would be the case if the levy applies, for example, to online sale of goods or services by a nonresident that has no physical presence in India, because the justification for creating a nexus between such taxpayer and India would be based solely on the “market demand” theory, and thus would be weaker than the case of online advertising or other cases of exploitation of user data.

One shortcoming of the equalization levy is the fact that it does not apply to revenues from online advertising that target the Indian market but were paid to the nonresident publisher by a nonresident advertiser (that has no PE in India). Theoretically, multinational corporations that need to advertise in India could have foreign subsidiaries pay for the online advertising expenses for the Indian market, and such foreign-to-foreign payments would not be subject to the equalization levy. This option is naturally only available for multinational companies and not for local businesses. The committee did envision this possibility and proposed that the levy should also apply to payments made by an Indian resident to a nonresident for reimbursement of expenses incurred by a third party outside of India in respect of services covered under the levy, but it seems that this recommendation was not adopted by the final legislation. A foreign company can also establish a local office through which it would conduct marketing activities in India, in which case, under the “preparatory of auxiliary” exception to the PE definition, such office would not create a PE for the company in India. In this scenario, payments made by the Indian marketing office to a nonresident online publisher should not be subject to the equalization levy, which only applies to payments made by Indian residents and nonresidents that have a PE in India. Note that the above two options to override the equalization levy depend on the payor (the advertiser), and thus is not subject to the control of the online publisher. However, this option could be used as a bargaining chip in the hands of the advertiser.

1230 COMMITTEE ON TAXATION OF E-COMMERCE, supra note 1211, at 89–90.
1231 See OECD Commentaries, supra note 390, at C(5)-13 and C(5)-26. The same conclusion would be reached under the revised language of the exception, as suggested by the BEPS Project’s final report on Action 7, provided the marketing activity is not a core business function of the entity; i.e., it is not a marketing company).
when negotiating the online advertising costs, or as a way to avoid the levy in case the online publisher chooses to pass on the levy to the advertisers by raising prices.\textsuperscript{1232}

An additional concern with the Indian equalization levy is the relatively high tax rate. Based on Google’s net income margin (pre-tax) of 26%, a levy of 6% on gross revenues is equivalent to a net income tax rate of 23%. Viewed separately, this is not a high tax rate, but when combined with the fact that the levy would not be creditable by the taxpayer in its country of residence, the levy could create a significant double taxation problem that would subject the taxpayer to a high effective tax rate (assuming the revenues are also fully taxed by the country of residence on a net basis). The committee argued that 6% is a low rate and that the exemption of the amounts subject to the levy from income tax further reduced the rate.\textsuperscript{1233} However, the exemption from income tax will not have such intended result, because the levy applies to those nonresidents that do not have a PE in India and therefore are not subject to Indian income tax to begin with (otherwise the equalization levy would have been redundant), and such exemption would not affect the nonresident’s tax liability in its country of residence. Interestingly, one of the committee’s responses to the creditability problem was that taxpayers subject to the levy are always welcome to establish a PE in India, thereby reliving themselves from the equalization levy. Thus, it seems that the committee, well aware of the creditability problem, chose not to offer a solution to this problem (not to say that such a solution necessarily exists) but rather considered this problem as a beneficial feature of the levy, that could result in additional investments in India coming from digital companies wishing to avoid the equalization levy.

As I have argued in prior parts of this chapter, it is doubtful that the main concern behind double taxation—creating disincentives for cross-border investment and business activity—has an equal importance with the digital economy as it does with the traditional economy. In a world where users (and their data) have become a valuable asset, digital companies go to great lengths to expand their user base.\textsuperscript{1234} It is thus unlikely that a dosage of double taxation would prevent any

\begin{itemize}
\item \textsuperscript{1232} The fact that this option is available only to multinational companies may create an unfair advantage compared to local businesses, but this is not different than the many other techniques that multinationals can use and that are not available to local businesses.
\item \textsuperscript{1233} COMMITTEE ON TAXATION OF E-COMMERCE, supra note 1211, at 99.
\item \textsuperscript{1234} See, e.g., Facebook’ initiative to bring internet access to every human on earth (Internet.org by Facebook, https://info.internet.org/en).
\end{itemize}
of the major digital companies from continuing to provide their services in India, which has the second largest user-base in the world.\(^{1235}\) This can also explain why, from all the countries in the world, India was the first to enact a direct tax on online advertising – given the value embedded in its digital market, India is likely one of few countries in the world that can directly tax online publishers without creating a significant disincentive for them to continue to operate in the country. This is also why the equalization levy might even succeed in incentivizing the major publishers to establish PEs in India, as hoped-for by the committee’s report.\(^{1236}\)

**10.3.4. Israel – Significant Economic Presence PE**

In April 2016, the Israeli Tax Authority published a circular that provides guidance regarding the operations of foreign corporations in Israel via the internet (the “ITA Circular”).\(^{1237}\) The ITA Circular interprets existing law in a manner that significantly expands the Israeli PE concept, and allows Israel to tax the profits of foreign companies that have significant economic presence in Israel. The ITA Circular is a non-binding administrative document, but taxpayers can rely on the guidance in the ITA Circular as a “safe harbor.”

The ITA Circular distinguishes between foreign companies that are residents of a country with which Israel has an income tax treaty, and those that are residents of countries that do not.

With respect to foreign companies from treaty countries, the ITA Circular explains that a foreign company has a PE in Israel if (1) the company has a fixed place of business, or (2) the company operates in Israel through a dependent agent (in accordance with traditional OECD PE rules).\(^{1238}\) With respect to the first option (operation via a fixed place of business), the ITA Circular states that activities that used to be clearly defined as preparatory or auxiliary (and thus excluded from


\(^{1236}\) One indication as to the importance of the Indian market to online publishers is the fact that some have already stated that they do not intend to pass on the costs of the equalization levy to the local advertisers. See, e.g., Sachin Dave, **LinkedIn Won’t Pass on Equalisation Levy to Companies Advertising on Its Platform**, THE ECONOMIC TIMES (July 15, 2016), http://economictimes.indiatimes.com/tech/internet/linkedin-wont-pass-on-equalisation-levy-to-companies-advertising-on-its-platform/articleshow/53220911.cms.


\(^{1238}\) **Id.** at ¶ 2.1.1.
the definition of PE under Article 5(4) of the OECD Treaty Model), may be considered as the main business activity of the corporation. Thus, a foreign corporation that has a significant digital presence in Israel and conducts activities in Israel that in the past would have been characterized as preparatory or auxiliary, may, under certain circumstances, be considered as having a PE in Israel (when the activity conducted is not preparatory but rather the main business of the corporation).\textsuperscript{1239} The ITA Circular provides the following criteria as indication for the existence of significant digital presence in Israel: (1) signing a significant number of contracts with Israeli residents for the provision of digital services; (2) the services provided by the foreign corporation are used by “many customers” in Israel; or (3) the foreign corporation provides online services that are tailored to Israeli customers or users (such tailoring could be indicated by the use of the Hebrew language, style, charging customers in the local currency, processing local credit cards in Israel, etc.).\textsuperscript{1240} Note that the above guidance still requires that the foreign company has some physical activity in Israel (at least activity that is traditionally considered preparatory or auxiliary), and therefore would not create a PE for an online publisher that is a resident of country with which Israel has a tax treaty if such publisher has no physical presence in Israel or if the online publisher’s presence is limited to preparatory or auxiliary activity that is not part of the online publisher’s core business (i.e., an activity that is truly preparatory or auxiliary in nature).

With respect to a PE via a dependent agent, the ITC Circular notes that multinational companies that operate in Israel via the internet are sometime assisted by Israeli subsidiaries or other Israeli subcontractors, and such agents can be considered, under certain circumstances, as dependent agents that create a PE in Israel for the foreign multinational.\textsuperscript{1241} The ITA Circular reviews the circumstances that can indicate when an agent is dependent (such as significant involvement of the agent in the modification of the agreement to the needs of the Israeli customer) but it does not provide any unique guidance on this issue with respect to digital companies.\textsuperscript{1242}

\textsuperscript{1239} Id. at ¶ 2.1.2.1.
\textsuperscript{1240} Id.
\textsuperscript{1241} Id. at ¶ 2.1.2.2.
\textsuperscript{1242} Id.
A foreign company that is a resident of a country with which Israel does not have a tax treaty is subject to income in Israel if it carries out a business activity in Israel. According to the ITA Circular, a business activity could be considered as being carried out in Israel if (1) it is carried out via a fixed place of business, (2) it is carried out via a dependent agent in Israel, or (and this is the innovative aspect of the ITA Circular) (3) if the foreign entity has significant economic presence in Israel (even in the absence of any physical presence in Israel).\footnote{1243}{Id. at ¶ 2.2.}

The ITA Circular includes several criteria that could indicate that a foreign corporation has significant economic presence in Israel: (1) the foreign corporation provides online services (like advertising, brokerage, marketing, support etc.) with respect to Israeli users; (2) the foreign corporation has a significant number of transactions with Israeli residents via the internet; (3) the foreign corporation provides online services that are tailored to Israeli users or customers (such tailoring could be indicated by the use of the Hebrew language, advertising, style, charging customers in the local currency, processing local credit cards in Israel, etc.); (4) the services provided by the foreign corporation are used by “many customers” in Israel via the internet; (5) the level of usage of the website by Israeli users is high; or (6) there is a strong connection between the payments made to the foreign corporation and the extent of use by Israeli users.\footnote{1244}{Id. at ¶ 2.2.3.}

Under the ITA Circular, attribution of profits to a PE of a foreign person that is a resident of a treaty country is be based on the Authorized OECD Approach. Under such approach, profits “attributed to a PE are the profits that the PE would have earned at arm’s length, in particular in its dealings with other parts of the enterprise, if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise.”\footnote{1245}{Id. at ¶ 2.3. and OECD, 2010 Report on the Attribution of Profits to Permanent Establishments (2010), https://www.oecd.org/ctp/transfer-pricing/45689524.pdf.} Attribution of profits to a business carried out in Israel by a foreign corporation from a non-treaty country is based on
the functions performed, assets used and risks assumed test, but the circular provides no specific guidance on this issue.\(^{1246}\)

The ITA Circular also includes guidance with respect to the Value Added Tax ("VAT") aspects of the activities of digital companies in Israel. The ITA Circular explains that under Israeli VAT law, a foreign person that carries out business in Israel is required to be registered as a “dealer” for VAT purposes, and thus is required to report and pay VAT with respect to its business in Israel.\(^{1247}\) According to the ITA Circular, a foreign corporation that is considered as carrying on a business in Israel because such corporation has significant economic presence in Israel, is required to register as a “dealer” under the Israeli VAT law, which will require the corporation to nominate an Israeli representative for VAT proposes and to report and pay VAT with respect to its transactions with Israeli customers.\(^{1248}\) It should be noted that in March 13, 2016, several weeks prior to the release of the ITA Circular, the Israeli Ministry of Finance published proposed legislation to amend the VAT law with respect to digital services in a manner generally consistent with the VAT-related guidance included in the ITA Circular.

The guidance issued by the Israeli Tax Authority in the ITA Circular is by far the most advanced unilateral measure adopted in terms of creating taxable presence for foreign persons that do not have a physical presence in the jurisdiction. Although there are open questions with respect the interpretation and application of the guidance,\(^{1249}\) based on the “significant economic presence” indications provided in the ITA Circular there is a high probability that a foreign online publisher from a non-treaty country would be found to have a taxable presence in Israel, despite having no physical presence in the country. The examples of such indications in the ITA Circular specifically include the provision of tailored services (such as advertising), a high level of usage of the foreign person’s website by Israeli users, and having a strong connection between the payments made to the foreign person and the extent of use by Israeli users. These indications are applicable in the case of foreign online publishers. However, given that Israel has a relatively

\(^{1246}\) ITA Circular, *supra* note 1237, at ¶ 2.4.

\(^{1247}\) *Id.* at ¶ 3.8.

\(^{1248}\) *Id.* at ¶ 3.9–3.10.

\(^{1249}\) For example, it is not clear what number of users is considered “many” or how would the ITA determine that the level of usage of a website by Israeli users is “high”, which are terms that are used in the ITA Circular.
extensive network of tax treaties (with 55 counties, as of February 2017), including with most of the developed countries, it is more likely that the standard for treaty country would apply. Under the ITA Circular, such standard requires a certain level of presence in Israel in addition to a significant economic presence, in order to create a PE for the foreign online publisher. Therefore, foreign online publishers from treaty countries would still be able to avoid having a PE in Israel if they either have no physical presence or have a true “preparatory or auxiliary” activity in Israel that is not a core business function.

It should also be noted that the expansive guidelines with respect to foreign persons from treaty countries are likely to be contradictory to existing treaty obligations, and thus it is not clear to what extent the guidelines would be applicable in such scenarios. Furthermore, it is also possible that the guidelines—that introduce an entirely new concept that changes legal rights and obligations under the Israeli tax law—would be considered by an Israeli court as an impermissible use of administrative power by the ITA. Despite these uncertainties, the ITA Circular already had an impact on the market, when, follow the publication of the circular, major banks in Israel started withholding corporate tax from payments made by Israeli companies to foreign online publishers, unless a certificate of no-withholding from the ITA was provided to the bank.1250

10.3.5. Other Countries

Many other countries have proposed measures intended to expand their tax jurisdiction and their abilities to tax digital companies. Some of these proposals are only at their initial stages, other have not yet been finalized, and some were proposed but rejected. Below is a review of several of these legislative proposals.1251

1250 Assaf Gilad, The Banks are Collecting Tax from Companies that Advertised with Facebook and Google Abroad (in Hebrew), CALCALIST (April 7, 2016), http://www.calcalist.co.il/internet/articles/0,7340,L-3692198,00.html

1251 In addition to the proposals mentioned in this section, several other countries consider imposing a ‘Google Tax’ on online advertising, such as Egypt (see Amr Eltohamy, Will Egypt Impose Taxes on Facebook Ads?, AL-MONITOR.COM (July 17, 2016), http://www.al-monitor.com/pulse/originals/2016/07/egypt-facebook-twitter-ads-revenue-proposed-law-parliament.html) Korea (see Lee Min-hyung, Korea to Impose ‘Google Tax’ on Multinational Firms, KOREA TIMES (Jul. 29, 2016), http://www.koreatimes.co.kr/www/news/tech/2016/07/133_210706.html) and Hungary (Hungary Urges ‘Google tax’ on Internet Firms, BUDAPEST BUSINESS JOURNAL (Sept. 12, 2016), http://bbj.hu/business/hungary-urges-google-tax-on-internet-
10.3.5.1. France

Despite the strong criticism against the Collin-Colin Report from 2013 (that recommended changing the PE definition to take into account the role of users in generating income for online companies), French legislators continued to pursue legislation that would introduce new taxes with respect to the digital economy. In February 2015, a report commissioned by France Stratégie (a think tank under the auspices of the French Ministry of Finance) was published under the title “Taxation and the Digital Economy: A Survey of Theoretical Models.”

The report noted that the existing rules for determining corporate tax liability of multinationals are based on transfer pricing and territorial definitions that have become obsolete. Therefore, the report recommends that new rules, that are adapted to the digital economy, would be put in place as part of international negotiations. The report suggested that such rules should be based on the number of users in each jurisdiction because the users are a necessary condition for the realization of the income. The report further recommended that if such new rules would not be adopted internationally, the government of France can implement an ad valorem tax on online advertising based on revenues generated in France. The report argues that the variable expenses associated with such revenues are negligible and thus profits can be identified with revenues, and that statistical rules could be adopted for purpose of determining revenues that are paid outside France.

If such ad valorem tax could not be implemented, the report recommended adopting a low-rate tax based on online activity, such as number of users, flow of data or number of advertisers.

The report notes that such a tax could be distortive and could change the behavior of the users,
advertisers and the online platform, including changes in prices and the exclusion of certain users from the platform. Therefore, the report argued that such a tax should only be used as a last resort if taxation based on profits or revenues is impossible.\textsuperscript{1258}

One of the report’s recommendation was to implement different tax rates based on the type of activity that generated the revenues. According to the report, revenues that are generated by a “one-time access” (such as a sale of an item online or advertising revenues linked to a keyword) should be taxed at a lower rate than revenues linked to the exploitation of users’ personal data (like the sale of data to third parties or storage of sales data for future targeting) in order to incentivize digital companies to decrease the exploitation of such data.\textsuperscript{1259}

The report and its recommendations were significantly criticized by industry interest groups, claiming that such a tax would result in a “digital recession” that would adversely affect non-digital businesses as well.\textsuperscript{1260} Ultimately, none of the reports’ recommendations were adopted by any concrete legislative proposal.

In November 2016, the French National Assembly’s Finance Committee approved legislation for the adoption of a tax similar to the U.K. DPT. The tax (which includes a punitive tax rate of additional 5 percentage points) would have applied to foreign companies providing digital services in France without a PE, unless they can show that the manner in which they engage in business is supported by economic substance and was adopted for business reasons other than tax avoidance (taxpayers from EU-member states would be subject to the tax only if the sole purpose of the arrangement was to avoid tax). The tax would have applied only to large companies (with assets exceeding €20 million, revenues exceeding €20 million, or more than 250 employees) and would have become effective on January 1, 2018.\textsuperscript{1261} However, on December 29, 2016, France’s

\textsuperscript{1258} Id.
\textsuperscript{1259} Id.
\textsuperscript{1261} See Ryan Finley, France: Panel Approves Diverted Profits Tax, 84 TAX NOTES INT. 751, 751–52 (Nov. 21, 2016).
Constitutional Council struck down the law on the grounds that it was unconstitutional because the law gave France’s tax administration the power to assert tax liability under the DPT in a manner that violates the French Constitution.\textsuperscript{1262}

10.3.5.2. Italy

In 2013, the Italian government proposed legislation that would require any Italian person that advertises online to purchase advertising space only from entities that are registered in Italy (and are thus taxed in Italy).\textsuperscript{1263} The legislation went so far as to require that all advertisements and links viewable by any person in Italy must be purchased from Italian-registered companies.\textsuperscript{1264} The tax was criticized as violating EU nondiscrimination law and the proposal was eventually abandoned.

In 2015, the Italian government announced that it plans to propose a ‘Google Tax’ that would apply to entities that provide digital services in Italy and are not subject to tax in Italy for such activity.\textsuperscript{1265}

10.3.5.3. Turkey

In 2016, Turkey introduced a draft legislation for the adoption of an “electronic PE” concept (the exact term used is “Place of Business in Electronic Environment”). According to the proposal, the use of the internet for commercial, industrial or professional activities will lead to the creation of an electronic PE. Under the new rule, intermediaries for the supply of goods and services via the internet, intermediaries for the collection of payments for such goods and

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services, and the purchasers of such goods and services, may all be held liable for the payment of relevant taxes.1266

10.3.6. Final Words

The OECD had warned that the adoption of unilateral tax solutions would increase the risk of double taxation and non-taxation, weaken the international efforts to combat BEPS and create additional compliance burden for taxpayers.1267 However, making unilateral changes to domestic laws is by far easier and faster than changing the treaty models and renegotiating existing bilateral treaties in a coordinated manner. Therefore, it is not surprising that so many countries have opted for the former.

The multitude of unilateral measures adopted around the world is a strong indicator of the low level of expectations that countries had with respect to the ability of the BEPS Project to resolve the many tax challenges that arise from the digital economy. To a degree, such low expectations became a reality with the publication of the final reports of the BEPS Project, which did not include a comprehensive change to the fundamental concepts of the international tax system, that so desperately needed to be revised in order to maintain their legitimacy and relevance. The increased public criticism regarding the low effective tax rates paid by the technology giants, followed by multiple public hearings, special committees and reports, combined with the inability of the BEPS Project to provide an adequate solution, have all led to the abundance of legislative measures discussed above.

These are interesting times for international tax. It is not very often that fundamental principles of the international tax system are being challenged by so many individual countries. These unilateral measures clearly do not adhere to the traditional international tax norms, and more specifically, they directly defy the traditional and internationally-accepted interpretation of the PE concept, under which a country has no right to tax the business profits of a nonresident that

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1267 OECD, supra note 615, at 26; OECD, supra note 955, at 4.
has no physical presence in such country (and thus no PE). One could argue that such unilateral actions are a proof that a customary international tax regime does not exist, because there seems to be nothing holding back these countries (as well as others that will surely follow in the coming years) from taking independent actions that are inconsistent with the fundamental principles of the international tax system and in some cases are inconsistent with existing treaty obligations. On the other hand, the fact that all these unilateral measures follow the same main principle—that a nonresident could have a taxable presence in a jurisdiction even without a physical presence if the nonresident benefits from the economy of such jurisdiction to a certain degree—shows that these unilateral actions are not truly independent in nature and they are not inconsistent with the fundamental principles of the international tax system, but are rather affecting widely-agreed changes in such principles and thereby changing the international custom. Custom, as a source of international law, is dynamic in nature. As the norms of international law change and countries change their behavior accordingly, the custom changes as well to reflect the new consensus. This is what we are witnessing with respect to the taxation of the digital economy. The measures discussed above do not represent an act of a single or even a few countries, trying to tax nonresidents based on principles completely contradictory to those adhered to by all other countries. These are measures adopted by some of the world’s largest economies (like the U.K., Australia and India), followed by numerous smaller countries, all of which are expressing changes in the customary international tax system that have been discussed and called for by multiple experts, scholars and special committees (even if the specific recommendations of each might have been different). The customary international tax system is undergoing a major change, and it seems that the general destination is clear (as represented by the multitude of unilateral measures adopted around the world) but the road will likely by bumpy, because several key questions remain open (such as the effect of the unilateral measure on double taxation and the consequent impact on the global digital economy) and because the U.S., the world’s largest economy, has not yet made its move in the game.

1268 MALCOLM N. SHAW, supra note 758, at 74.