U.S. Income Taxation of Electronic Sales: A Virtual Office as Fixed Place of Business[*]

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A. Overview

A foreign corporation selling personal property into the United States is taxable only on its "effectively connected income." It generally can avoid having effectively connected income either by not engaging in business in the United States or by not having U.S.-source income. Because the "engaged in business" threshold is low, however, the first option is not likely to be available to a foreign corporation that engages in substantial business activities within the United States.

The second option -- not having any U.S.-source income -- is available only if the foreign corporation is able (1) to pass title to goods that it then sells to U.S. customers outside the United States and (2) to avoid having a U.S. office (or other fixed place of business). If the foreign corporation has a U.S. office, the passage of title rule for determining the place of sale is overridden by the office source rule. Under the office source rule, the place of sale, and thus the source of the income, is the place where the office is located.

The advent of electronic commerce threatens to make hash of this statutory scheme, as it does of the whole structure of international treaties based on the OECD Model Treaty or the United National Model Treaty. Electronic commerce gives remote sellers direct

[*]This article is drawn from "U.S. Taxation of Foreign Corporations in the Digital Age," 55 (9/10) *Bulletin for International Fiscal Documentation* 498-506 (2001). Minor technical changes were made, and a brief conclusion has been added.

access to all U.S. consumers with access to the Internet. Customers can log onto the remote seller's web site, select products for purchase from an online catalogue, and consummate the sale online by filling out a form and charging the purchase to their personal credit card. Remote sellers can pass title to the goods outside the United States without difficulty by inserting some boilerplate language in the sales agreement. If these electronic sales are viewed as made through a U.S. office, the office source rule applies and the income from the electronic sales is taxable as effectively connected income. If, however, the virtual office is not treated as an "office" for purposes of the office source rule, the income derived from the electronic sales will escape U.S. taxation and will probably escape taxation everywhere else as well.

A foreign corporation cannot have effectively connected income unless it is engaged in business in the United States. The mere use of a web site electronically present in the United States to advertise products or to give ordering information to potential customers clearly would not constitute engaging in business in the United States. Such use of a web site is strongly analogous to use of the mail, television and radio for solicitation. Only if the web site is used to make actual sales of goods or to make delivery of goods held for sale would the use constitute engaging in business.

Foreign corporations engaged in the electronic commerce business in the United States may be able to invoke the protection of a tax treaty even if a virtual office is treated as an office under the Internal Revenue Code. Under Arts. 5 and 7 of the typical tax treaty, a foreign corporation entitled to treaty benefits is not taxable by the United States on its business profits unless the profits are derived through a permanent establishment located in the United States. The treaty issue is whether a virtual office constitutes a permanent establishment.

The policy advantages of treating a virtual office as an "office" for tax purposes are substantial. Such treatment would result in a level playing field for electronic sales and other types of sales and would avoid the very substantial risk that corporations engaged in electronic commerce will avoid all taxes by shifting their income to tax haven countries. This article, however, does not address these policy issues in detail. The focus here is on analyzing current U.S. law. In Section B, the article addresses the question whether an electronic presence through a web site that functions like a "bricks and mortar" office is an "office" for purposes of the office source rule of the Internal Revenue code. In Section C, the article then addresses the question whether a virtual office constitutes a permanent establishment under U.S. tax treaties.

B. Status of a Virtual Office under the Office Source Rule

The regulations under Internal Revenue Code. § 864(c) provide that an office or other fixed place of business is a place, site, structure or similar facility through which a foreign person engages in a trade or business (Treas. Reg. § 1.864-7(b)(1)). Absent special circumstances, a foreign corporation will not be deemed to have a U.S. office because a

related party, such as its U.S. subsidiary, has such an office. Limited guidance is given in the regulations as to what constitutes an office or other fixed place of business. Internal Revenue Code. Section 865(e)(3) provides that the principles developed under Internal Revenue Code § 864(c)(5) are to be applied in determining whether a taxpayer has an office for purposes of the office source rule and whether income is attributable to that office.

The regulations under Internal Revenue Code § 864(c)(5) make no specific reference to electronic commerce or virtual offices. This silence is not surprising in that the regulations were issued long before the advent of the Internet and electronic web sites. In giving some content to the term "office or other fixed place of business," Treas. Reg. § 1.864-7(b)(1), issued in 1972, provides:

> 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 nonresident alien individual or a foreign corporation engages in a trade or business.

One might argue that a web site is not a "fixed facility" within the meaning of the above language because the web site appears on the computer of potential customers only if the customers have their computer turned on and the browser pointed to the web site address. In response, two points can be made. First, the requirement of a "fixed facility" is only a general rule, not an absolute requirement. Second, Treas. Reg. § 1.864-7(b)(1) goes on to provide that a "fixed facility may be considered an office or other fixed place of business whether or not the facility is continuously used by a nonresident alien individual or foreign corporation." A reasonable interpretation of this qualifying language is that the term "fixed" refers to the fixed availability of the facility. A web site, although not fixed on any particular computer screen, is fixed in the sense that it is available whenever the computer user wishes to access it.

In addition, Treas. Reg. § 1.864-7(b)(1) specifically provides that "a store or other sales outlet" constitutes a fixed place of business. A web site used to sell goods can fairly be described as a "sales outlet." Of course, it is also possible to define "sales outlet" in a way that would not include a web site. The core argument for treating a web site through which sales are actually made as an office or sales outlet is that such a web site performs the functions typically associated with a traditional office or sales outlet. This argument has force, but it is not dispositive.

The simple fact is that the current regulations do not address in a meaningful way the question whether a web site used to make sales to customers constitutes an office or other fixed place of business. No mention is made in the regulations of the possibility of an electronic presence constituting an office. At the same time, there is no language that can fairly be read as requiring that the "office" be a traditional office. For example, there is no suggestion that the "office" must have employees or agents present or that it must have any particular type of physical attributes. On the contrary, the regulations provide that

"due regard" should be given to "the physical facilities actually required by the taxpayer in the ordinary course of the conduct of his trade or business" (Treas. Reg. § 1.864-7(b)(2)). In the case of a foreign corporation making remote sales over the Internet, the only "physical facilities" required to conduct its U.S. business are the electronic images projected on the computer screen of its potential customers.

There is little doubt that, if a virtual office constitutes an office under Internal Revenue Code § 865(e)(3), the income earned from electronic sales made through the web site would be attributed to that office. According to the relevant regulations, income will be attributed to a U.S. office (or other fixed place of business) if the office is a "material factor" in the production of the income and the office regularly carries on the activities from which the income was derived (Internal Revenue Code § 864(c)(5)(B)). To be a material factor in the earning of income, the U.S. office "must be an essential economic element" in the realization of the income (Treas. Reg. § 1.864-6(b)(1)).

To be a material factor in earning income from the sale of inventory property, a U.S. office must generally actively participate "in soliciting the order, negotiating the contract of sale, or performing other significant services necessary for the consummation of the sale" (Treas. Reg. § 1.864-6(b)(2)(iii)). It is generally enough that the order was received by a U.S. office for the office to materially participate in the sale, even if the order was unsolicited, as long as the office is held out to customers as a place where orders may be sent (Treas. Reg. § 1.864-6(b)(2)(iii)). Given this language, it would be difficult for a foreign corporation to argue successfully that a web site did not materially participate in a sale that was made through the web site.

C. A Virtual Office As A PE Under U.S. Tax Treaties

The article also looks briefly at the protection from U.S. taxation that a foreign corporation engaged in electronic commerce in the United States might obtain through a tax treaty. The basic issue, under the Internal Revenue Code and under U.S. tax treaties, is whether a foreign corporation operating a business in the United States through a virtual office has a fixed place of business within the United States. A virtual office, for purposes of this discussion, is a web site employed by a taxpayer to transact its business. The article suggests that a virtual office is functionally equivalent to a "bricks and mortar" office and should be treated as a fixed place of business if function is to prevail over form. This view obviously rejects the contrary position recently taken by the OECD in its new Commentary on Art. 5 (Permanent establishment) of the its Model Tax Convention on Income and on Capital (OECD Model).[1]

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[1] See OECD Committee on Fiscal Affairs, *Clarification on the Application of the Permanent Establishment Definition in E-commerce: Changes to the Commentary on the Model Tax Convention on Article 5*, Paris, 22 December 2000 (hereafter "new OECD Commentary").

Under the typical U.S. tax treaty, the business profits of a foreign person entitled to treaty benefits cannot be taxed by the United States unless that person has a permanent establishment located in the United States and the profits are attributable to that permanent establishment.[2] A permanent establishment is a fixed place of business through which the business of an enterprise is wholly or partly carried on;[3] the examples given include an office, a branch, a place of management, a factory, a workshop and a mine.[4]

The term “office” is not defined in any of the U.S. tax treaties. No attempt is made in the permanent establishment article, for example, to distinguish between a “bricks and mortar” office and a virtual office. The term used is “office,” without adornment or qualification. As a result, its meaning, for purposes of interpreting the permanent establishment clause of a U.S. tax treaty, is its meaning under U.S. law, unless the context requires otherwise.[5] It is unclear under U.S. law whether a foreign corporation that operates a web site in the United States as a virtual office has a U.S. office for tax purposes. The issue simply has not yet been addressed in any cases or administrative rules, and the term “office” could be interpreted to income both a virtual office and a brinks-and-mortar office or only the latter type of office.

1. Speculating on Original Intent

In interpreting the unclear language of a treaty, the intent of the parties should prevail.[6] The permanent establishment concept embodied in U.S. tax treaties is based on the OECD Model or, in some cases, on the United Nations Model. That concept itself is quite ancient,[7] and the model treaties that embody it were drafted before electronic commerce was developed. It seems remote in the extreme, therefore, that governments negotiating a tax treaty prior to the development of electronic commerce intended to bargain away their right to tax income derived from what would become a major method of exploiting their markets.

In speculating about the intent of the parties negotiating a permanent establishment clause before the development of electronic commerce, it may be useful to engage in the following thought experiment. Assume that some visionary informed representatives of

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[2] See e.g. Art. 7(1) of the United States Model Income Tax Convention of 20 September 1996 (hereafter “U.S. Model”).

[3] See e.g. Art. 5(1) of the U.S. Model.

[4] See e.g. Art. 5(2) of the U.S. Model.

[5] See e.g. Art. 3(2) of the U.S. Model.

[6] See Vienna Convention on the Law of Treaties, Art. 31(1) (“A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in light of its object and purpose.”) The United State is not a signatory to this Convention, but does accept it as an authoritative statement of customary international law.

[7] A PE clause was included in a tax treaty between Prussia and Austria as early as 1899.

two countries negotiating a tax treaty that some time in the future a powerful new form of commerce would be developed that would allow residents of one contracting state to sell goods directly to customers in the other contracting state without the need for a traditional office made of bricks and mortar. The representatives were then asked to decide whether they wanted their government to be foreclosed by the permanent establishment clause from taxing the profits arising in their country from the exploitation of this new technology. The only plausible assumption is that no sane negotiators acting in the best interests of their respective countries and without pressure from entrenched special interests would intentionally negotiate away that right.

2. The New OECD Commentary

Whatever the intent of the original permanent establishment clause, the OECD, in its role as keeper of the dominant model tax convention for developed countries, has decreed that a web site that constitutes a virtual office does not constitute a permanent establishment for purposes of Art. 5 of the OECD Model.[8] The OECD interpretation was developed though a joint undertaking between representatives of the OECD Member countries and the major multinational companies (MNEs) engaged in electronic commerce. It would appear that most of the OECD countries and the MNEs reached an early consensus that source countries should be precluded by treaty from taxing income derived from electronic commerce.[9] Portugal and Spain refused to join this consensus and have formally dissented from the resulting interpretation of Art. 5.[10]

3. Newly Minted Physical Presence Test

The new OECD Commentary states that a virtual office cannot be a permanent establishment because a permanent establishment requires a “physical presence”. This argument is wrong as a matter of law and a matter of physics. It fails on legal grounds because it has no support in the language of Art. 5 or in the prior OECD Commentary. The test is newly minted and, as such, has no relevance in interpreting the existing language of Art. 5.

The newly minted physical presence test also fails as a matter of physics. According to the new OECD Commentary, a web site is “a combination of software and electronic

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[8] New OECD Commentary, supra note 1, Para. 42.2.

[9] It is interesting to note that the OECD has acted forcefully, with the cooperation of MNEs, to preserve taxation at source under the European VAT. The OECD apparently is unwilling to jeopardize the VAT, which is the most important revenue source in Europe.

[10] For Spain’s general position on e-commerce, see Ministry of Finance (Spain), *Report of the Commission for the Analysis of the Impact of Electronic Commerce on the Spanish Tax System* (Updated English summary, October 2000).

data" and "does not in itself constitute tangible property".[11] This description of a web site is inaccurate. The issue to be decided is whether a remote seller's web site appearing on the computer screen of a potential customer constitutes a permanent establishment of the remote seller when it operates as a virtual office. The images appearing on that screen are tangible. Like all visible matter, they are made up of small particles of matter that are themselves invisible to the eye. Although the form of those images is controlled by software, the images themselves are not software. They are real and tangible, not an apparition.[12] Nor are they intangible, as that term has been understood in legal parlance for centuries.

In the author's view, the proper test is a functional test. A virtual office should be considered a permanent establishment of its owner if it is used to perform the functions of a traditional office. Of course, the various exceptions applicable to a "bricks and mortar" office should apply to a virtual office as well. Thus, a virtual office used merely for preliminary or auxiliary activities, within the meaning of Art. 5 (4) of the OECD Model or U.S. Model, would not be treated as a permanent establishment. In general, a virtual office would constitute a permanent establishment only if it is used to make actual sales of goods or services on a more than casual basis.

4. Impact of the New OECD Commentary on U.S. Tax Treaties

The United States is part of the consensus that led to the adoption of the new OECD Commentary on Art. 5. It is reasonable to infer, therefore, that the United States does not consider a virtual office located in the United States to be a permanent establishment under its tax treaties. The new Commentary, however, is not binding on countries that are not part of the consensus. Portugal and Spain, for example, have formally registered exceptions to the new OECD Commentary, and many countries having treaties with the United States are not members of the OECD and have not agreed to be bound by the new Commentary. The Commentary to the United Nations Commentary does not address the question whether a virtual office can constitute a PE in some circumstances.

It is unclear whether the United States is prepared to give corporations resident in countries that are not part of the consensus the benefit of the exemption from source taxation provided by the new Commentary. The United States may be reluctant, for example, to exempt from tax a corporation resident in Portugal or Spain that is engage in

[11] New OECD Commentary, supra note 1, Para. 42.2.

[12] The new OECD Commentary goes on to assert that the computer files stored on the hard drive of an independent service provider cannot constitute a permanent establishment because they are intangible and have no "location". Id., Para 42.3. This assertion is odd in the extreme. Obviously, those files are located on that hard drive, and the files obviously have a physical presence and can be altered by physical means. For example, they can be corrupted and even destroyed if the hard drive is hit by a hammer or exposed to a strong magnetic field. In addition, the files obviously change some physical aspects of the hard drive.

electronic commerce in the United States through a virtual office when a U.S. corporation engaged in comparable activities in Spain or Portugal would be taxable in those countries. The same issue might arise if a foreign corporation is resident in a country that has a treaty with the United States based on the United National Model Treaty.

D. Conclusion

The OECD initiative on e-commerce has added to the general understanding of the tax issues that have become of great important as a result of the huge increase in global commerce over the Internet. Some of the recommendations and conclusions reached by the OECD are beyond reproach. Its conclusion that a virtual office cannot constitute a PE, however, is not required by prior interpretations of the PE clause in the OECD Commentary and is inconsistent with sound tax policy. If that interpretation becomes generally accepted by the international tax community, it almost certainly will lead to the non-taxation of income derived from e-commerce inthe source country and in the residence country as well. E-commence in the 21st century will end up as a tax-free activity, much the way international shipping because a tax-free activity in the 20th century due to ill-advised treaty rules.

The OECD has implicitly conceded that the PE rule of its model convention, as interpreted in its new Commentary, is badly flawed. It has undertaken a project to devise a new PE rule. That reevaluation is certainly welcome. Unfortunately, the adoption of the new Commentary has seriously reduced the prospects that a revised PE rule will be adopted by the OECD. The new Commentary was adopted through a consultative process that was financed in large part by the multinational enterprises (MNEs). The MNEs achieved the interpretation they were seeking. A new PE rule that is more in line with sound public policy will attract political opposition from the MNEs and from member states of the OECD that tend to voice the position of the MNEs. As a result, stalemate within the OECD on the PE issue is highly likely. Any successful movement to reform the flawed PE rule created by the new Commentary almost certainly will have to come at least in part from outside the OECD.