Testimony of

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"How Much Should Borders Matter?: Tax Jurisdiction in the New Economy"

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My name is Michael Mundaca and I am a principal in the international tax services group of the accounting firm of Ernst & Young here in Washington, DC. I want to thank Subcommittee Chairman Thomas, Senator Bingaman, and the other members of this subcommittee for inviting me to speak at this hearing today. I very much appreciate the opportunity to testify on this important topic.

Although many of our clients are of course are very interested in the issue of tax jurisdiction, I am not testifying on behalf of any clients or on behalf of Ernst & Young. The views expressed here are my own.

My testimony will be focus primarily on international tax jurisdictional issues, in accord with my background. Prior to joining Ernst & Young in 2002, I was the Deputy International Tax Counsel in the Treasury Department's Office of Tax Policy, in addition to being Tax Policy's Senior Advisor on Electronic Commerce. While at Treasury, I represented the United States at meetings of the Organization for Economic Cooperation and Development (OECD) regarding electronic commerce tax policy, and participated in the work of the OECD's Technical Advisory Groups regarding both direct and indirect taxation of electronic commerce. I also participated in drafting the OECD Model Treaty commentary regarding electronic commerce, including commentary regarding permanent establishment issues. In addition, while at Treasury I worked on matters relating to the Internet Tax Freedom Act, and was a Treasury staffer on the

Congressional Advisory Commission on Electronic Commerce. Finally, I have also been an adjunct professor at the Georgetown University Law Center, teaching a seminar on U.S. income tax treaties.

I would like this morning to discuss the current U.S. federal income tax jurisdictional rules, with particular emphasis on the rules contained in various income tax treaties, as well as discuss the application and development of those rules with respect to transactions in the new economy. I hope this discussion might provide some insights for the discussion of the income tax jurisdictional rules that should apply to the U.S. states. In addition, I would like to address briefly some possible international effects of expanded state income tax jurisdiction, with reference to some prior disputes.

Background – US Federal Income Tax Jurisdiction

U.S. Trade or Business

In general, under the Internal Revenue Code ("Code"), a foreign corporation is subject to U.S. income tax on income that is effectively connected with a U.S. trade or business. That is, a foreign corporation must meet two requirements to be subject to U.S. income tax under the Code on its business income. First, the corporation must be engaged in a U.S. trade or business; second, the corporation must earn income effectively connected with that U.S. trade or business.

The Code does not provide a comprehensive definition of a "U.S. trade or business," but provides merely that a U.S. trade or business generally includes the performance of services within the United States, but generally does not include certain stock, securities, or commodities trading. As a result of this lack of a comprehensive statutory definition, the analysis of whether a foreign corporation is engaged in a U.S. trade or business consists primarily in applying case law and administrative guidance to the underlying facts and circumstances regarding the corporation's economic activities in the United States.

Courts and the IRS have generally held that profit-oriented activities in the United States amount to a trade or business if the activities are regular, substantial, and continuous. Incidental or sporadic activities generally do not rise to the level of a trade or business. There does not appear, however, to be any explicit requirement of physical presence of the foreign person in the United States in order for a trade or business to be found.

In addition, it is not always clear what level and type of activities give rise to a U.S. trade or business. For instance the Tax Court has held that the delivering merchandise into the United States and maintaining a U.S. office to receive payments, without the solicitation or negotiation of the terms of the orders, is not sufficient activity in the United States to constitute a trade or business, because all true profit generating activity occurred outside the United States. In contrast, the Tax Court has also held that a Canadian sole proprietor who manufactured postcards in Canada was engaged in a U.S. trade or business because of his relationship with a U.S. distributor through which the postcards were sold. Similarly, the IRS has determined that a foreign corporation was engaged in a U.S. trade or business by virtue of the U.S. activities of its exclusive U.S. distributor.

In the context of the new economy, the application of these rules to, for example, cross-border sales over the Internet and the delivery of services over the Internet, is even more uncertain, in part because the U.S. trade or business rules have no explicit requirement of physical presence.

U.S. Tax Treaties

In contrast to the U.S. trade or business jurisdictional rules of the Internal Revenue Code, U.S. tax treaties use the "U.S. permanent establishment" concept to determine the limits of U.S. taxation of business income, and those limits are based on substantial physical presence. If a foreign person is eligible for treaty benefits, that person may choose to apply the treaty in lieu of applying the rules of the Internal Revenue Code. Under our treaties, the business profits of foreign persons eligible to claim treaty benefits are taxable by the United States only if the foreign person has a U.S. permanent establishment (PE) and only if the business profits are properly attributable to the PE. The PE concept is found in every one of the more than 60 U.S. income tax treaties, as well as in most of the literally thousands of bilateral tax treaties in force between countries around the globe.

The PE concept originated in the work of the League of Nations, in the 1920s, spurred in part by efforts of some governments to levy income tax on foreign corporations that simply had customers in their country. Concerned with this expanding jurisdiction over business income, the League of Nations adopted the PE concept as a safeguard. That is, the League recommended that countries agree bilaterally to impose income tax on the business income of a foreign corporation only if the foreign corporation had a substantial physical presence in their country.

While the PE concept and provisions have developed somewhat over the last 80 years, they have retained their firm grounding in physical presence.

Before I turn to some of the issues regarding the application of the PE rules to transactions in the new economy, I should take a moment to explain the PE rules more fully.

Most tax treaties currently in force are based on one of three model treaties: the United Nations model, the U.S. model, or the OECD model. With respect to determining the taxing jurisdiction of business profits, all three models incorporate the PE concept, and there are only minor variations among the three. I will describe the OECD model PE provision, as that provision is probably the most widely used, and differs only in very minor respects from the provision in the U.S. model. In addition, the OECD provision has been the subject of recent review regarding its application in the new economy, as I will discuss shortly.

Under the OECD model provision, the business profits of a non-resident enterprise are taxable in the source state only to the extent the business profits are attributable to a permanent establishment. The model treaty generally defines a PE as a “fixed place of business through which the business of an enterprise is wholly or partly carried on," including, but not limited to, a place of management, a branch, an office, a factory, a workshop, or a mine, quarry, or oil or gas well. Thus, to reiterate, in general, a physical presence in the form of a fixed place of business is required before tax jurisdiction may be asserted.

Moreover, because the place of business must be "fixed" in order to be a PE, temporary places of business do not give rise to PE. According to the OECD, PEs normally have *not* been considered to exist in situations where a business has been carried on through a place of business maintained for less than six months. In a special rule included in the OECD (and U.S.) model, a building site or construction or installation project constitutes a PE only if it lasts longer than 12 months.

The model treaty also includes a list of certain "preparatory or auxiliary" activities that will *not* constitute a PE, even if conducted through a fixed place of business. Such activities include the use of facilities solely for the purpose of storage, display, or delivery of goods or merchandise, as well as the maintenance of a stock of goods or merchandise solely for the purpose of storage, display, or delivery. Thus, for example, under the OECD model (and US model) PE provisions, a foreign corporation could remotely solicit and conclude orders with U.S. customers (e.g., by mail or over the Internet) and fulfill those orders from a stock of goods maintained in a facility in the United States and not be subject to U.S. income tax with respect to the profits from the sales, because the foreign corporation would not be deemed to have a PE in the United States.

There is one potential exception to the fixed place of business requirement of the PE rules: if a foreign corporation has an agent in a jurisdiction and that agent has, and habitually exercises, an authority to conclude contracts in the name of the corporation, then if the agent is not independent of the foreign corporation, the agent will create PE, regardless of whether the agent has a fixed place in business.

Thus, in general, the PE provisions of the OECD model (as well as those of the U.S. and UN models) require substantial physical presence before taxing jurisdiction may be asserted. Moreover, through the “preparatory and auxiliary” rules, the construction site rules, and the ordinary rules of application, certain fixed places of business that constitute substantial physical presence are nevertheless deemed *not* to be PEs.

Appropriateness of the PE Rules in the New Economy

Obviously, much has changed in the global economy and in business practices since the development of the PE concept in the 1920s, and some have questioned whether a tax jurisdiction concept so reliant on physical presence makes sense in an economy that is now so much more driven by services and intangibles than it was 80 years ago, especially as so much value can now through new technologies be developed and delivered at a distance.

It was just these sorts of questions, as well as other more practical and administrative questions, that prompted the United States, the OECD, and others in 1996 to begin to consider both the application of the current PE rules to new business models as well as consider whether the current PE rules should be substantially changed in response to new business models.

I participated in the OECD discussions and negotiations as a member of the Treasury Department. The position of the Administration at that time was that the current Treaty rules, including the PE jurisdictional rules, could be adapted to deal with new business models, and did not need to be abandoned or substantially changed. That was not the position of all the members of the OECD. Nevertheless, after literally years of study, discussion, and consultation, in late 2000, the OECD was able to release consensus changes to the official interpretation of the PE rules as applied to certain electronic commerce business activities which maintained the rules’ strong reliance on physical presence. I think it is fair to say that those adaptations so far have proven to work well, and have provided revenue agencies and taxpayers a set of reasonable and certain rules that are relatively easy to apply and administer.

That is not to say, however, that there does not continue to be dissent and calls for change. Spain and Portugal, for example, did not join the OECD consensus position, and have pressed the OECD to take up the larger project of assessing whether the PE rules should be fundamentally changed, in light of new technologies and new business models. And countries outside the OECD as well have been pushing for a re-evaluation of the PE standard, in addition to applying the current standard quite expansively.

So what are the arguments in favor of a new standard that moves away from reliance on physical presence? It is difficult to deny that the global economy, business models, and technology have changed over the last 80 years in ways that bear directly on the theoretical and practical justifications for basing income tax jurisdiction on physical presence. For example, the connection between the physical location of business activities and the physical location of the customer or other sources of business income has become increasingly attenuated. In addition, more and more goods, and more and more value, in the new economy are intangible and therefore not clearly located in any particular physical location.

Nevertheless, strong arguments remain for keeping the PE physical presence standard. An almost universal consensus has been achieved regarding use of the PE standard to determine income tax jurisdiction. This has created much needed uniformity, predictability, and certainty for multinational corporations and other taxpayers. Moreover, the consensus around the standard helps to mitigate double taxation and prevent tax jurisdictional disputes, which is especially important in a global economy. Finally, the rule prevents the administrative burden for multinational corporations and other taxpayers of having to file net basis income tax returns in every jurisdiction in which they have customers or other sources of business income. And as we discovered in the OECD process I just discussed, gaining a global consensus around a new standard would be difficult, if not impossible.

Federal Law Limits on State Income Tax Jurisdiction

Now, I'd like to turn briefly to the interaction of the federal income tax jurisdictional rules I just discussed with state income tax jurisdictional rules. That is, do the PE rules in our tax treaties that I just described impose any limits on the U.S. states' ability to impose income taxes? The short answer is, no they do not. By their terms, U.S. income tax treaties do not in general apply to state and local taxes. Thus, the PE rules I just discussed do not apply to limit the application of state and local income taxes, and therefore it is possible that a foreign corporation may be exempt from income taxation on the federal level because they have no physical presence in the United States, but may nevertheless be subject to state income taxation.

The issue of federal limits on state taxing powers has been the subject of litigation, and the Supreme Court has spoken regarding the international interactions as recently as 1994. In *Barclays Bank PLC v. Franchise Tax Board*, 512 US 298 (1994), the Supreme Court held that California's requirement of worldwide combined reporting for income tax purposes was constitutional even when applied to foreign corporations. One key to the Court's determination was that U.S. tax treaties, which provide for a different taxing standard than did California, do not generally cover state taxes, which the Court took to be an implicit grant of authority to the states to impose potentially contrary tax rules. In addition, the Court noted that the Senate had rejected a provision in a proposed income tax treaty with the United Kingdom that would have imposed a limit on state taxation, which the Court took to be an explicit determination that the states need not follow treaty rules.

Interestingly, although California's worldwide combined reporting tax system was validated by the Supreme Court in *Barclays*, California had by the time of the *Barclays* decision allowed taxpayers an election to limit application of its worldwide system (by allowing a so-called "water's edge" election). That change was made in response to threats by foreign corporations to take their business elsewhere, as well as to the threat of federal legislation restricting the use of worldwide apportionment, which was itself prompted by complaints from foreign governments.

International Implications of State Taxing Decisions

The *Barclays* case is interesting not only because it illustrates the limited effect of tax treaties on state tax authority, but also because it illustrates the potential reaction of foreign corporations and foreign governments to expansive state taxation. Coupled with the already increasing pressure on the PE standard from countries that view the rules as inadequate and antiquated, assertions of expansive tax jurisdictions by the U.S. states could not only prompt protests by foreign corporations and foreign governments, but could also encourage foreign countries and international organizations to re-evaluate the PE standard and potentially replace it with an economic nexus standard. We have already seen a move by the European Union in the context of value-added taxes to place tax collection obligations on corporations that have customers but no physical presence in the EU.

Conclusion

To conclude, our experiences in the international tax area using the well-established PE concept have demonstrated that, for the most part, a clear physical presence standard is an appropriate basis for determining tax jurisdiction. As I have said, the international consensus regarding use of the PE concept has created needed uniformity, predictability, and certainty for multinational corporations and other taxpayers. It has helped to mitigate double taxation and prevent tax jurisdictional disputes. In addition, it has alleviated the administrative burden that would be imposed on multinationals if they were forced to file net basis income tax returns in every jurisdiction in which they have customers or other sources of business income.

Multistate taxpayers—and state revenue agencies—likewise could benefit from a similarly clear, consensus standard. There is no argument that our economy has changed and that our tax rules need to reflect those changes. Similarly, however, there should be no argument that we should strive for uniform, predictable, and clear jurisdictional rules that minimize double taxation and that are easy to comply with and administer.

Thank you for the opportunity to testify. I would be happy to answer any questions you may have.