International Tax

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I. Global Issues

International practitioners not specialized in the tax area should note two important international tax issues. The first issue is the growing concern regarding the appropriate taxation of electronic commerce. The second issue is the conflict between the Organization for Economic Co-operation and Development (OECD) countries and countries considered by the OECD to be tax havens. Significant activity occurred in both areas in 2000.

II. Electronic Commerce

The growth of electronic commerce presents challenges to the international community in the areas of income taxation, value added (or retail sales) taxation, and customs duties.

A. Income Tax

Electronic commerce, in general, presents enforcement problems, as it eliminates the paper records and intermediaries that have always played an important role in tax administration. A more interesting challenge is the characterization of electronic commerce in the traditional international tax framework. The traditional international income tax rules, especially bilateral treaties to avoid double taxation (tax treaties), have placed great emphasis on physical presence as a prerequisite to taxing a foreign (non-resident) taxpayer on its income in a country where such taxpayer carries on business activity. The prevailing rule focuses on whether the foreign taxpayer has a "permanent establishment" in the other country. In the absence of a permanent establishment, tax treaties limit income taxation to the country of residence. Each country is free to tax non-residents however it chooses in

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the absence of a tax treaty; however, a foreign taxpayer's activities can be difficult to control if there is no permanent presence and no tax treaty in force that permits exchange of information between the two countries.

Great efforts have been made to fit the new world of electronic commerce into the traditional system. In international conferences and academic papers there is considerable commentary on which electronic commerce activities should result in a permanent establishment. There is some level of consensus among developed countries that neither a website nor a web hosting arrangement alone will constitute a permanent establishment, though major countries, such as India and China, have expressed disagreement. A key battleground is the server. Some experts view the presence of a server alone as sufficient to constitute a permanent establishment; others view a server, in the absence of regular human participation, as insufficient to create a permanent establishment; still others distinguish among servers, with only a "smart" server being a permanent establishment. The OECD currently supports the notion that a server is a permanent establishment only if it performs significant core business of the enterprise.

Some observers consider the foregoing dispute irrelevant in light of the ease with which a website or server can be relocated. Others consider the proposed rules as the tax equivalent of rearranging the deck chairs on the *Titanic*. The rise of electronic commerce clearly presents a very serious challenge to traditional international tax rules. It is possible that electronic commerce, ultimately, will undermine the current system. Those defending this position have difficulty making themselves heard. They must first explain the ever-increasing income tax revenue at a time when electronic commerce is increasing dramatically.

Another underlying theme is the potential conflict between developed and developing countries in the area of electronic commerce. The permanent establishment rule has always been a barrier to tax treaties between developed and developing countries, because this reciprocal provision does not have a reciprocal effect. Developing countries often resist tax treaties because many enterprises from developed countries would be able to use the permanent establishment article to escape taxation in the developing country, whereas few companies from the developing country would be able to use the permanent establishment article. The foregoing is simply a reflection of investment flows.

The rise of electronic commerce will make it even easier to operate internationally without a permanent establishment. Moreover, the imbalance of business operations is likely to be even greater in the area of electronic commerce. Under existing international tax norms, electronic commerce will make it easier for non-residents (primarily from developed countries) to do business in other countries (many developing) without a permanent establishment, and therefore without paying any tax at source. The beneficiaries will be the revenue authorities of the developed countries.

Developing countries are only beginning to study this new challenge. It remains to be seen whether they will resist the rules that are now being established by developed countries. It should be noted that much work also is being carried out, coordinated primarily by the OECD, to establish rules on more specific issues. Several types of electronic commerce income have been identified with the goal of establishing recognized norms for how such payments will be characterized.

B. Value Added Tax

Electronic commerce has prompted significant debate in the United States as it relates to state-level Retail Sales Tax (RST). Electronic commerce has exacerbated a problem that has long existed in the United States: how to impose RST or collect RST from sellers who do not have any presence in the purchaser's state. Such commerce has long been carried on by mail order and telephone, and the Internet promises to push such activity to a much higher level.

Practical issues aside (such as collection of small amounts), the U.S. Supreme Court[1] long ago ruled that collection of sales tax from out-of-state sellers can only be regulated by the Congress, which has failed to act on this issue. Furthermore, the desire to promote the Internet has made such taxation a delicate political issue and a moratorium is in effect for various types of "Internet" taxation.

This issue could be explosive in the international environment, because the Value Added Tax (VAT) has become the norm around the world. VAT rates are often four to five times higher than average RST rates in the United States, and therefore account for a more important portion of revenue. When combined with the potential savings of customs duties, an Internet purchase may involve a savings of 35 percent or more. Control of individual items shipped into a country is difficult, but for the several items that can be transmitted over the Internet (software, music, etc.) it is nearly impossible.

C. Customs Duties

As noted, purchases from remote sellers make collection of various taxes more difficult, and in the international arena, customs duties are a significant item that will become easier to avoid. The point of control for both VAT and customs duties is generally the point of entry into the country. In an era of growing international trade, controlling individual purchases is a difficult task. In addition, as noted above, digital products never physically pass through any point where they can be controlled.

The overwhelming majority of electronic commerce is currently within the United States. This is expected to change. In light of the revenue at stake for countries and the potential savings to consumers if they avoid VAT and customs duties, much attention is being given to these issues. But given the difficulty within the United States, with much less revenue at stake, and a federal government that can intervene, the international context is worrisome. The reality of electronic commerce has already led some to believe that some sort of international tax organization is inevitable.

III. Tax Havens and the OECD

In 2000, the OECD attacked an issue that has been festering for some time, that of "tax havens," a term widely used, but whose meaning is not universally agreed. The effort provoked what has been called a "roller-coaster ride." The ride started in June with the OECD's publication of a list of countries that do not comply with norms that the OECD considers necessary to avoid tax evasion and "unfair" tax competition. The countries were given less than one year to explain why they should not be on the list, and punitive measures were suggested for countries not mending their ways.

Countries on the list are those featuring (among other things generally associated with tax havens) bank secrecy, little or no tax for "offshore" activity, and no exchange of infor-

1. Quill Corp. v. North Dakota, 504 U.S. 298 (1992).

mation with other countries. For countries not reforming their policies in accordance with OECD indications, the OECD suggested that such countries potentially could be subject to special information reporting, denial of foreign tax credits, and denial of deductions. In other words, such jurisdictions would become untenable for most legitimate investment.

The balance of the year saw a flurry of activity in response to the OECD list. Some countries that had not taken the OECD's signals seriously began to work with the OECD to resolve differences. Many investors started to re-think their offshore structures. But the surprise was the ability of the listed countries (led apparently by Barbados) to mount an effective campaign against the list. Accusing the OECD of being a "rich man's club" consisting of countries where the revenue coffers are full, several listed countries cast themselves as poor countries in danger of being steamrolled. Indeed, many of the countries on the list are tiny island nations.

The David versus Goliath tactics succeeded to a greater extent than most observers imagined possible. Not only did the listed countries earn a seat at the table to negotiate the tax haven issues, but they also gained a reprieve. The new timetable sets 2005 for the OECD to recommend action in appropriate cases. It remains to be seen whether the listed countries are engaging in dilatory tactics, or whether common ground can be negotiated.

IV. U.S. Developments of International Interest

This is a non-exhaustive summary of some of the developments during 2000.

A. Court Decisions

1. *ASA Investerings Partnership v. Commissioner*[2]

The circuit court affirmed the Tax Court's decision to disallow the taxpayer's deduction of losses that flowed through a partnership because the partnership had not been formed for a valid purpose. The partnership entered into short swing sales of securities that were mutually offsetting, thereby creating both capital losses and gains. The capital losses were allocated to the domestic partner and gains to the foreign partner who was not subject to U.S. tax. The courts found that the transactions amounted to a wash.

2. *Salina Partnership v. Commissioner*[3]

Although the taxpayer ultimately lost the case on a technical securities issue, the case is considered a setback for the Internal Revenue Service (IRS) in their attempt to classify a taxpayer's investment in a partnership engaged in short sales of securities as a sham transaction. The court found the taxpayer's investment in the limited partnership was not motivated by tax avoidance, but rather had economic substance and served a valid business purpose.

3. *Kenco Restaurants, Inc., et al. v. Commissioner*[4]

The taxpayer failed to document how it allocated management and administrative service costs to its affiliates. Although this is a domestic case, the court's reasoning is applicable to Section 482[5] service allocation.

2. ASA Investerings P'ship v. Comm'r, 340 U.S. App. D.C. 55 (2000), *cert. denied*, 121 S. Ct. 171 (2000).
3. Salina P'ship v. Comm'r, 80 T.C.M. (CCH) 686 (2000).
4. Kenco Rest., Inc. v. Comm'r, 206 F.3d 588 (6th Cir. 2000), *cert. denied*, 148 L. Ed. 2d 18 (2000).
5. I.R.C. § 482 (2000).

B. Regulations

1. *Corporate Tax Shelter Temporary Regulations*

The IRS issued temporary regulations in February regarding corporate tax shelters; revisions were issued in August.[6] The regulations address (1) registration by promoters of shelters; (2) promoters' maintenance of records of shelter investors; and (3) disclosure of investments in shelters on users' tax returns.

2. *Withholding Regulations Amended*

The IRS issued amendments[7] to the final regulations regarding the withholding and reporting of payments made to non-U.S. persons. The regulations focus on financial institutions and their role as intermediaries.

3. *Final Regulations Regarding Reduced Treaty Withholding*

The IRS issued final regulations[8] clarifying its position regarding withholding rates under U.S. treaties for U.S. source payments to pass-through entities in the United States or treaty country.

C. Legislation

1. *FSC Repeal*

President Clinton signed the FSC Repeal and Extraterritorial Income Exclusion Act of 2000.[9] The Act was made in response to a World Trade Organization (WTO) ruling that the U.S. FSC structure is, in reality, an export subsidy.

2. *Proposed Tax Shelter Legislation*[10]

Proposed legislation imposes significant penalties upon corporations (20 to 40 percent of any understatement) who enter into tax shelters. The legislation would also exempt opinions from tax advisors who have a compensation agreement with the promoter from being used as a means of establishing reasonable belief. Further, the legislation would increase penalties for those aiding and abetting the shelter and would require more detailed disclosure for transactions where the tax benefit is greater than $5 million.

D. Technical Advice Memoranda, Private Letter Rulings, and Field Service Advice

1. *Non-compete Agreement Payments Are Not Business Profits*

The IRS reasoned in Technical Advice Memorandum 199947031,[11] that payments from a non-compete agreement are not derived from income-producing activities, but rather are

6. Requirements To Maintain List of Investors in Potentially Abusive Tax Shelters, 65 Fed. Reg. 11211 (proposed March 2, 2000) (to be codified at 26 C.F.R. pts. 301 and 602).

7. Modification of Tax Shelter Rules, 65 Fed. Reg. 49,955 (proposed August 16, 2000) (to be codified at 26 C.F.R. pts.1 and 301).

8. Revisions to Regulations Relating to Withholding of Tax on Certain U.S. Source Income Paid to Foreign Persons and Revisions of Information Reporting Regulations, 65 Fed. Reg. 32,152-01 (proposed May 22, 2000) (to be codified at 26 C.F.R. pts. 1 and 31).

9. FSC Repeal and Extraterritorial Income Exclusion Act of 2000, H.R. 4986, 106th Cong. § 2 (2000).

10. I.R.C. § 304 (2000).

11. Tech. Adv. Mem. 199947031 (Aug. 24, 1999).

a property right. Furthermore, the IRS ruled that the income is taxable in the United States to the extent a payment is U.S. source income.

2. *Sale of Controlled Foreign Corporation's Assets Is Foreign Personal Holding Company Income*

In Field Service Advice (FSA) 200046008,[12] the IRS held that gain from the sale of assets by a controlled foreign corporation is subject to foreign personal holding company income taxation.

3. *Valid Business Purpose Required for Tax-Free Exchange*

In FSA 200020035,[13] the IRS stated that a tax-free exchange entered into for estate planning purposes does not qualify under Section 351 of the Internal Revenue Code (the "Code")[14] because it is not a valid business purpose.

4. *Redemption Found Not to Exist*

In Private Letter Ruling 200005023,[15] the IRS found that a foreign corporation's attempt to use disregarded entities to acquire a domestic subsidiary's stock did not qualify for treatment under Section 304 of the Code (redemption through the use of a related corporation).[16]

12. Field Serv. Adv. 200046008 (Aug. 4, 2000).
13. Field Serv. Adv. 200020035 (May 19, 2000).
14. I.R.C. § 351 (2000).
15. Priv. Ltr. Rul. 200005023 (Nov. 9, 1999).
16. I.R.C. § 304 (2000).