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Special Reports



U.S. Taxation of Profits From Internet Software Sales — An Electronic Commerce Case Study

by J. Clifton Fleming, Jr.

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It is now commonplace for software vendors to advertise their products over the Internet and for customers to browse Internet catalogs, place product orders, and provide credit card information via the Internet and then download the desired products to their personal computers.¹ When these transactions occur across international boundaries, uncertainty arises over whether the vendor's

income can be taxed by the source country — that is, by the customer's country of residence — and, if so, how the income is to be classified (as business profits or royalties) for income tax purposes. This paper investigates these issues in the context of a hypothetical fact situation involving an Australian computer software vendor selling to U.S. customers. The analysis,

however, is applicable to software vendors resident in most countries that have bilateral income tax treaties with the United States, and much of the analysis is applicable to Internet sales into the U.S. of any digitizable product by a foreign vendor entitled to treaty benefits.

I. The Facts

Assume that Southern Cross Cyber Products Pty., Ltd., is an Australian limited company (i.e., a corporation) that qualifies for benefits under the Australia-U.S.

¹See U.S. Treasury Dept., *Selected Tax Policy Implications of Global Electronic Commerce* (available on the World Wide Web at <http://www.treas.gov/policy/internet.html>) section 3.2 (1996)[hereinafter *Global Electronic Commerce*]; Australian Tax Office, *Tax and the Internet* (available on the World Wide Web at <http://www.ato.gov.au/ecp/ecp.htm>) sections 3.4.3-3.5.1, 5.7.5 (1997); New Zealand Inland Revenue, *Guidelines to Taxation and the Internet* (available on the World Wide Web at <http://www.ird.govt.nz/resource/discuss/taxaint/taxaint.htm>) 1.6 (1998); Minister's Advisory Committee on Electronic Commerce, *Electronic Commerce and Canada's Tax Administration* (available on the World Wide Web at <http://www.rc.gc.ca/ecommm>) section 1.2.1 (1998).

income tax treaty.² Southern Cross has developed a computer software program called Matilda 1.0 that is a smash hit in Australia and Japan. Southern Cross wishes to market this and related items in the United States through a Web site that will allow interested customers to review detailed information about Matilda 1.0 and a complementary line of Southern Cross software products. The Web site information will be stored in full on a computer server, and U.S. customers will be able to access this information by using the Internet from their own computers. A U.S. purchaser who wishes to acquire a Southern Cross product will provide credit card information to the server. The server will contact the card issuer's server, obtain appropriate authorization, effect the credit charge and then allow the customer to download the purchased software over the Internet to the customer's own computer. Southern Cross will have no other activities or presence in the United States.

II. The Issues

A. Will the U.S. tax the income from these transactions if they are structured as sales, if the Web site is located at leased space on a computer server in Los Angeles, if all modifications to the Web site are made electronically from Australia, and if all required maintenance of the server is furnished by the lessor?

The primary source for answering this question is the Australia-U.S. income tax treaty, which entered into force on October 31, 1983 (the treaty).³ Assuming the transactions are structured as sales⁴ and that the purchase consideration is not contingent on the productivity, use, or further disposition of the software,⁵ Southern Cross's U.S.

profits will be characterized as business profits by the treaty.⁶

Under the treaty, the United States is permitted to tax business profits of an Australian company only to the extent that the income is attributable to business carried on through a permanent establishment of the company in the United States.⁷ Southern Cross's activity of providing product information through the U.S. server and then entering into binding sales contracts with U.S.

²Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect to Taxes on Income, Aug. 6, 1982, U.S.-Aus., art. 16, 1986-2 C.B. 220, 225-26 [hereinafter the treaty]. See also, Sanford H. Goldberg, "United States-Australia Income Tax Convention," 10 *Int'l Tax J.* 407, 426 (1984).

Under U.S. law, congressional legislation that is seemingly inconsistent with a prior treaty does not override the treaty unless Congress intended the override to occur. If an override was not intended, the treaty remains in force and constrains domestic law. See S. Rep. No. 445, 100th Cong. 2d Sess. 370-71, 384-85 (1988); American Law Institute, *International Aspects of United States Income Taxation II: Proposals on United States Income Tax Treaties*, 63-64, 72 (1992). When the Australia-U.S. income tax treaty became effective in 1983, federal income tax legislation was contained in the Internal Revenue Code of 1954. Congress subsequently replaced this statute by enacting the currently effective Internal Revenue Code of 1986. This code is inconsistent with important features of the treaty but it is generally believed that an override was not intended. Thus, the treaty is regarded as having survived the 1986 congressional action and as being currently in force. See reg. section 1.884-1(g)(4)(i); Rev. Rul. 91-58, 1991-2 C.B. 340, 341. See also, Staff of Joint Comm. on Tax'n, 100th Cong., 1st Sess., General Explanation of the Tax Reform Act of 1986, 1038, 1043 (Comm. Print 1987); S. Rep. No. 445, *supra* at 370-77, 381, 384-85 (1988).

³See note 2, *supra*.

⁴That is, the customer acquires ownership of the software and not merely a right to use the software for a period of time. See treaty art. 12(4)(a); Goldberg, *supra* note 2 at 421. Under this standard, most software shrink-wrap licenses are treated as sales for U.S. income tax purposes. See reg. section 1.861-18(h) examples 1, 10-11, 13.

⁵If the purchase consideration were subject to any of these contingencies, it would be treated as royalty income unless it were earned through a U.S. permanent establishment, in which case it would be ordinary business income. See treaty art. 7(6), 12(3), (4)(c); Goldberg, *supra* note 2 at 421-22. For possible planning opportunities created by these rules, see text at notes 86 to 87, *infra*.

⁶See U.S. Treasury Dept. Technical Explanation of the Convention and Protocol Between the Government of the United States of America and the Government of the United Mexican States for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect to Taxes on Income [hereinafter U.S. Treas. Technical Explanation of U.S.-Mexico Treaty], 1994-2 C.B. 489, 496; U.S. Treasury Dept., Technical Explanation of United States Model Income Tax Convention of September 20, 1996 [hereinafter U.S. Treas. Technical Explanation of 1996 Model], Article 7, Paragraphs 7-8, reprinted in 74 *Taxes* 1083, 1094-95 (1996) (for the full text, see 96 *TNI* 186-17 or *Doc* 96-25868 (151 pages)); Sen. Exec. Rep. No. 16, 98th Cong. 1st Sess. (1983), 1986-2 C.B. 229, 230. See also, 3 Joseph Isenbergh, *International Taxation* 57:8-57:9, 60:6-60:7 (3d ed. 1990). Regarding the degree of deference accorded to Treasury Department technical explanations and to treaty explanations contained in U.S. Senate executive documents, see Robert Thornton Smith, "Tax Treaty Interpretation by the Judiciary," 49 *Tax Lawyer* 845, 888-89 (1996).

⁷Treaty art. 7(1). In this respect, the treaty follows the international norm for bilateral income tax treaties. See OECD, Model Tax Convention on Income and Capital [hereinafter OECD model tax convention] art. 7 (1992); 3 Isenbergh, *supra* note 6, at 55:6.

If the treaty permits the United States to tax Southern Cross's profits on sales through the U.S. Web site to U.S. customers, two levels of tax will be collected. First, there will be a tax on the profits imposed by section 11 of the U.S. Internal Revenue Code of 1986 [hereinafter IRC] at graduated rates ranging from 15 to 35 percent. See IRC sections 11, 882(a). Second, a 15 percent branch profits tax will be imposed on the profits remaining after the section 11 tax. See treaty art. 10(6); IRC section 884; U.S. Treas. Department Income Tax Regulations [hereinafter reg.] sections 1.884-1(a), (b)(1), (d)(1)(iii), (f)(1), (g)(4)(i)(B); U.S. Treas. Dept., Technical Explanation of the Convention Between the Government of the United States of America and the Government of Australia for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect to Taxes on Income (May 24, 1983) [hereinafter U.S. Treas. Technical Explanation of Australia-U.S. Treaty], 1986-2 C.B. 246, 251; 3 Isenbergh, *supra* note 6 at 57:28-57:29.

customers through the server is virtually certain to constitute carrying on business in the U.S. for treaty purposes.⁸ Thus, the capacity of the United States to tax Southern Cross's U.S. sales profits will turn on whether the sales are made through a U.S. permanent establishment.

The treaty principally defines a permanent establishment as a "fixed place of business"⁹ and provides a nonexclusive list of examples that includes "a place of management,"¹⁰ "a branch,"¹¹ and "an office."¹² Southern Cross's only U.S. presence is leased space on a machine in Los Angeles that makes information available to customers and that accepts orders, concludes contracts, and delivers products. Unless this electronic presence constitutes a sufficient analog to a fixed place of business, a place of management, a branch, or an office, the U.S. Internal Revenue Service cannot tax Southern Cross's profits from sales to U.S. customers.

In Rev. Rul. 56-165,¹³ the IRS addressed the case of an individual Swiss resident who was a sole trader engaged in manufacturing logging equipment in Switzerland. The Switzerland-U.S. income tax treaty was indistinguishable on the point under consideration from the current Australia-U.S. income tax treaty.¹⁴ The Swiss sole trader came to the United States with equipment, and for two years traveled continuously through forests in the United States demonstrating the equipment and concluding binding sales contracts. Swiss employees accompanied the sole trader as assistants. The business was conducted in a purely itinerant fashion — there was no warehouse or other fixed base.

Nevertheless, Rev. Rul. 56-165 makes the peremptory declaration that the Swiss sole trader's demonstrating and contracting activity over a two-year period amounted to being "engaged in trade or business in the United States through a permanent

establishment situated therein,"¹⁵ even though the Swiss sole trader lacked a U.S. fixed place of business in the conventional sense.

If the IRS takes the same position under the Australia-U.S. treaty, it seems certain that the IRS will insist on characterizing the information-providing and order-concluding activity of Southern Cross's U.S. Web site as a U.S. permanent establishment regardless of whether the Web site is a fixed place of business in the conventional sense. Fortunately, there are several reasons for

The capacity of the United States to tax a corporation's U.S. sales profits will turn on whether the sales are made through a U.S. permanent establishment.

believing that the IRS will not be so aggressive. First, the United States has never applied Rev. Rul. 56-165 in any published document to anyone other than the Swiss sole trader who was the ruling's object. Furthermore, if the IRS asserted that extensive advertising and order-concluding activity invariably constituted a permanent establishment even though no conventional fixed place of business existed in the United States, the result would be to virtually negate the requirement in all of the approximately 50 U.S. bilateral income tax treaties that a permanent establishment gener-

ally requires a fixed place of business.¹⁶ This would be a brazen

⁸Because the treaty does not contain a definition of carrying on business, the U.S. Internal Revenue Service will be permitted to rely on principles of U.S. income tax law in determining whether Southern Cross's activity through the U.S. server amounts to carrying on business in the United States. Treaty art. 3(2); 3 Isenbergh, *supra* note 6, at 57:7. In U.S. income tax law, the concept of engaging in, conducting, or carrying on a trade or business is the equivalent of the treaty's concept of carrying on business. It is clear that ongoing order solicitation and contract-making activity through a U.S. sales office amounts to conducting a trade or business in the United States, as does the same activity carried on in the United States by a traveling salesperson without a fixed office. Reg. section 1.864-4(b) example 1; Rev. Rul. 62-31, 1962-1 C.B. 367; Rev. Rul. 56-165, 1956-1 C.B. 849, 850. This strongly suggests that using a U.S. computer server to regularly solicit orders and enter into sales contracts with U.S. customers amounts to carrying on a trade or business in the United States. See also Boris I. Bittker and Lawrence Lokken, 3 *Federal Taxation of Income, Estates and Gifts* 66-39, 66-60 (2d ed. 1991); 1 Isenbergh, *supra* note 6, at 20:20, 20:29-20:30.

⁹Treaty art. 5(1).

¹⁰Treaty art. 5(2)(a).

¹¹Treaty art. 5(2)(b).

¹²Treaty art. 5(2)(c).

¹³1956-1 C.B. 849.

¹⁴Compare Treaty art. 5(1)-(2) with Convention for Avoidance of Double Taxation, May 24, 1951, U.S.-Switzerland [hereinafter U.S.-Switzerland treaty] art. II(1)(c), 1955-2 C.B. 815.

¹⁵1956-1 C.B. at 850 (quoting art. III(1)(a) of the U.S.-Switzerland treaty).

¹⁶See U.S. Treas. Technical Explanation of 1996 Model, *supra* note 6, Article 5, reprinted in 74 *Taxes* at 1090-92. Indeed, in Priv. Ltr. Rul. 8526005 (March 8, 1985), 1985 PRL Lexis 3963, the IRS cited Rev. Rul. 56-165 for the proposition that itinerant service activities involving substantial equipment will constitute a permanent establishment if they occur over a greater than 12-month period within a limited geographical area. Thus, it is possible that the equipment-demonstrating and selling activities in Rev. Rul. 56-165 took place within a limited geographical area and that this fact was omitted from Rev. Rul. 56-165. If so, Rev. Rul. 56-165 is not an assertion that advertising and sales activity alone can amount to a permanent establishment.

move that should not be lightly attributed to the IRS.

Indeed, it is quite likely that Rev. Rul. 56-165 was not intended to signal general disregard of the permanent establishment concept by the IRS but, instead, had a considerably more limited purpose. To be specific, the applicable Switzerland-U.S. income tax treaty contained the following provision, which is identical in substance to article 5(4)(a) of the current Australia-U.S. treaty:

The term "permanent establishment" . . . does not include . . . an agency unless the agent has and habitually exercises a general authority to negotiate and conclude contracts on behalf of an enterprise or has a stock of merchandise from which he regularly fills orders on its behalf. An enterprise . . . shall not be deemed to have a permanent establishment in the other State merely because it carries on business dealings in such other State through . . . [an] independent agent acting in the ordinary course of his business as such.¹⁷

If the Swiss sole trader in Rev. Rul. 56-165 had sent an employee to the United States to carry out the sole trader's activities (demonstrating equipment and making binding sales contracts), the employee would have constituted a permanent establishment under this treaty provision because the employee would have been a dependent agent who habitually exercised a general authority to negotiate and conclude contracts on behalf of the Swiss sole trader.¹⁸ This would be the case even though the employee was a traveler with no fixed place of business. The Swiss trader avoided this result by coming to the United States himself and entering into contracts himself. Since the IRS has apparently never applied Rev. Rul. 56-165 to anyone other than the unlucky

Swiss resident who was its target, it is highly probable that the ruling has the limited purpose of blocking sole traders who would otherwise avoid the above-quoted treaty provision by conducting their U.S. contract-making activities in person instead of through an employee. Although this is an unauthorized extension of the treaty language, it stops far short of broadly asserting that the demonstration of goods and conclusion of contracts is invariably sufficient to constitute a permanent establishment even if no fixed place of business or

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contract-making employee is involved. In sum, it seems unlikely that Revenue Ruling 56-165 is applicable to the issue of whether an Australian limited company's leased space on a U.S. server will be considered a permanent establishment by the Internal Revenue Service. The answer to that question requires additional analysis.

One approach is to investigate the U.S. understanding of the purpose underlying the permanent establishment requirement. The legislative report prepared in connection with the U.S. Senate's consideration of the treaty indi-

cates that the permanent establishment requirement is intended to ensure that neither the United States nor Australia applies a source-country income tax to the ordinary business income of a resident of the other country unless that resident has a physical presence in the source country that is greater than mere business activity.¹⁹ The pertinent portion of the report states:

The taxation of business profits under the proposed treaty differs from United States rules for taxing business profits primarily by requiring more than merely being engaged in trade or business before a country can tax business profits and by substituting the "attributable to" standard for the Code's "effectively connected" standard. Under the Internal Revenue Code, all that is necessary for effectively connected business profits to be taxed is that a trade or business be carried on in the United States. Under the proposed treaty, on the other hand, some level of fixed place of business must be present and the business profits must be attributable to that fixed place of business.²⁰

¹⁷U.S.-Switzerland treaty, art. II(1)(c), 1955-2 CB at 815.

¹⁸It seems reasonably clear that the IRS will always regard employees of the taxpayer as dependent agents. See reg. section 1.864-7(e); U.S. Treas. Technical Explanation of 1996 Model, *supra* note 6, Article 5, Paragraph 6, reprinted in 74 *Taxes* at 1092; 3 Isenbergh, *supra* note 6, at 57:18-57:19.

¹⁹This is consistent with the international consensus regarding the permanent establishment concept. See OECD Model Tax Convention, *supra* note 7, Commentary on Article 5 at paragraphs 2-5; 3 Isenbergh, *supra* note 6, at 57:10-57:11.

²⁰S. Exec. Rep. No. 16, 98th Cong., *supra* note 6, at 236. See also, U.S. Treasury Dept., *Selected Tax Policy Implications of Global Electronic Commerce*, *supra* note 1, section 7.2.2 (1996).

Thus, Southern Cross's space on the U.S. server will not be regarded as a permanent establishment unless the space and connected activities are sufficient to distinguish Southern Cross from an Australian who is carrying on mere business activity in the United States, such as soliciting orders through a traveling independent agent.²¹ Unfortunately, there is nothing obvious about Web sites or computer servers that furnishes a ready resolution of this issue. Consequently, close scrutiny of other relevant portions of the treaty will be necessary. A useful approach is to begin by examining two treaty provisions that initially seem to furnish straightforward answers to Southern Cross's question.

First, the preceding discussion has noted that the Australia-U.S. treaty, like the Switzerland-U.S. treaty, provides that carrying on business in the U.S. through an employee empowered to make binding contracts amounts to doing business through a permanent establishment even if the Australian taxpayer has no U.S. office or other fixed place of business. The specific treaty language reads:

an enterprise of one of the Contracting States shall be deemed to have a permanent establishment in the other Contracting State if:

(a) it carries on business in that other State through a person, other than an agent of independent status . . . , who has authority to conclude contracts on behalf of that enterprise and habitually exercises that authority in that other State. . . .²²

Because Southern Cross's U.S. Web site will have authority to conclude contracts in Southern Cross's name and will (hopefully) habitually exercise that authority in the United States, it is useful to ask whether this Web site will be considered a U.S. permanent

establishment on the ground that it is a dependent agent regularly making contracts for its principal. The answer to this question is clearly negative, because the preceding quotation does not treat an agent as a permanent establishment unless the agent is a person. Article 3(1)(a) of the treaty limits persons to individuals, decedents' estates, trusts, partnerships, companies, and "any other body of persons."²³ Since space on a computer server is clearly not included in this list, the contract-

The portion of the treaty that treats certain dependent agents as permanent establishments turns out to be unhelpful in determining whether Southern Cross's leased space on a U.S. server qualifies as a U.S. permanent establishment.

making activity of Southern Cross's Web site cannot cause the Web site to be treated as the kind of agent that constitutes a permanent establishment.²⁴

But this does not end the concern over contract-making agents. The lessor of Southern Cross's U.S. computer server space is most likely a U.S. corporation — an entity that is included in the treaty's definition of "person." Thus, if the lessor is regarded as a contract-making agent of Southern Cross, then Southern Cross will be selling products through a U.S. permanent estab-

lishment. There seems little danger, however, of the IRS successfully invoking this approach, because the lessor of the server space only provides space, it does not enter into contracts on behalf of Southern Cross.²⁵ Furthermore, the treaty treats a contract-making agent as a permanent establishment only if the agent is a dependent agent. An agent is regarded as independent, not dependent, for this purpose if the agent is "a broker, general commission agent, or any other agent of independent status, where such broker or agent is acting in the ordinary course of his business as a broker, general commission agent or other agent of independent status."²⁶ A typical

²¹See Charles H. Gustafson, Robert J. Peroni, and Richard Crawford Pugh, *Taxation of International Transactions* 143 (1997). See also note 8, *supra*.

²²Treaty art. 5(4) (emphasis added).

²³Treaty art. 3(1)(a).

²⁴See Jean-Luc Pierre and Frederick Subra, "The Internet and French Direct Taxes," *24 Tax Planning Int'l Rev.* 3 (Nov. 1997), which reaches the same conclusion with respect to the similar provision in the current U.S.-France income tax treaty. See also David L. Forst, "The Continuing Vitality of Source-Based Taxation in the Electronic Age," *Tax Notes Int'l*, Nov. 3, 1997, pp. 1455, 1470, or *97 TNI 212-17*, or *Doc 97-29889* (31 pages).

The treaty also provides that an Australian company is deemed to have a U.S. permanent establishment if "it maintains substantial equipment for rental or other purposes within [the U.S.] (excluding equipment let under a hire-purchase agreement) for a period of more than 12 months." Treaty art. 5(4)(b). Neither the treaty nor the U.S. explanatory documents elucidate this language. See Goldberg, *supra* note 2 at 413. It seems unlikely, however, that the U.S. Internal Revenue Service would assert that maintaining leased space on a single U.S. computer server amounts to maintaining substantial equipment in the United States for purposes of this treaty provision.

²⁵See Deloitte & Touche LLP, "Deloitte & Touche Offers Comments on Tax Policy Implications of Global Electronic Commerce," *Tax Notes Int'l*, Nov. 3, 1997, pp. 1483, 1493-94, or *97 TNI 212-23*, or *Doc 97-29888* (21 pages).

²⁶Treaty art. 5(5).

lessor of computer server space would be dealing with numerous unrelated lessees on an arm's-length commercial basis and would easily be classified as an independent agent under this definition.²⁷ For these reasons, the lessor of space on the computer server would not be a contract-making dependent agent of Southern Cross who gives rise to a U.S. permanent establishment. In sum, the portion of the treaty that treats certain dependent agents as permanent establishments turns out to be unhelpful in determining whether Southern Cross's leased space on a U.S. server qualifies as a U.S. permanent establishment.

A second treaty provision that initially seems to furnish a straightforward, and favorable, answer for Southern Cross with respect to the permanent establishment issue is article 5(3). This provision states that a fixed facility is not a permanent establishment if it is used only for

(a) the . . . storage, display or delivery of goods or merchandise belonging to the enterprise;

(b) the maintenance of a stock of goods or merchandise belonging to the enterprise for the purpose of storage, display or delivery; . . .

(e) . . . activities which have a preparatory or auxiliary character, such as advertising . . . , for the enterprise. . . .²⁸

This language looks promising for Southern Cross at the outset because Southern Cross's U.S. presence consists entirely of leased space on a computer that makes a product catalogue available to U.S. customers, that processes and concludes sales contracts with those customers, and that makes direct delivery of products to the U.S. buyers. However, this language fails to be helpful because it does not apply to a place of business through which binding sales contracts are

concluded.²⁹ This is precisely what Southern Cross's U.S. server does — conclude binding sales contracts, much like a vending machine.

The vending machine analogy is ominous because of the commentary to article 5 of the 1992 OECD model income tax treaty, which is identical in substance to the Australia-U.S. income tax treaty on the point of present discussion. The commentary states:

[A] permanent establishment may nevertheless exist if the

The U.S. might regard Southern Cross's U.S. server as indistinguishable from a vending machine located in the U.S. and, therefore, as constituting a permanent establishment.

business of the enterprise is carried on mainly through automatic equipment, the activities of the personnel being restricted to setting up, operating, controlling and maintaining such equipment. Whether or not gaming and vending machines and the like set up by an enterprise of a State in the other State constitute a permanent establishment thus depends on whether or not the enterprise carries on a business activity besides the initial setting up of the machines. A permanent

establishment does not exist if the enterprise merely sets up the machines and then leases the machines to other enterprises. A permanent establishment may exist, however, if the enterprise that sets up the machines also operates and maintains them for its own account. This also applies if the machines are operated and maintained by an agent dependent on the enterprise.³⁰

Although this commentary does not expressly deal with either a vending machine serviced by an independent agent or a vending machine with which the customer has no physical contact, those cannot be distinguished with confidence from the scenarios expressly covered in the last two

²⁷Mark M. Levey, Thomas A. O'Donnell, and J. Pat Powers, "Cyberspace Transactions Present Interesting International, State and Local Tax Issues," 49 *Tax Executive* 476, 480 (1997); *Global Electronic Commerce*, *supra* note 1, section 7.2.5. See generally, *Taisei Fire and Marine Insurance Co. v. Commissioner*, 104 T.C. 535 (1995) (for the full text, see 95 *TNI* 86-8 or *Doc 95-4474* (38 pages)), *acq.*, 1995-2 C.B. 1 (for the full text, see 95 *TNI* 205-12 or *Doc 95-9620* (2 pages)); U.S. Treas. Technical Explanation of 1996 Model, *supra* note 6, Article 5, Paragraph 6, reprinted in 74 *Taxes* at 1092. See also ABA Tax Section, Committee on U.S. Activities of Foreigners and Tax Treaties, Comments Concerning the Technical Explanation to the 1996 Model Tax Treaty 12 (1998).

²⁸Treaty art. 5(3)(a)-(b), (e).

²⁹J. Isenbergh, *supra* note 6, at 57:14-57:16; OECD Model Tax Convention, *supra* note 7, Commentary on Article 5 at paragraph 30.

³⁰OECD Model Tax Convention, *supra* note 7, Commentary on article 5 at paragraph 10. See also paragraph 4 of the commentary on article 5, which states that [a] place of business may . . .

exist where no premises are available or required for carrying on the business of the enterprise and it simply has a certain amount of space at its disposal. It is immaterial whether the premises, facilities or installations are owned or rented. . . .

sentences of this quotation. It seems prudent to assume, for transactional planning purposes, that the drafters of the OECD model treaty would regard Southern Cross's U.S. server as a permanent establishment. Furthermore, the U.S. Treasury has indicated in its 1996 study of the income taxation of global electronic commerce that it might take the same view. Specifically, the study states that "computer equipment owned or used by a foreign person engaged in electronic commerce raises a question as to whether this equipment could constitute a fixed place of business of the foreign person in the United States, taking into account that there would not necessarily be any employees present."³¹ Moreover, this statement is referenced to the following footnote: "See e.g. OECD Model Tax Convention, . . . Commentary to Article 5, at paragraph 10 (circumstances under which a vending machine could constitute a permanent establishment)."³² In addition, the definition of permanent establishment in the 1996 U.S. model income tax convention is virtually identical to the treaty's definition, and the official commentary on the U.S. model treaty states that its definition "follows closely . . . the OECD Model."³³

Obviously, there is a danger that when the U.S. ultimately develops its position on this issue, it might regard Southern Cross's U.S. server as indistinguishable from a vending machine located in the U.S. and, therefore, as constituting a permanent establishment. If the U.S. Internal Revenue Service successfully asserts this position, then the U.S. income tax will apply to Southern Cross's profits on sales to U.S. customers through the U.S. server so long as the U.S. tax does not exceed the limitation imposed by the treaty — that is, so long as the U.S. Internal Revenue Service limits itself to taxing sales profits attributable to the U.S. server.

The U.S. generally taxes business profits of a nonresident corporation only to the extent that the profits are both (1) U.S.-source income and (2) effectively connected with a trade or business carried on by the nonresident within the United States.³⁴ With respect to source, the applicable U.S. rule provides that income from a nonresident's sales of inventory personal property (including computer software) is U.S. source to the extent that it is

The proper resolution of the permanent establishment issue is uncertain because relevant authority is scant.

attributable to an office or other fixed place of business maintained by the nonresident in the United States.³⁵ If Southern Cross's leased space on the U.S. server is a permanent establishment for treaty purposes, it will also be an office or other fixed place of business for purposes of this U.S. sourcing rule.³⁶

Nevertheless, Southern Cross's sales profits will be U.S.-source income under this rule only to the extent they are attributable to the U.S. office or other fixed place of business — that is, only to the extent they are attributable to the Web site on the U.S. server. This raises the same issue presented

by the treaty's rule that Southern Cross's U.S. sales income cannot be taxed except to the extent that it is attributable to a U.S. permanent establishment.³⁷ The proper resolution of this attribution issue is uncertain because relevant authority is scant. It is possible that the treaty will be regarded as lacking a definitive income attribution rule³⁸ so that the U.S.

³¹Global Electronic Commerce, *supra* note 1, section 7.2.4 (emphasis added). See also, Minister's Advisory Committee on Electronic Commerce, *Electronic Commerce and Canada's Tax Administration*, section 4.2.2.4 (1998).

³²Global Electronic Commerce, *supra* note 1 at n.57.

³³U.S. Treas. Technical Explanation of 1996 Model, *supra* note 6, article 5, reprinted in 74 *Taxes* at 1091.

³⁴IRC sections 864(c)(4), 882(a). A limited exception in section 864(c)(4)(B) allows taxation of foreign-source income that is attributable to a U.S. office or other fixed place of business.

³⁵IRC section 865(e)(2)(A). This rule contains a limited exception with respect to sales of inventory for use, disposition, or consumption outside the United States if the seller's fixed place of business outside the United States materially participated in the sale. IRC section 865(e)(2)(B).

³⁶IRC section 865(e)(3); reg. section 1.864-7(b)(1); 1 Isenbergh, *supra* note 6, at 21:26; American Law Institute, *International Aspects of United States Income Taxation: Proposals on United States Taxation of Foreign Persons and of the Foreign Income of United States Persons* 91 (1987).

³⁷Treaty art. 7(1).

³⁸The U.S. model treaty provides that "the business profits to be attributed to the permanent establishment shall include only the profits derived from the assets or activities of the permanent establishment." United States Model Income Tax Convention of September 20, 1996 art. 7.2, reprinted in 74 *Taxes* 1071, 1074 (1996). There is no comparable provision in the treaty. See also, Goldberg, *supra* note 2 at 416. The absence of such a provision in the treaty may support the view that the treaty lacks an adequately detailed income attribution rule. Indeed, the U.S. Treasury Department's explanation of the treaty can be interpreted as adopting the U.S. domestic rule. See U.S. Treas. Technical Explanation of Australia-U.S. Treaty, *supra* note 7, at 249.

domestic rule, which generally takes a formulaic approach,³⁹ will be applied to fill the vacuum.⁴⁰ Alternatively, the following treaty provisions, which seem to rely on an arm's-length approach, might be considered to provide sufficient guidance for attributing income to a permanent establishment:

(2) Subject to the provisions of paragraph (3), where an enterprise of one of the Contracting States carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the business profits which it might be expected to make if it were a distinct and independent enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment or with other enterprises with which it deals.

(3) In the determination of the business profits of a permanent establishment, there shall be allowed as deductions expenses which are reasonably connected with the profits (including executive and general administrative expenses) and which would be deductible if the permanent establishment were an independent entity which paid those expenses, whether incurred in the Contracting State in which the permanent establishment is situated or elsewhere.⁴¹

Fortunately, a detailed description of the possible mind-numbing differences between the U.S. domestic attribution rule and the preceding treaty provisions is not necessary for this article.⁴² Instead, it is sufficient to note that if the United States decides to treat the U.S. Web site as a

permanent establishment, then regardless of whether U.S. domestic law or a treaty rule controls the income attribution question, the United States will tax the lesser of (1) the amount of sales income attributable to the U.S. Web site under U.S. domestic law or (2) the amount attributable under the treaty rule. To be specific, U.S. income tax law will levy a tax on the amount attributable to the U.S. Web site at graduated rates ranging from 15 to 35 percent⁴³ and the treaty will most likely permit the levy.⁴⁴ In addition, the U.S. will apply a 15 percent branch profits tax to the portion of this attributable amount that remains after imposition of the graduated rate tax.⁴⁵ The treaty will probably permit this additional tax.⁴⁶

Of course, Southern Cross is not without hope of forestalling the preceding results in litigation with the IRS by successfully distinguishing its leased space on the U.S. server from a U.S. vending machine or a U.S. sales office.⁴⁷ Nevertheless, it seems

³⁹The domestic rule generally makes a 50/50 allocation of sales income and expenses between a U.S. permanent establishment and foreign manufacturing operations. See IRC sections 865 (e)(2), (3); reg. sections 1.863-3(b)(1), (d), 1.861-8(f)(3)(ii).

⁴⁰Treaty art 3(2); Rev. Rul. 89-115, 1989-2 C.B. 130.

⁴¹Treaty art. 7(2)-(3). In *North West Life Assurance Co. of Canada v. Commissioner*, 107 T.C. 363 (1996), the U.S. Tax Court may have held that similar language in the U.S.-Canada treaty was sufficient to establish a treaty attribution rule that trumps any domestic rule. Curiously, however, the Tax Court may have also held that this treaty rule requires an analysis of the permanent establishment's accounting records instead of the arm's-length analysis suggested by the quotation in the text above. See *id.* at 381, 383, 389, 392, 394-95, 398-99. (For the full text of *North West Life*, see 96 *TNI* 242-23 or *Doc* 96-32148 (71 pages).)

⁴²For a useful explanation, see Charles I. Kingson, *International Taxation* 299-302 (1998). See also ABA Tax Section, *supra* note 27, at 17-18.

⁴³IRC sections 11, 882.

⁴⁴That is, if the IRS insists that the U.S. Web site is a permanent establishment, U.S. courts will probably agree and hold that the graduated rate of tax is permitted by treaty art. 7(1).

⁴⁵IRC sections 884(a), (b), (d).

⁴⁶See note 7, *supra*. The treaty apparently allows the branch profits tax to apply only to the profits of a permanent establishment. See U.S. Treas. Technical Explanation of Australia-U.S. Treaty, *supra* note 7, 1986-2 C.B. at 251. See also U.S. Treas. Technical Explanation of 1996 Model, *supra* note 6, article 10, paragraph 8, reprinted in 74 *Taxes* at 1100; 3 Isenbergh, *supra* note 6, at 57:28-57:29; Goldberg, *supra* note 2 at 419-20. Thus, application of the branch profits tax is probably dependent on whether the Web site is a permanent establishment.

⁴⁷Southern Cross would argue that the intangible nature of its Web site and the ease with which it can be moved to another server distinguish the Web site from a vending machine or a sales office. See Levey, *et al.*, *supra* note 27, at 480; Pierre and Subra, *supra* note 24, at 4, both asserting that these characteristics deprive the Web site of the permanency required for a permanent establishment. Note, however, the following from the OECD model treaty commentary: "this does not mean that the equipment constituting the place of business has to be actually fixed to the soil on which it stands. It is enough that the equipment remains on a particular site." OECD Model Tax Convention, *supra* note 7, commentary on article 5 at paragraph 5. This suggests that a movable business site can be a permanent establishment if it is not moved in fact. See also Priv. Ltr. Rul. 8526005, *supra* note 16, in which the IRS held that a floating drilling platform constituted a permanent establishment under the general fixed-place-of-business concept when the platform was used to drill 17 oil wells over a 26-month period in a particular portion of the Gulf of Mexico.

Southern Cross would also argue that the Web site is further distinguished from a vending machine by the fact that U.S. customers never physically interact with it and employees or other agents of Southern Cross never enter the United States to fill it with goods and remove money. Indeed, Pierre and Subra, *supra*, suggest that a Web site analogous to Southern Cross's could not be a permanent establishment under the U.S.-France income tax treaty, which is identical in substance to the portions of the Australia-U.S. treaty under discussion, because the computer server on which the Web site is located would be maintained by employees of the lessor instead of Southern Cross employees. But see the text at notes 29-32, *supra* and Forst, *supra* note 24, at 1469-70.

prudent to look for ways to structure Southern Cross's activities so that the danger of losing on this point is made irrelevant.⁴⁸

One way to do so is to move the contract-making software from the U.S. Web site to a server in Australia or replace the contract-making software with an individual in Australia to whom the U.S. Web site forwards orders for acceptance on behalf of Southern Cross. This approach would leave the U.S. Web site with no functions other than display of goods through an electronic catalog and delivery of goods once a purchase contract is concluded in Australia. A facility whose activities are limited to these is expressly declared not to be a permanent establishment by article 5(3) of the treaty.⁴⁹ However, the use of an Australian employee would deprive Southern Cross of the efficiency of having the contract-making function handled by its software, and moving that software to Australia while leaving the rest of the relevant software on the U.S. server seems inconvenient. This approach should not be adopted unless no better alternative can be found.

A different approach suggested by a distinguished commentator is that a business in Southern Cross's position should periodically move its Web site from one U.S. server to another so that the fixed-place-of-business requirement in the permanent establishment definition is not satisfied.⁵⁰ But even if this strategy achieves the desired legal result,⁵¹ it carries the inherent danger of a damaging loss of data during one of the moves.

Yet another alternative is for Southern Cross to operate through a single, fixed U.S. server and point out that even if the server is a permanent establishment, article 7 of the treaty only allows the United States to tax income *attributable* to the U.S. permanent establishment.⁵² Southern Cross would then argue that because the software was

developed and produced in Australia and is supported from Australia, and because the contents of the Web site were created in Australia, the portion of the sales income attributable to the U.S. server is very small.⁵³

The simplest solution, however, would be to locate the Web site on a server in Australia; the next part of this article investigates this approach.

A distinguished commentator has suggested that a business in Southern Cross's position should periodically move its Web site from one U.S. server to another so that the fixed-place-of-business requirement is not satisfied.

B. Will the United States tax income from these transactions if they are structured as sales and if the computer server is located in Australia?

In this scenario Southern Cross's only U.S. activity consists of transmitting advertising information from outside the United States via the Internet and print media to dispersed U.S. residents and delivering goods to U.S. customers over the Internet. Thus, Southern Cross clearly lacks a U.S. permanent establishment because it has neither a U.S. fixed place of business nor a contracting agent in the United States.⁵⁴ Moreover, Southern Cross's activi-

ties do not even amount to carrying on a trade or business in the United States.⁵⁵ This means that the United States would not tax Southern Cross's U.S. sales

⁴⁸See Jeffrey Owens, "The Tax Man Cometh to Cyberspace," *Tax Notes Int'l*, June 2, 1997, pp. 1833, 1847, or 97 *TNI* 105-26, or *Doc 97-15527* (30 pages); Peter A. Glicklich, Stanford H. Goldberg, and Howard J. Levine, "Internet Sales Pose International Tax Challenges," 84 *J. Tax'n* 325, 326 (1996).

⁴⁹See Owens, *supra* note 48 at 1846-47; Glicklich, Goldberg, and Levine, *supra* note 48 at 326. See also Australian Tax Office, *Tax and the Internet*, *supra* note 1, sections 7.2.15 to 7.2.17, 7.5.4; *Global Electronic Commerce*, *supra* note 1, section 7.2.4.

⁵⁰Owens, *supra* note 48 at 1847. See also, Australian Tax Office, *Tax and the Internet*, *supra* note 1, section 3.4.2.

⁵¹This strategy should be successful because it would prevent the various servers from having the permanent quality required by the permanent establishment concept. See S. Exec. Rep. No. 16, *supra* note 6, at 236; U.S. Treas. Technical Explanation of 1996 Model, *supra* note 6, article 5, reprinted in 74 *Taxes* at 1091; OECD Model Tax Convention, *supra* note 6, commentary on article 5 at paragraphs 5-6.

⁵²Treaty art. 7(1)-(3).

⁵³The treaty provides that an arm's-length standard is to be used in attributing profits to a permanent establishment, and that appropriate expenses are deductible in computing those profits. Treaty art. 7(2)-(3). Otherwise, the treaty is silent on how the profit attribution is to be made. The U.S. Internal Revenue Service will presumably fill this void by looking to U.S. domestic rules. Treaty art. 3(2); Rev. Rul. 89-115, 1989-2 C.B. 130. In this regard, see reg. sections 1.863-3(b)(3), (d), which prescribe an allocation procedure, based on the taxpayer's books of account. *But see* the text at notes 40-41, *supra*.

⁵⁴Treaty art. 5. See also Joseph L. Andrus, "Determining the Source of Income in a Changing World," 75 *Taxes* 839, 848 (1997); Forst, *supra* note 24, at 1468; *Global Electronic Commerce*, *supra* note 1, section 7.2.4.

⁵⁵See Treas. reg. section 1.864-4(b) example (3); *Piedras Negras Broadcasting Co. v. Commissioner*, 43 BTA 297, 304, 311-12 (1941), *aff'd on alternate ground*, 127 F.2d 260 (5th Cir. 1942); *Global Electronic Commerce*, *supra* note 1, sections 7.2.1.1, 7.2.3.1

profits even in the absence of the treaty's permanent establishment requirement.⁵⁶

The expedient of locating the server in Australia suggests an examination of the mirror server scenario. Suppose that Southern Cross maintains servers in both Brisbane and Los Angeles that contain identical software and perform identical functions. Customers who seek out the Southern Cross Web site are channeled to either the Brisbane or Los Angeles server, depending on Internet traffic patterns, but they are unaware of, and indifferent to, which of the servers they are dealing with. The preceding analysis suggests that the U.S. would likely assert taxing jurisdiction over profits on transactions through the Los Angeles server but not profits on transactions through the Brisbane server. This raises the practical question of whether the IRS will be able to determine which transactions occurred through which server. It might be possible to require vendors like Southern Cross to maintain records that answer this question. If so, the IRS must consider whether it is feasible to determine whether the vendor has in fact complied with the recordkeeping requirement. For example, how readily could the IRS ascertain that a Web site on a U.S. server was keeping a tax record of only one-third of the transactions made though it?⁵⁷ Furthermore, the fact that the property being sold is software downloaded from the Internet by the customer means that the Internal Revenue Service would not be alerted to taxable transactions by the entry of goods through a U.S. port. In addition, a vendor like Southern Cross would deal with a relatively large number of U.S. customers in relatively small transactions. Thus, it would be impractical to enforce a regime under which U.S. customers were required to withhold tax and remit it to the Internal Revenue Service. Finally,

credit-card-issuing banks would use their political power to strenuously resist being required to determine which of their multitude of transactions involved taxpayers like Southern Cross and then to withhold tax on those transactions.⁵⁸

These considerations may cause the United States to give up source taxation of income in the mirror server situation. If so, are the practical difficulties of enforcing the tax likely to be any less when Southern Cross employs only a single server located in the

Credit-card-issuing banks would use their political power to strenuously resist being required to determine which of their multitude of transactions involved taxpayers like Southern Cross and then to withhold tax on those transactions.

United States, and should the United States bother with trying to collect the tax, given the ease of shifting to a foreign server?⁵⁹ Perhaps developments over the next several years will result in the United States forgoing efforts to tax profits from Southern Cross's U.S. sales even if the server is located in the United States.⁶⁰ The United States might not do so, however, until experience has first demonstrated the practical futility of trying to collect the tax, and perhaps not until the United States has nego-

tiated amendments to its bilateral tax treaties that provide a reciprocal tax exemption for U.S. vendors. Thus, this development in U.S. tax policy might not occur in the near future⁶¹ and Southern Cross should be prepared to resolve its near-term U.S. tax issues under the worst-case assumption that a U.S. server through which sales are made in the United States will be a U.S. permanent establishment.

⁵⁶IRC section 864(c)(1)(B); *Global Electronic Commerce*, *supra* note 1, sections 7.2.1, 7.2.4.

⁵⁷*See generally*, Australian Tax Office, *Tax and the Internet*, *supra* note 1, sections 8.5.1 to 8.5.3, 8.6.1 to 8.6.3 (1997); *Global Electronic Commerce*, *supra* note 1, sections 8.5 to 8.6.

⁵⁸*See generally*, Australian Tax Office, *Tax and the Internet*, *supra* note 1, recommendation 19.

⁵⁹*See generally* Australian Tax Office, *Tax and the Internet*, *supra* note 1, sections 3.4.2, 7.2.15-17, 7.5.4, 7.6.9.

⁶⁰*See* ABA Tax Section, *supra* note 27, at 14-15; Deloitte and Touche, *supra* note 25, at 1493; *Global Electronic Commerce*, *supra* note 1, sections 7.1.5, 7.2.3.1. For a general discussion of practical problems encountered in taxing income from Internet transactions, see Jeffrey Owens, "Emerging Issues in Tax Reform: The Perspective of an International Bureaucrat," *Tax Notes Int'l*, Dec. 22, 1997, pp. 2035, 2062-63, or 97 *TNI* 245-23, or *Doc* 97-34107 (59 pages).

⁶¹For an example of the slowness with which the United States can act to abandon a provision of domestic law that imposes an unenforceable tax on the income of foreign residents, see the story of the U.S. Congress's decision to adopt the international norm of providing a withholding tax exemption for interest on portfolio debt instruments issued by U.S. borrowers to foreign residents, in 1 Isenbergh, *supra* note 6, at 18:4-18:5; Staff of Joint Comm. on Tax'n, 98th Cong., 2d Sess., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, 388-96 (Comm. Print 1984). With respect to practical obstacles to abandoning source-based taxation of income from Internet transactions, see Andrus, *supra* note 54, at 845, 848-849; Forst, *supra* note 24, at 1472.

C. Will the United States tax income from these transactions if they are structured to produce royalty income?

If the transactions between Southern Cross and its U.S. customers were structured to produce royalty income, Southern Cross's receipts from the U.S. customers might be treated very differently by the IRS than if the transactions were structured as sales of goods. Then again, they might not. To be specific, the treaty provides that profits earned by an Australian limited company (that is, by an Australian corporation) on *noncontingent sales of computer software through a U.S. permanent establishment* may be taxed by the United States as ordinary business profits — that is, on a net basis at rates ranging from 15 to 35 percent.⁶² In contrast, the treaty specifies that *royalties unrelated to a permanent establishment* “may be taxed in the Contracting State in which they have their source, and according to the law of that State, but the tax so charged shall not exceed 10 percent of the gross amount of the royalties.”⁶³ Nevertheless, the treaty further provides that if “the property or rights giving rise to the royalties are effectively connected with . . . [a] permanent establishment” maintained in the United States by the Australian recipient, the royalties are taxable by the United States as ordinary business profits.⁶⁴ These treaty principles mean that if Southern Cross's transactions with its U.S. customers produce royalty receipts instead of sales profits, the receipts will be free of U.S. income tax unless (1) their source is in the United States even though they are not linked to a Southern Cross U.S. permanent establishment, or (2) they are effectively connected with a U.S. permanent establishment maintained by Southern Cross. In the first case, the gross amount of the royalties will be taxed at a 10

percent rate. In the second case, the royalties will be taxed on a net basis at graduated rates.

For treaty purposes, royalties are U.S. source if they are paid by a U.S. resident or incurred in connection with, and borne by, a fixed base or permanent establishment maintained by the payer in the United States, regardless of the payer's country of residence.⁶⁵ Assuming that Southern Cross's Web site is located in Australia and that it has no permanent establishment in the United States, this rule will usually cause

A critical issue regarding the proper U.S. tax treatment of payments to Southern Cross by its U.S. customers for software downloaded from the Australian Web site is whether those payments are indeed royalties.

payments by Southern Cross's U.S. customers to be taxable as U.S.-source royalty income⁶⁶ unless the payments are classified as sales proceeds instead of royalties. Thus, a critical issue regarding the proper U.S. tax treatment of payments to Southern Cross by its U.S. customers for software downloaded from the Australian Web site is whether those payments are indeed royalties.

This question is answered in large measure by article 12(4)(c) of the treaty, which provides that royalties include “income derived from the sale, exchange or other

disposition of any [patents, copyrights or various other items of intellectual and artistic property] to the extent to which the amounts realized on such sale, exchange or other disposition are *contingent* on the productivity, use or further disposition of such property or right,”⁶⁷ and by article 12(4)(a) of the treaty, which provides that “payments . . . for the *use of or the right to use any*: (i) copyright, patent, design or model, plan, secret formula or process, trademark or other like property or right”⁶⁸ are royalty payments. Thus, when Southern Cross does not have a U.S. permanent establishment, payments by U.S. customers are taxable as

⁶²Treaty art. 7(1), 12(4)(c); IRC sections 11, 882(a).

⁶³Treaty art. 12(2). Because the United States ordinarily taxes royalties on a gross basis at a 30 percent rate, IRC section 881(a); reg. section 1.881-2(b), the effect of the treaty is to limit the United States to a 10 percent gross-basis tax.

⁶⁴Treaty art. 12(3).

⁶⁵Treaty art. 12(6)(a).

⁶⁶Under U.S. federal income tax, royalties paid for the use of software are U.S.-source income if they are paid for the privilege of using the software in the United States. IRC section 861(a)(4). Royalties paid to Southern Cross by U.S. customers would virtually always be U.S.-source income under this rule. Thus, there would rarely be a case in which Southern Cross royalty income was U.S. source under the treaty but was nevertheless not taxable by the United States because it was considered foreign source under U.S. federal income tax.

⁶⁷Treaty art. 12(4)(c) (emphasis added). See also treaty art. 13(3).

⁶⁸Treaty art. 12(4)(a)(i) (emphasis added). The U.S.-Mexico income tax treaty employs a definition of royalties that is identical in substance to the portion of the treaty definition quoted in the text. The U.S. Treasury Department's explanatory memorandum on the U.S.-Mexico treaty states that “[t]he term ‘copyright’ [in the definition of royalties] is understood to include the use or right to use computer software programs.” U.S. Treas. Technical Explanation of U.S.-Mexico Treaty, *supra* note 6, at 500.

royalty income if (1) they are contingent on the productivity, amount of use, or further disposition of the Southern Cross software (even if the software transaction is structured as a sale) or (2) they are for the use of or the right to use Southern Cross software. The first category of payments, those that are dependent on productivity, amount of use, or further disposition of the property, seems self-defining.⁶⁹ The meaning of the second category, however, is not so clear. When are payments considered to be for the use or right to use software instead of for the ownership of software? Since the treaty does not answer this question, the IRS will be permitted to rely on U.S. domestic law in resolving the issue.⁷⁰

The U.S. Treasury Department's most recent domestic law pronouncement on this matter is a set of Treasury regulations promulgated in late 1998.⁷¹ These regulations involve two levels of characterization. First, they classify computer software transactions as follows:

1. A software transfer is regarded as a conveyance of copyright rights in the software if any of the following non-*de minimis* rights are transferred to the customer:

(i) the right to make copies of the software for purposes of public distribution through sale, lease, or lending;

(ii) the right to make derivative software based on the transferred software; and

(iii) the right to make a public performance or display of the software.⁷²

2. A conveyance of software is regarded as the mere transfer of a copy if the software is conveyed to the customer without any of the preceding privileges that would cause the transaction to be treated

as a transfer of copyright rights.⁷³

These transactional categories are next subdivided by the regulations as follows:

1. A transaction regarded as a transfer of copyright rights must be classified as either a royalty-generating license or a sale.⁷⁴

2. A transaction regarded as the transfer of a copy must be classified as either a rent-generating lease or a sale.⁷⁵

Under the treaty, however, all payments for the use of copyrights, patents, and similar items of intellectual property are classified as royalty income.⁷⁶ Thus, the distinction drawn by the regulations between licenses and leases of computer software is meaningless in the treaty context because both produce royalty income for treaty purposes.⁷⁷ Instead, the critical distinction under the treaty is between (1) licenses and leases of software (which yield royalty income) and (2) sales of software (which yield ordinary business profits, except to the extent the sales proceeds are treated as royalties because they are contingent on the productivity, use, or further disposition of the software).

The regulations make this distinction by employing a facts and circumstances test designed to discriminate between transfers of the right to use software and transfers of the ownership of software.⁷⁸ This determination will presumably control whether consideration received by an Australian software vendor will be regarded by the U.S. Internal Revenue Service, for treaty purposes, as royalty income or the proceeds of a sale. The following examples illustrate the operation of the test.

Example 1: Australian limited company A owns the copyright to computer program X. A makes program X available to U.S.

customers on a Web site. P, a U.S. customer, makes a noncontingent

⁶⁹To the extent clarification is required, see treaty art. 3(2); reg. sections 1.871-11(a)-(b).

⁷⁰Treaty art. (3)(2).

⁷¹Reg. section 1.861-18. See Alan Levenson, Alan Shapiro, Robert Mattson, and Ned Maguire, "Taxation of Cross-Border Payments for Computer Software," *Tax Notes Int'l*, Nov. 30, 1998, p. 1723, or 98 TN 229-15, or Doc 98-34374 (14 pages); Rene E. Chaze and Robert B. Jennings, "Guiding Taxpayers Through the U.S. IRS Computer Program Classification Rules," *Tax Notes Int'l*, Dec. 14, 1998, p. 1953, or 98 TN 239-17, or Doc 98-32779 (11 pages).

⁷²Reg. sections 1.861-18(c)(1)(i), (c)(2).

⁷³Reg. sections 1.861-18(c)(1)(ii), (c)(3).

⁷⁴Reg. sections 1.861-18(a)(2), (f)(1).

⁷⁵Reg. sections 1.861-18(a)(2), (c)(3), (f)(2).

⁷⁶See text at note 69, *supra*. This may be consistent with an international norm. See Gary D. Sprague and Robin A. Chesler, "Characterization of Computer Software Revenue in International Transactions," 74 *Taxes* 1144, 1155 (1996).

⁷⁷The U.S. Treasury Department's explanatory memorandum on the treaty indicates that the phrase "consideration for the use of or the right to use" includes rental income. U.S. Treas. Technical Explanation of Australia-U.S. Treaty, *supra* note 7, at 252. Furthermore, the U.S.-Mexico income tax treaty is identical in substance to the treaty with respect to the issue under consideration and the U.S. Senate Foreign Relations Committee's explanatory report on the U.S.-Mexico treaty also states that the phrase "consideration for the use of or the right to use" includes rental income. S. Exec. Rep. No. 20, 103d Cong., 1st Sess. (1993), 1994-2 C.B. 438, 465. See also Howard S. Engle, "The U.S.-Mexico Tax Treaty," 21 *J. Corp. Tax'n* 263, 271 (1994).

⁷⁸The regulations actually apply separate tests depending on whether the transaction is a transfer of a copyright right or a transfer of a copy. In the former situation, consideration received by the software vendor is royalty income unless "all substantial rights" in the copyright right have been conveyed to the customer, in which case the consideration is sale income. Reg. 1.861-18(f)(1). In the latter situation, the consideration is rental income (treated as royalty income under the treaty) unless the "benefits and burdens of ownership" have been conveyed to the customer. If they have, the consideration is sale income. Reg. section 1.861-18(f)(2). The subtle differences between these tests need not, however, be explored in this article.

payment to A and downloads program X (via the Internet) onto the hard drive of her computer. As part of the electronic transaction, P agrees to the following: the transaction is denominated a license by the parties; the license is stated to be perpetual; no reverse engineering, decompilation, or disassembly of the program is permitted; P receives the right to use the program on two of her own computers provided that only one copy is used at a time. Although P did not buy a disk with the program on it, the means of transferring the program is irrelevant, as is the fact that the parties have called the transaction a license.⁷⁹ Under the regulations, P has acquired ownership of a copyrighted article. Therefore, there has been a sale of a copyrighted article rather than the grant of a license or lease,⁸⁰ and the amount paid by P is ordinary business profits, which the Internal Revenue Service will probably treat as taxable if A's Web site is located in the United States.

Example 2: Australian limited company B owns the copyright to computer program Y. B makes Y available to U.S. customers through an Australian Web site on the following terms: a customer may only use program Y for one week, at the end of which an electronic lock within the program is activated and further use is impossible. If the customer wishes to continue using program Y, the customer must return to B's Web site and pay B for an electronic key that will reactivate the program for an additional week. This procedure must be repeated for as long as the customer uses the program. The customer does not receive any rights that would cause the transaction to be treated as a transfer of copyright rights. Under the regulations, the weekly transactions between B and the customer are leases, not sales.⁸¹ For treaty purposes, therefore, the weekly transactions generate royalty income for B and since the

customers are U.S. residents, the treaty provides that the income is U.S. source.⁸²

1. Planning Possibilities

As noted above, payments that are royalties under the proposed regulations are nevertheless characterized by the treaty as ordinary business profits if the property giving rise to the royalties is effectively connected with the Australian payee's U.S. permanent establishment.⁸³ This rule creates a possible planning opportunity for Southern Cross. To illustrate, suppose Southern Cross decides

When the transactions are structured to generate royalty income from U.S. customers, the income will generally be taxed by the United States regardless of the Web site's location.

that it can generate greater revenue from licensing Matilda 1.0 to U.S. customers than from selling copies to those customers. But assume that because there are large related deductible expenses, Southern Cross will be better off having the payments from its U.S. customers taxed on a net basis as business profits under article 7 of the treaty instead of on a gross basis as royalties under article 12. In response, Southern Cross could locate its Web site, including a full master copy of Matilda 1.0, on leased server space in the United States and insist that payments by U.S.

customers for the use of software downloaded from the U.S. Web site are royalties generated by property attributable to a U.S. permanent establishment.⁸⁴ In this situation, we might be treated to the spectacle of the U.S. Internal Revenue Service arguing against a previously adopted position, discussed above, that a U.S. Web site that concludes binding contracts constitutes a U.S. permanent establishment.

If the Internal Revenue Service does reverse itself, Southern Cross will have occasion to explore the uncertain ramifications of article 5(4)(b) of the treaty, which states that

an enterprise of one of the Contracting States shall be deemed to have a permanent establishment in the other Contracting State if: . . .

⁷⁹The regulations state that "[n]either the form adopted by the parties to a transaction, nor the classification of the transaction under copyright law, shall be determinative." Reg. section 1.861-18(g)(1).

⁸⁰Reg. section 1.861-18(h) example 2. See also reg. section 1.861-18(h) example 10.

⁸¹Reg. section 1.861-18(h) example 4.

⁸²See text at notes 65-66, *supra*.

⁸³See text at note 65, *supra*. Since the treaty does not define "effectively connected," resort must be had to domestic law. The domestic rule that seems likely to control is reg. section 1.864-4(c). See U.S. Treas. Technical Explanation of 1996 Model, *supra* note 6, article 7, paragraph 2, reprinted in 74 *Taxes* at 1093; 3 Isenbergh, *supra* note 6 at 57:26-57:27, 59:21. This regulation suggests that royalty-producing property is effectively connected with a U.S. permanent establishment if the property is held principally to promote the business of the U.S. permanent establishment or held in a direct relationship to the business of the U.S. permanent establishment.

⁸⁴See 3 Isenbergh, *supra* note 6 at 59:21. Southern Cross should be aware, however, that if its argument for treating the Web site as a U.S. permanent establishment is successful, the attributable profits will be subject to both the IRC section 11 tax and the branch profits tax. See note 7, *supra* and Goldberg, *supra* note 2, at 422.

(b) it maintains substantial equipment for rental or *other purposes* within that other State (excluding equipment let under a hire-purchase agreement) for a period of more than 12 months.⁸⁵

Southern Cross would argue that maintaining and actively using a Web site on a U.S. server to conclude sales and deliver software satisfies the requirements of this provision. Thus, Southern Cross would contend that at the end of 12 months, the Web site is a U.S. permanent establishment retroactive to its date of installation on the server, even if the Web site is not a permanent establishment under the treaty's general definition.⁸⁶ The prospects for successfully advancing this argument are unclear.

Now assume in the alternative a discovery by Southern Cross that maximum revenue can be generated by selling copies of Matilda 1.0 to U.S. customers but that relevant expenses are small, and that the best tax regime is the 10 percent gross basis levy applicable to royalties. In this situation, Southern Cross could locate its Web site in Australia to clearly avoid having a U.S. permanent establishment and could also, assuming commercial feasibility, structure the sales transactions so that the consideration is contingent on the productivity, use, or further disposition of each customer's copy. The contingent nature of the consideration and the absence of a U.S. permanent establishment would cause the

sales consideration to be characterized by the treaty as royalties subject to the 10 percent gross basis tax.⁸⁷

III. Conclusion

U.S. income taxation of profits from software sales by Australian vendors to U.S. customers through a Web site depends heavily on whether the computer server that houses the Web site is located inside or outside the United States. If the server has a U.S. location and the transactions are structured as sales, there is a danger that the United States will tax a portion of the sales profits. This danger can be eliminated by locating the host server in Australia, avoiding the use of any other U.S. permanent establishment, and avoiding sale consideration that is contingent on the productivity, use, or further disposition of the software. When the transactions are structured to generate royalty income from U.S. customers, however, the income will generally be taxed by the United States regardless of the Web site's location. Nevertheless, location remains relevant with respect to the nature of the tax imposed. If the Web site is housed on an Australian server and the vendor has no U.S. permanent establishment, royalty revenue received by Southern Cross from U.S. customers will be subject to a 10 percent U.S. gross basis withholding tax. If, however, the Web site is located in the United States, the royalty revenue might be taxed as ordinary business profits. ♦

Full Text Citations

- **Australia-U.S.** income tax treaty, signed August 6, 1982. AccServ & Microfiche: *Doc 93-30415 (63 pages, in English)*; Electronic: *86 TNI 35-35 (in English)*
- **Mexico-U.S.** income tax treaty and protocol, signed September 18, 1992. AccServ & Microfiche: *Doc 93-31458 (74 pages, in English)*; Electronic: *93 TNI 131-15 (in English)*
- **Mexico-U.S.** protocol to the 1992 income tax treaty, signed September 8, 1994. AccServ & Microfiche: *Doc 94-30657 (10 pages, in English)*; Electronic: *94 TNI 205-36 (in English)*
- **Switzerland-U.S.** income tax treaty and protocol, signed May 24, 1951. AccServ & Microfiche: *Doc 93-30461 (33 pages, in English, German)*; Electronic: *86 TNI 35-56 (in English)*
- **Switzerland-U.S.** income tax treaty and protocol, with memorandum, signed October 2, 1996. AccServ & Microfiche: *Doc 97-25262 (108 pages, in English)*; Electronic: *97 TNI 176-30 (in English)*

⁸⁵Treaty art. 5(4)(b) (emphasis added).

⁸⁶The U.S. Treasury Department's explanatory memorandum on the treaty states that in cases in which article 5(4)(b) applies, "the income is taxable from the beginning in accordance with Article 7 (Business Profits)." U.S. Treas. Technical Explanation of Australia-U.S. Treaty, *supra* note 7, at 252.

⁸⁷Treaty art. 12(3), (4)(c).

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