Nexus for corporate income taxes in the international context: what can be learned from current developments in US state taxation?

In order to justify taxation of a person, a country must establish that some connection exists between that country and that person. The international standard for nexus for taxing business profits, permanent establishment, was developed before the widespread globalisation of business. It is now subject to widely varying interpretations, creating uncertainty. The paper examines whether proposals before Congress for partial codification of nexus for US state tax purposes might have assisted in the resolution of some recent international cases and whether the proposals might usefully be adopted internationally.

Note: for the avoidance of confusion, the term 'state' is reserved in this paper for a state of the USA. The normal usage of the term with respect to double tax treaties is replaced by the word 'country'.

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The source principle is part of the bedrock of international tax law. With respect to business enterprises, most countries provide, in their domestic laws, that where a foreign enterprise has a permanent establishment within its borders, that country has jurisdiction to tax any profits arising from that permanent establishment. All bilateral double tax treaties provide that one contracting country may tax the profits of an enterprise of the other contracting country to the extent that they arise from a permanent establishment situated within its borders. Problems can arise where an enterprise plans on the basis that its activities in another country do not amount to a permanent establishment, but then faces a demand for taxation from that country based on an assertion that a permanent establishment does, in that country's opinion, exist. This paper examines the concept of nexus for the purpose of determining the threshold presence in a country beyond which a permanent establishment comes into existence.

Permanent establishment as the nexus for taxation of business profits in the international context

Internationally, the threshold requirements for a permanent establishment are generally accepted as those set out in the OECD's Model Tax Convention on Income and on Capital[1]. A brief enquiry into the origins of the permanent establishment concept leads us back to the reasoning behind the initial adoption of the source principle by the League of Nations. In its 1923 report[2], the League of Nations, although expressing a preference in principle for taxation by residence

[1] OECD (2008) Model Tax Convention on Income and on Capital.
[2] League of Nations (1923) *Report on Double Taxation. Submitted to the Financial Committee by Professors Bruins, Einaudi, Seligman and Sir Josiah Stamp,* Geneva: League of Nations, E.F.S.73.F.19 <http://setis.library.usyd.edu.au/pubotbin/toccer-new?id=brulegi.sgml&images=acdp/gifs&data=/usr/ot&tag=law&part=1&division=div1> accessed 12 May 2009)

alone, concluded that this approach would be unrealistic. They noted[3] 'A survey of the whole field of recent taxation shows how completely the Governments are dominated by the desire to tax the foreigner.' The adoption of the source principle was justified by the use of Schanz's theory of 'economic allegiance'[4]. Out of the four principles of economic allegiance identified in the 1923 Report, the principle of origin of wealth is the one on which the permanent establishment concept is founded: 'the place where the wealth is produced, that is, to the community the economic life of which makes possible the yield or the acquisition of the wealth.'[5]

The definition of permanent establishment in the current OECD Model Convention is used in double tax treaties around the world, with few variations from the Model text compared with other treaty definitions[6]. Variations do exist though, and where they do they can result in uncertainty for enterprises as to whether a permanent establishment exists. The unexpected assertion by a host country of the existence of a permanent establishment can lead to an absolute increase in worldwide taxation if the country of residence operates a system of double tax relief by exemption or if the residence country is a tax haven. The provisions of the OECD Model Convention are well known; a permanent establishment exists if either:

[3] See fn2, above at p40

[4] G Schanz, *Die Doppelbesteuerung und der Volkerbund,* Finazarchiv 40, 353-70, *cited in* T Rixen.The Political Economy of International Tax Governance (Palgrave Macmillan Basingstoke 2008)

[5] See fn2, above, at p24. Interestingly, the definition is then expanded to incorporate requirements as to "human agencies" which lends support to the often-used assertion that the OECD concept of permanent establishment is founded on the basis of human physical presence.

[6] Tax treaties which are based on the OECD model tend to vary only as to whether they adopt the provisions of the 1963 Model or those of later versions. The 1963 Model is wider in scope with respect to the definition of a dependent agent and narrower in scope regarding activities which, although carried on at a fixed place of business, are considered merely preparatory or auxiliary and thus do not constitute a permanent establishment.

- An enterprise has, in the other country, a fixed place of business through which the business of the enterprise is wholly or partly carried on (activities considered merely preparatory or auxiliary are disregarded, even if carried on through such a 'fixed place') or

- An enterprise has a dependent agent in the other country

Treaties based on the UN Model Tax Convention[7], which itself is based on the OECD Model, use a wider definition of permanent establishment. The definition of 'fixed place of business' is interpreted more liberally, the list of activities treated as 'merely preparatory or auxiliary' is narrower, and the definition of a 'dependent agent' is wider. Treaties based on the UN model tend to be associated with more uncertainty as to the possible existence of a permanent establishment than treaties based on the OECD model. Over the past decade there have been many disputes concerning the existence, or otherwise, of a permanent establishment. How public these disputes become depends on the way a country chooses to deal with them. Disputes in countries such as China (whose treaties contain elements of the UN Model) undoubtedly arise, but because the accepted mode there of resolving such disputes has traditionally been via negotiation and private settlement rather than going through the courts, they attract little publicity. Evidence of such disputes is difficult to gather as the negotiations are private to the taxpayer and tax authority. In contrast, India has used its court system extensively to settle tax disputes.

[7] UN Model Tax Convention 2001 <http://unpan1.un.org/intradoc/groups/public/documents/un/unpan008579.pdf> accessed 12 June 2009

The treaties which use the UN Model in the negotiation of their tax treaties are those between developed and developing countries. The UN Model skews source taxation rights towards the developing country to compensate for the asymmetry in the expected capital flows: FDI is far more likely to flow into the developing country than into the developed country. However, there are many different types of developing country and India and China are examples of countries at stages of development which may achieved by other countries over the next few decades. Although still net capital importers, they have large internal markets and are not as reliant on tax revenues from foreign multinational enterprises as smaller countries at a less advanced stage of development. Such countries can afford to take a more aggressive stance in insisting on the right to tax under the source principle, and are increasingly ready to assert the existence of a permanent establishment.[8] India, in particular, has brought a steady stream of cases against foreign multinationals in recent years, asserting the existence of permanent establishments. One of the reasons that India is able to do this is that Indian domestic law[9] defines a permanent establishment in quite a different way to its treaty definitions, requiring a 'business connection'.[10]

[8] Despite its record of aggressive assertion of the existence of a permanent establishment, even India is prepared to take a pragmatic view of the worth of pursuing foreign taxpayers in some instances. In *Union of India v Azadi Bachao Andolan* (2003) 6 ITLR 233 (Supreme Court of India) a treaty shopping case involving Mauritius, it was noted that FDI flowing into India via Mauritius had increased from R37.5million in 1993 to R61673 million in 2001. The Court, permitting the benefit of the treaty despite some rather obvious treaty shopping practices, observed (at 280) that "Overall, countries need to take, and do take, a holistic view. The developing countries allow treaty shopping to encourage capital and technology inflows, which developed countries are keen to provide to them. The loss of tax revenues could be insignificant compared to the other non-tax benefits to their economy. Many of them do not appear to be too concerned unless the revenue losses are significant compared to the other tax and non-tax benefits from the treaty, or the treaty shopping leads to other tax abuses."

[9] S9, Income Tax Act 1961 (India)

[10] Conveniently, once such a connection has been proved by the Indian Courts, it is a relatively simple matter for the Indian tax liability to be calculated, even in the absence of anything

The need for an increased level of certainty as to whether or not a permanent establishment exists

Whether or not a permanent establishment exists is often a grey area. The outcome can be influenced by the facts themselves, the provisions of any relevant double tax treaty and the provisions of domestic law in the host country. A further factor is the policy and practice of the host country in attempting to assert the existence of a permanent establishment. There have been many high profile cases in recent years where taxpayers have found themselves liable to foreign taxation due to the assertion by a host country of the existence of a permanent establishment where none was intended or budgeted for. The results of a review of the IBFD Tax Treaty Case Law Database, searching on keywords 'permanent establishment' and 'Article 5' are given in Table 1. This gives an idea of the numbers of cases concerned with the existence or otherwise of a permanent establishment.

resembling branch accounts. This is because the 1962 Income Tax Rules (Rule 10, Income Tax Rules 1962 (India)) permit the profits of a permanent establishment to be determined, where no suitable branch accounts exist, as a percentage of gross revenues. This is but one example of the widespread use of presumptive taxation methods in India.

Table 1: number of reported cases concerning the existence of a permanent establishment[11]

Australia	1	Japan	1
Austria	8	Luxembourg	2
Belgium	36	Netherlands	46
Botswana	1	New Zealand	1
Canada	6	Norway	13
Denmark	4	Portugal	1
France	28	South Africa	2
Germany	27	Spain	7
India	26	Sweden	1
Italy	10	Switzerland	5
		US	12
		TOTAL	243

However, the IBFD database only reports cases considered to be of international significance. A review of the Indian court reports for the years 1990 onwards, searching with the term ‘permanent establishment’ reveals the following:

Table 2: Indian court reports concerning permanent establishment issues

	No of cases
Supreme Court/High Courts	18
Income Tax Appellate Tribunal	83

[11] All searches conducted January 2010

Authority for Advance Rulings	41

The regularity with which disputes arise as to the existence of a permanent establishment stems from the fact that there is no international fiscal meaning of the term.[12]

Nexus for the taxation of business profits in US state taxation

The concept of nexus for the purpose of taxing net profits at state level in the US provides an insight into ways in which nexus might be determined outside of the accepted OECD practices. Although the division of the tax base between the various states is commonly done on the basis of formulary apportionment, in contrast to the ‘distinct and separate enterprise’ principle used at international level, the states have the right to determine nexus for tax purposes. There is a wealth of case law in which some principles of nexus have been developed that are markedly different from those adopted by the OECD. However, before this case law is examined, it is necessary to establish that the relative positions of two states of the US and two independent countries are not so different as to render these insights meaningless in the international context. In particular, it is necessary to demonstrate that the federal and constitutional constraints placed upon the individual states do not preclude the principles developed at state level

[12] It is submitted that an international fiscal meaning can be developed through decisions of national courts where the judgement is recognised as acceptable by a critical mass of countries. For instance, an international fiscal meaning of the term “beneficial ownership”, crucial in tax treaties, is widely considered to have been developed in a case head before the UK Court of Appeal which nevertheless concerned an Indonesian company on the one hand and a Netherlands company on the other: *Indofood International Finance Ltd v JP Morgan Chase Bank NA* (2006) 8 ITLR 653

from informing the debate at international level. Examining the US case law will demonstrate the existence of the right of an individual state to devise its own rules as to nexus and also provide some necessary background to the partial codification proposals which are the subject of this paper.

A common perception outside the US of state taxation in the US is that it involves simple sales taxes. However, most states also impose corporate income taxes on the net profits of enterprises.[13] Revenues from state corporate income taxes amounted to nearly $59 billion in 2008 out of total state tax collections of $792 billion.[14] Some case law on nexus for the purpose of state taxation concerns sales and use[15] taxes, and these cases must be approached with caution. These taxes are charged on the gross selling price: enterprises resident in a state and making sales to customers in that state are obliged to collect a sales tax, calculated as a percentage of the price. The courts have examined the extent to which the principles established in certain key nexus cases involving sales and use taxes may be applied to taxes on net profits, with divergent views emerging. However, there is also an abundance of case law solely concerned with the right of a state to charge taxes on part of the net profits of an out-of-state enterprise. The

[13] The exceptions are Nevada, South Dakota, Texas Washington and Wyoming. New Hampshire and Tennessee only tax dividends and interest income.
[14] U.S. Census Bureau: Federal, State and Local Governments 2008 State Government Tax. Although state taxes on corporate profits account for less than 10% of all state tax collections on average, the current budget shortfalls in the US economy are forcing states to examine their budgets carefully and to consider ways in which tax collections could be increased. Corporate income tax collections have been declining in recent years, making these taxes a target for reforms. The fall in property values has limited the ability of many states to collect the usual amount of property taxes. Several states[14] are currently considering proposals to raise the rates of corporate income tax. For Fiscal Year 2009, the largest planned increases in any tax were in corporate income taxes ($1.4 billion) with average increases in revenues of 2% planned. collections < http://www.census.gov/govs/www/statetax08.html> accessed 3 June 2009.
[15] Many states also require sellers resident in another state of the US to collect a 'use' tax and pay it over to the state in which the customer is resident. The position of a seller in State A of the US selling to customers in State B is similar in some ways to that of a Member State of the EU selling to customers in a fellow Member State under the VAT distance selling rules.

following outline of the present position concerning nexus for state tax purposes should persuade the reader that the case law rules are difficult to apply, arising as they do from interpretations of various clauses of the United States Constitution which, arguably, were never intended by the authors to cover taxation matters.[16] Case law presents us with multiple tests of nexus, with some uncertainty as to which takes precedence and to which taxes they apply.

A most interesting set of proposals for new federal legislation on the matter has been put forward as a result of the uncertainty arising from the case law. In Congress, a Bill[17] is currently before the House Subcommittee on Commercial and Administrative Law which aims to partially codify nexus for state taxes on net corporate income from interstate commerce. Thus, the issue of nexus for net corporate income taxes at state level in the US provides a rich source of judicial views and proposals for statutory reform, which may inform the debate as to the recognition of a permanent establishment in an international setting.

Important differences between the tax positions of a state of the USA and an independent country

With notable exceptions[18] countries do not generally cooperate in taxation matters on a multilateral basis. It is sometimes thought that, in contrast, the states of the

[16] See fn23 below
[17] HR1083, fn 59 below
[18] For instance, within the European Union, the Mutual Assistance Directives, e.g. the recent proposal COM(2009)29 final. Other examples would be the Nordic Treaty and the Andean Community Treaty.

US have an outright obligation in the matter of mutual assistance on taxation matters. This is not so. Indeed, the Compact Clause overtly states that 'no State shall enter into any treaty, alliance or confederation……No State shall, without the consent of Congress, enter into any agreement or compact with another State, or with a foreign power.'[19]

A key tax difference between the states of the USA and independent countries is that the most US states do not impose withholding taxes. Thus, if a state wishes to tax an out-of-state enterprise, the principal means at its disposal apart from sales and use taxes is a net profits tax. In order to impose a tax on net profits, there must be some nexus with the state. It is this lack of withholding taxes, particularly on royalties, which has led to many of the disputes as to nexus within the US. The reason most states do not impose withholding taxes is that they have, in the past, been thought to contravene the Privileges and Immunities Clause of Article 4 of the US Constitution[20].

[19] US Const art. 1, s10. Nevertheless, there exists an agreement known as the Multistate Compact, developed by the Multistate Tax Commission to coordinate the taxation of inter-state enterprises. Its right to exist has survived judicial challenge by taxpayers. Only 40 of the states belong to the compact, notable omissions being Delaware and New York. Although the Commission instigated a Nexus Program in 1990, this does not appear to have resulted in any particular agreements between the members and the main use of the Compact has been the development of a common set of rules for the division of the income of interstate enterprises where more than one state has successfully asserted nexus, rather than the development of a common set of rules for determining nexus. Although the Compact has established a 'nexus program' with the aim, *inter alia*, of developing a uniform nexus standard which satisfies requisite constitutional standards, the proposals do not appear to have been adopted to any significant extent.

[20] "the Citizens of each State shall be entitled to all Privileges and Immunities of Citizens in the several States." US Const art 4, s.2, §1. Some parallels might be drawn between this clause and the "fundamental freedoms" contained in the EC Treaty. Note that the constitutionality of Oklahoma's withholding tax on payments of royalties on oil and gas to out-of-state owners was upheld in *Panhandle Producers & Royalty Owners Ass'n v.Oklahoma Tax Com'n* 162 P.3d 960, 2007 OK CIV APP 68 *cert. denied*. The withholding tax was correctly analysed as a method of collecting a tax rather than the imposition of a tax. It was held to violate neither the Privileges and Immunities Clause nor any of the other provisions of the Constitution concerned with taxation, which are discussed in this article. The failure of the states to introduce the widespread imposition of withholding taxes on out-of-state income recipients therefore remains something of a mystery.

The legal constraints on the rights of states to assert nexus for tax purposes stem from judicial interpretations of certain clauses in the US Constitution[21] . The constitutional clauses accepted as placing constraints on the right of a state to charge tax on an out-of-state US enterprise are the Commerce Clause[22] and the Due Process and Equal Protection Clauses. The Commerce Clause simply states: 'The Congress shall have power….. to regulate commerce with foreign nations and among the several states, and with the Indian tribes'. In practice, this has been interpreted in such a way as to give rise to the so-called 'Dormant Commerce Clause': Although not expressly stated anywhere in the US Constitution, this principle has been deduced by the Supreme Court in interpreting the Commerce Clause. Under the principle, a state is prevented from exercising its powers to tax where this would unduly burden interstate commerce[23]. In *Gibbons v Ogden* [24] Chief Justice John Marshall stated that the power to regulate interstate commerce 'can never be exercised by the people themselves, but must be placed in the hands of agents, or lie dormant'. The doctrinal foundations of this interpretation of the Commerce Clause are not without critics. [25]

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[21] However, only the Duty of Tonnage and the Import-Export clauses in the Constitution specifically refer to state taxation. These clauses are aimed at preserving the customs union of the states, and merely forbid the charging of taxes on imports and exports involving trade with other countries at state level. With respect to the rest of the clauses, historians have cast doubt as to whether the authors of the US Constitution ever intended them to be applied to tax at all. This may account for some of the more tortuous interpretations offered by the courts. Panayi notes that "The Supreme Court has single-handedly erected an entire body of constitutional limits on the states' tax power by a purposive and at times ingenious interpretation of clauses dispersed in the US Constitution." C. Panayi, *Double Taxation, Tax Treaties, Treaty shopping and the European Community* Eucotax Series on European Taxation, Kluwer Law International, 2007

[22] US Constitution, Art 1 s.8, §l. 3

[23] Erwin Chemerinsky, *Constitutional Law* 317 1st ed, Aspen Publishers, 2001

[24] 22 US 1 (1824) at 189

[25] Justice Scalia, in *Tyler Pipe Industries v Dept of Revenue* 483 US 232 (1987) at 265, observed, in relation to the development of the dormant commerce clause and its application to state taxation, "the Court for over a century has engaged in an enterprise that it has been unable to

Whilst tax scholars in the UK are familiar with the twin concepts of equity: ability to pay, and the benefits principle, statute and case law which refer expressly to either of these principles are rare. In contrast, a variant[26] of the benefits principle has been explored in many state tax cases in the US as a result of the judicial interpretation of the Due Process clause. The combined Due Process and Equal Protection clause reads: ‘No State shall make or enforce any law which shall abridge the privileges or immunities of citizens of the United States; nor shall any State deprive any person of life, liberty, or property, without due process of law; nor deny to any person within its jurisdiction the equal protection of the laws.’[27] The accepted interpretation of the Due Process clause with respect to taxation is that the state which seeks to tax must give something in return. To justify charging the tax, the state must be offering opportunities, benefits or protections commensurate with the tax charged[28]. The principle has been taken to extremes so that the benefits in question need only be tenuous: for example, in *Burger King Corp. v Rudzewicz*:

> ‘Has the corporation, as a foreign entity, availed itself of the legal and economic benefits of a forum state? Applying these principles, we have

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justify by textual support or even coherent nontextual theory, that it was almost certainly not intended to undertake, and that it has not undertaken very well. It is astonishing that we should be expanding our beachhead in this impoverished territory, rather than being satisfied with what we have already acquired by a sort of intellectual adverse possession.”. Elsewhere in his judgment he referred to the law on state taxation and the Dormant Commerce Clause as “a quagmire”.

[26] Some authors (e.g. NH Kaufman, 'Equity considerations in International Taxation' (2000-2001) 26 BrookJInt'l L 1465) hold that the benefits principle deals only with the distribution of a collective obligation to pay tax to produce a given amount of revenues for the government. However, the variant of the benefits principle relevant here is one which is more opportunistic and considers only the right to charge tax as a quid pro quo for benefits received.

[27] US Const, Fourteenth Amendment Art 1

[28] *American Oil Co. v. Neill*, 380 US 451 (1965); *Wisconsin v. J.C. Penney Co*., 311 US 435 (1940)

> held that if a foreign corporation purposely avails itself of the benefits of an economic market in the forum state, it may subject itself to the state's *in personam* jurisdiction even if it has no physical presence in the state.'[29]

According to Hellerstein,[30] the Commerce Clause and the Due Process clause give rise to rather different tests of nexus for tax purposes. The Commerce Clause test of nexus, as developed by the courts, is concerned with whether the imposition of tax will result in an unreasonable burden on interstate commerce. The Due Process Clause, on the other hand, focuses on whether a person's connections with a state are sufficient to legitimise taxation of that person by that state.

The statutory definition of nexus for tax purposes varies between the states. For instance, the nexus rule in West Virginia is 'engaging in business or doing business in West Virginia means any activity of a corporation that enjoys the benefits and protection of the government or laws of West Virginia'[31]. Other States have rather more detailed provisions, which include physical presence requirements.[32]The legal arguments on nexus for state tax purposes were explored by the US Supreme Court in 1967 in *National Bellas Hess, Inc. v.*

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[29] 471 US 462, at 478 (1985)
[30] W Hellerstein, *State Taxation* Third Edition at 6.02 (accessed via Westlaw)
[31] W.Va.Code § 11-24-3a(11) Code of State Rules § 110-24-3a.7

[32] E.g. New Jersey will assert nexus for the purposes of its corporate franchise tax where a company is either doing business in the state, employees or owns capital or property there, or maintains an office in the state. It has expanded these rules to reflect case law developments discussed in this paper, so that from 2002 it also includes corporations which derive receipts from sources in New Jersey or which engage in contacts within New Jersey. N.J.Rev.Stat. §54:10A-2; N.J. Admin Code § 18:7-1.4, 1,6, 1,8

Department of Revenue.[33] This is one of many cases concerning out-of-state mail order firms and it was held that a state had no power to tax such a firm which had no office, agents, solicitors, property or telephone listing in that state and where all contacts which the firm had with the state were via mail or common carrier. The tax at issue was a use tax on the sales price, which the State of Illinois obliged the company to charge to customers and remit to the State. National Bellas Hess argued that the requirement to comply with this tax violated the Due Process Clause and created an unconstitutional burden on interstate commerce. In relation to the Commerce Clause, the taxpayer cited *Freeman v. Hewit*[34].

‘State taxation falling on interstate commerce can only be justified as designed to make such commerce bear a fair share of the cost of the local government whose protection it enjoys’.

Regarding the Due Process Clause, the taxpayer cited *Wisconsin v. J. C. Penney Co*.[35]:

‘the simple but controlling question is whether the state has given anything for which it can ask in return’. In *Miller Bros. Co. v. State of Maryland*,[36] a case which also concerned use taxes, the Constitution was stated to require ‘some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax’.

[33] 386 US 753 (1967).
[34] 329 U.S. 249 (1946)
[35] 311 U.S. 435 (1940) at 444
[36] 347 U.S. 340 (1954) at 344-345

The decision in *National Bellas*[37] was that the firm could not be compelled to colllect and pay over the Illinois use tax, as it had no physical presence in Illinois. This has come to be known as the 'bright line physical presence' test. This test was examined in a leading case decided by the US Supreme court in 1992, *Quill Corporation v North Dakota,*[38] which re-examined the principles set out in *National Bellas.* The North Dakotan court considered that the physical presence test established in *Bellas Hess* was obsolete, due to the 'tremendous social, economic, commercial and legal innovations'[39] which had taken place since *Bellas Hess* was decided, back in 1967*.* The North Dakotan Supreme Court determined that the nexus test suggested by the Due Process Clause was met as Quill had targetted ('purposefully directed its activities at') the North Dakota market via mailings and had won considerable custom as a result. The question posed by the North Dakotan Supreme Court was whether the company had sufficient contacts with the forum state to expect to defend a suit there. The US Supreme Court observed:

'the due process nexus analysis requires that we ask whether an individual's connections with a state are substantial enough to legitimate the state's exercise of power over him'[40].

Despite answering this in the affirmative, Quill had no physical presence in North Dakota and therefore lacked the 'substantial presence' thought by the Supreme

[37] *National Bellas* and *Miller Bros* were both slighly awkward in that, strictly speaking, the taxes in question (use taxes) fell on the consumer: the plaintiffs were merely being asked to act as tax collectors.
[38] 504 US 298 (1992)
[39] *Quill Corp v North Dakota* 470 N.W.2d 203, 208 (1991) rev'd
[40] *Quill, fn39 above* at 312

Court to be demanded under the judicial interpretation of the Commerce Clause, as applied to tax. Thus, the decision of the US Supreme Court in *Quill* was that North Dakota Supreme Court had no right to compel Quill to collect use tax in North Dakota in the absence of any physical presence there.

Questions arose in the course of the hearing as to how widely these principles were to apply. The Supreme Court acknowledged that judicial interpretation of the state tax implications of the Commerce Clause was far from certain. The Court also clearly stated that its judgment was not to be interpreted as an outright affirmation of the ‘bright line physical presence’ rule in *Bellas Hess.* [41] However, the reasons given by the Court for this were more to do with the administrative convenience of the physical presence rule as opposed to its legal respectability.

The combined application of the Commerce Clause and the Due Process Clause had been considered by the Supreme Court in *Complete Auto Transit Inc. v. Brady*[42]*,* a 1977 case which provides a widely accepted set of rules:

1. The tax must be applied to an activity with a substantial nexus to the taxing state.
2. The tax must be fairly apportioned.
3. The tax may not discriminate against interstate commerce.
4. The tax must be fairly related to the services provided by the state.

[41] fn36 above at 317
[42] 430 US 274 (1977)

The importance of *Complete Auto Transit* is that it has since been accepted by the State and federal courts as providing the framework whereby the state taxation concepts deemed by the courts through a long series of cases to emanate from the Constitution are encapsulated.

The key questions on nexus which arise from US state tax case law are:

- Is a physical presence of personnel necessary?
- Do the decisions in *National Bellas* and *Quill* apply only to sales and use taxes?
- Must the two separate tests of nexus (the Due Process Test and the Commerce Clause test) identified by the Supreme Court in *Quill* both be met in all cases?

Quill is significant in that it addressed the issue of nexus in detail, but both *Quill* and *National Bellas Hess* were concerned with use taxes on the gross sales price rather than with taxes on net corporate income. For a true comparison of US state practice concerning nexus for tax purposes with nexus in the international context, the position regarding taxes on net corporate income must be studied. *Northwestern States Portland Cement Co. v Minnesota*[43] was a landmark 1959 case in which the courts first stated definitively that the Commerce Clause does not prevent a tax on the net income of an out-of-state corporation. Hellerstein[44] reports that this 1959 decision brought to an end an era in which hundreds of state tax cases had led to a position whereby the Commerce Clause was thought

[43] 358 US 450 (1959)
[44] Hellerstein, fn28 above at 4.11

to prevent tax on inter-state commerce. One widespread effect of this affirmation of the right of the states to levy taxes on net corporate income was the switch made by many states from a franchise tax to a tax on the net income of out-of-state enterprises[45]. Franchise taxes, charged by a state exclusively on out-of-state businesses, merely for the privilege of being permitted to carry on business in a state, had recently been outlawed in *Spector Motor Serv. V O'Connor*[46]*.* The protests from business at this turn of events led to a rare instance of Congress enacting a statute restricting the right to charge state taxation of net corporate income on out-or-state enterprises, Public Law 86-272, which is discussed below[47].

The impetus for Congress to legislate further: recent developments in state case law on nexus

Many later cases concern payments for the use of intangibles to out-of-state owners of intellectual property. Some understanding of the main tax avoidance opportunities is useful in appreciating the significance of cases of this type which often involve Delaware legal entities. Delaware is well known for its corporate laws, which differ significantly from those found in other states and other countries. Importantly, Delaware does not impose state income taxes on royalty income.[48] Since *Quill*, the widespread use of tax avoidance schemes, typically

[45] a tax levied by a state simply for the privilege of being permitted to do business in that state. The tax base can be either the net earnings, the capital value or turnover.
[46] 340 US 602 (1951)
[47] See fn 54 below
[48] If an enterprise sets up an IP subsidiary in Delaware, it can transfer IP to that subsidiary, then have the Delaware subsidiary license the IP rights to subsidiaries or branches in other states. The royalties flowing into Delaware should be tax deductible for state income tax purposes in the paying states, and are tax free in Delaware. Delaware does impose a state franchise tax, but this is often outweighed by the tax advantage on the royalty income. Profit can be extracted from the Delaware corporation in the form of dividends, which in many states are not taxable in the hands

involving Delaware entities, has led to the state tax courts developing arguments to assert nexus for net income taxes where there is no physical presence. Three types of nexus can be identified apart from the physical presence nexus: affiliate/agency nexus, where an in-state group company acts for the out-of-state group company, economic nexus, involving the use of intangibles so that there is a substantial presence, and the so-called 'flash' nexus, where a taxpayer brings goods into the state and sells them there[49].

Geoffrey, Inc v South Carolina Tax Comm'n[50] was the first in a line of cases concerning Geoffrey Inc in which successive states have ruled that the 'bright line' physical presence test in *Quill* only applies to sales and use taxes. Geoffrey Inc (a Delaware subsidiary of the Toys 'R' Us group, which held the group's IP and, under Delaware's tax regime, escaped tax there on the royalties) was subjected to tax on net corporate income in respect of the licensing of intangibles (to fellow subsidiaries in the Toys 'R' Us group). Geoffrey's only connection with South Carolina was the licensing of intangibles and deriving income from their use but this was held to constitute a 'substantial nexus' with South Carolina. The first line of attack by the South Carolina tax authorities was to prohibit the deduction of the royalties by the payer. However, it subsequently decided to prosecute the view that there was sufficient nexus between Geoffrey and the state to permit taxation

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of the parent company (although some states consider them taxable, e.g. North Carolina). Upstream loans may also be used. So long as the IP company has sufficient nexus with Delaware to protect against assertions that the income should be taxed on the parent company, considerable tax savings can be achieved. The IP company should have physical nexus in Delaware : offices, bank account, Delaware tax registration, mailing address, employees based in Delaware, Board meetings in Delaware and so on. In other words, the tax residence of the IP company should, in substance as well as in form, be in Delaware.

[49] W.F. Fox, L. Luna, M.N. Murray *Emerging State Business Tax Policy: More of the Same or Fundamental Change?* Tax analysts Special Report, State Tax Notes, May 7 2007

[50] 313 S.C. 15, 437 S.E.2d 13 S.C. (1993) Cert. denied

of Geoffrey itself on its net income, relying mainly on the Due Process Clause. According to the South Carolina court, *Quill* applied only to sales and use taxes, not to taxes on net income. In considering the nexus with the State, it was stated: 'any corporation that regularly exploits the markets of a state should be subject to its jurisdiction to impose an income tax even though not physically present'[51].

However, this decision must be viewed in the light of the absence of withholding taxes on royalties at South Carolina State tax level. Hellerstein[52] confirms that state withholding taxes are not prohibited. Whilst the OECD Model Convention currently recommends no withholding tax on royalties, the UN Model retains the provision for withholding tax, as do many existing treaties based on former versions of the OECD Model. The case is perhaps best studied from the perspective of its divergence from current OECD thinking on the source principle as it applies to royalties. The case is of particular importance in the US as it led to other states altering their statutes on nexus to reflect the decision.

In a New Jersey case, *Lanco, Inc v Direct, Division of Taxation.*[53] the court used an 'economic nexus' standard. The case concerned an out-of-state licensor of trademarks and trade names to related in-state licensees. The New Jersey Supreme Court, in a per curiam opinion, stated that it did not believe that in *Quill* the US Supreme Court intended to create a universal physical presence requirement for state taxation.

[51] *Geoffrey* at 23. Note though that the quote originates from Hellerstein (fn26 above at 6.08) in the first place
[52] fn28 above at 6.03
[53] 879 A2d 1234 N.J. Super A.D. (2005); aff'd per curiam 908 A2d 176 N.J. (2006); cert. denied

In *Tax Commissioner v MBNA America Bank, N.A.*[54] the question addressed in was whether a net income tax on a taxpayer with no physical presence violated the Commerce Clause substantial nexus requirement. The State court interpreted the Commerce Clause as requiring that they adopt a 'substantial economic presence standard' of nexus. Again, the taxpayer was an out-of-state firm with no physical presence in the state (West Virginia). MBNA, a Delaware-based bank, issued and serviced credit cards and promoted its business in West Virginia via mail shots and telephone. It had no real or tangible personal property and had no employees in West Virginia. The case related to both corporate net income tax and business franchise tax. The physical presence test used in *Quill* was again held to relate only to sales and use taxes (on gross sales values). The West Virginia Court considered that the rationale for *Quill* was mainly the precedent set in *National Bellas* which also concerned sales and use taxes. The Court further observed that the compliance burdens imposed on out-of-state firms by the corporate income tax and franchise taxes were far less onerous than those created by the imposition of sales and use taxes. The judgment also acknowledged that the physical presence test, articulated in *National Bellas* back in 1967 made little sense now. The Court had been influenced by an academic paper on *Quill* as it related to electronic commerce.

'The mechanical application of a physical presence standard to franchise and income taxes is a poor measuring stick of an entity's true nexus with a state'[55]

[54] 640 SE2d 226 W.Va. (2006); cert. denied
[55] fn52 above at 234

The ‘substantial economic presence’ test which the Court adopted considers the degree of exploitation of the local market and the frequency, quantity and systematic nature of a taxpayer’s economic contacts with a state. Despite considerable outrage at the Court’s decision, the US Supreme Court refused to review the case.

Geoffrey and subsequent state tax cases have confirmed the general belief that the ‘bright line physical presence’ test affirmed in *Quill* does not apply to taxes on net income. Therefore out-of-state enterprises with no physical presence in a state are protected against sales and use taxes but not against other forms of taxation. The current problems in establishing nexus for state tax purposes may thus be summed up:

- There are no adequate federal statutory tax provisions governing the question of nexus for state taxes
- Case law is founded upon tortuous and controversial interpretations of certain clauses of the US Constitution
- The law governing nexus varies according to whether the tax in question is a sales or use tax, or a tax on net profits
- Nexus may be established on grounds which are, arguably, tenuous

There already exists a very limited ‘safe harbour’ from liability to state taxes on net corporate income. The Interstate Commerce Act (PL86-272),[56] enacted in 1959, sets out certain activities within a state which will not constitute nexus. It may be viewed for the purposes of this paper as the loose equivalent of Art 5. para 4 of the OECD Model Convention. That paragraph outlines activities which, even if carried on from a fixed base (or by a dependent agent) would not give rise to a permanent establishment. Broadly, these are activities which are merely preparatory or auxiliary to the carrying on of business.[57] What PL 86-272 does is to prohibit a state from levying taxes on net income where the only activity within the state is the solicitation of orders for the sale of physical goods by a representative of the company, where those orders are sent to another state for acceptance and processing and where the goods are shipped into the purchaser’s state from an out-of-state location. This provision was enacted in 1959 as a reaction to the decision in *Northwestern Portland Cement* and was intended to be temporary, although it is still in force.

The main limitations of PL 86-272 are that it only applies to net income taxes as opposed to sales and use taxes computed on turnover or gross sales values. It does not apply to the provision of services or intangibles by an out-of-state corporation. Therefore, it does not apply to the transport or the telecommunications industries. This restriction in scope gives rise to numerous disputes as to whether a services element of the sale of goods may be separated out for tax purposes.

[56] http://uscode.house.gov/download/pls/15C10B.txt. Note that despite being popularly referred to as PL86-72: it is in fact 15 U.S. Code § § 381 to 384

[57] Unsurprisingly, the list of activities considered merely preparatory or auxiliary in the equivalent Article of the UN Model Convention is somewhat shorter.

Although the statute is couched in terms of what would not give rise to nexus for tax purposes, subsequent case law has provided examples of what is outside the protection of PL 86-272: In particular, the maintenance of an office or other place of business, even on a very temporary basis, has been held to be outside its protection. [58] The replacement of stale gum in retailers' premises by a sales representative of a chewing gum manufacturer was outside its protection.[59] The Willis Committee[60] examined the scope of PL 86-272 in 1965 and listed some activities which were definitely not protected.

The recent developments in case law at the state level, and the resultant uncertainty for businesses operating across multiple states, have led to efforts to improve and extend the federal statutory limitations on nexus for state tax

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[58] Note that the Tax Appeals Tribunal, State of New York, found that the lease of a showroom in New York and the solicitation of orders by a company's sales staff (employees) from there for a period of only three weeks was held to take the company outside the protection of PL86-272 and thus render it liable to New York corporation franchise tax (on net profits from those sales). *In the Matter of the Petition of Hugo Bosca Company Inc. 1991 WL 218614 (N.Y. Tax.App.Trib.)*

[59] *Wisconsin Dept of Revenue v William Wrigley, Jr.,, Co* 505 U.S. 214, 112 S.Ct 2447 U.S. Wis (1992)

[60] H.R. Rep No 89-952(1965), cited in JA Swain, 'State Sales and Use Tax Jurisdiction: An Economic Nexus Standard for the Twenty-First Century' (2003-2004) Georgia Law Review at 387. A useful extract is also given in Hellerstein, fn28 above at 6.17: a company had to be carrying out at least one of the activities listed as protected, but none of those listed as unprotected. Unprotected activities were listed as:

- maintenance of any business location in the state, including any kind of office,
- Ownership of real property in the state
- Ownership of a stock of goods in a public warehouse
- Ownership of a stock of goods in the hands of a distributor or other nonemployee representative, if used to fill orders for the owner's account
- Usual or frequent activity in the state by employees soliciting orders with authority to accept them
- Usual or frequent activity in the state by employees engaged in purchasing activity or in the performance of services (including installation, assembly and repair of equipment
- Operation of mobile stores in the state regardless of frequency
- Installing or making repairs to products
- Provision of technical assistance, service or training
- Investigation of creditworthiness of customers
- Approving or accepting orders

purposes. There have been repeated attempts to widen the scope of PL 86-272, the latest being HR1083.[61] This bipartisan Bill, known as the Business Activity Tax Simplification Act of 2009 was introduced in the House of Congress on February 13, 2009. It seeks to update the minimum jurisdictional standards for the levying of state and local taxes on net income and of other business activity taxes. In particular, where nexus turns on the presence of natural persons, *de minimis* limits are set so that very short periods of presence cannot give rise to nexus.

HR1083 and PL 86-272 represent the best example we have in the world of an attempt to partially codify nexus for tax purposes across a group of jurisdictions of significant size. Although it is correct to view them as a response to particular situations which have arisen as a result of state practices, the rules they contain bear examination in the international context. Table 3 provides a summary of the differing provisions of the nexus provisions of the OECD and UN Model Conventions and of both PL86-272 and HR1083. A fundamental difficulty in producing such a comparison is that whilst Art 5 of OECD and UN Models is couched both in terms of what would and what would not constitute nexus, both PL 86-272 and HR1083 are couched only in terms of what would not constitute nexus.

The overriding requirement of HR1083 is for a physical presence in the taxing state, either of the proprietor, employees, an agent or of tangible personal property or real estate. PL 86-272 would be expanded to encompass services and intangibles. The new rules would apply to all business activity taxes, not merely

[61] 111th Congress, 1st Session H.R.1083 IH

taxes on net corporate income. Note that whilst the term ‘physical presence’ in the context of the OECD Model Convention is usually taken to mean the presence of people[62], at state tax level the term is used to encompass tangible property as well.

[62] Although the Commentary to Article 5 makes it clear that nexus can, in very limited circumstances, be asserted due to the presence of certain tangible assets, without the presence of people.

Table 3: Comparison of Art 5 (OECD and UN Model Tax Conventions), PL 86-272 and HR1083

	OECD provisions	**UN provisions**	**Provisions of PL86-272 (S381 US Code)**	**Provisions of PL86-272 as amended by HR1083**
Positive indicators of nexus	Fixed place of business Building/construction site existing for > 12 months Dependent agent	Fixed place of business Building/construction site existing for > 12 months Performance of services >6 months in any 12 months Dependent agent	No positive indicators (although may be present in individual state tax codes)	No positive indicators (although may be present in individual state tax codes) No nexus possible unless physical presence of natural persons OR a person either leases or owns tangible personal or real property situated in that state (note that leasing or licensing of computer software is excluded)
Effect of performance of services in the other state	Optional clause offered in the Commentary: Individual present >183 days in aggregate in any 12 month period AND >50% gross revenues attributable to business activities OR	Performance of services for >6 months in aggregate in any 12 months on same or connected project will create nexus	The net corporate income from furnishing of services for any length of time, at all or in any value, can be taxed by the host state.	Performance of services gives rise to nexus, but with a range of exceptions, based on the type of activities, and the duration of the physical presence of persons in the host state.

	Employees perform services for an enterprise on one or more connected projects in the other state and are present there for more than 183 days in aggregate in any 12 month period.			
Exceptions relating to type of activity in host state	Activities which, although carried on at a fixed place of business, do not result in a permanent establishment • storage • display • delivery • maintaining a stock of own goods for storage, display or delivery or for processing	Activities which, although carried on at a fixed place of business or which constitute the furnishing of services, do not result in a permanent establishment : • storage • display • maintaining a stock of own goods for storage or display or for processing by another enterprise	Where the business activities within a state are limited to solicitation of orders for sales of tangible personal property, provided that the orders are sent outside the state for approval or rejection and are fulfilled by shipment or delivery from a point outside the state.	Where the business activities within a state are limited to: • solicitation of orders for tangible and intangible real and personal property and services (see cell above) where fulfilment of the orders takes place outside the state • furnishing information to customers or affiliates • covering events (e.g. trade exhibitions) • gathering information where such information is used or disseminated

	by another enterprise • purchasing goods • collecting information any activity, or combination of activities, which is preparatory or auxiliary	• purchasing goods • collecting information any activity, or combination of activities, which is preparatory or auxiliary		from a point outside the state • activities relating to the purchase of goods or services, provided that the final decision to buy is taken outside the state
Is there an express requirement for presence of people?	No	No	No	No No nexus possible, regardless of activities carried out, unless a person has a physical presence in the state. Definition of 'physical presence' includes assets as well as people: • An individual is physically present there • Employee(s) physical present there • A dependent agent (working exclusively for the out-of state business) is present there, for the purpose of establishing or maintaining the market in that state • A person either leases or owns tangible

				personal or real property situated in that state (note that leasing or licensing of computer software is excluded) Physical presence of persons will be ignored if an individual (proprietor) or employee(s) are present in the state either for: • Less than 15 days p.a. minimum (or the minimum laid down by the state, if greater) OR • For the purpose of conducting only limited or transient business activity
Effect of use of agents	Dependent agent: Art 5 para 5 An agent constitutes a permanent establishment if he has, and habitually exercises in a state an authority to conclude contracts in the name of the	Dependent agent: Art 5 para 5 An agent constitutes a permanent establishment if: he has, and habitually exercises in a state an	Sales of or solicitation of orders for tangible personal property by an 'independent contractor' will not give rise to nexus.	Use of an independent contractor will not give rise to nexus. An independent contractor is defined as a commission agent, broker or other independent contractor engaged in selling or fulfilling transactions or soliciting orders for a sale or

	enterprise (unless the activities are excluded as above)	authority to conclude contracts in the name of the enterprise (unless the activities are excluded as above)) OR he lacks such authority but habitually maintains a stock of goods from which he regularly delivers goods on behalf of the enterprise. OR he acts wholly or almost wholly for the enterprise and commercial and financial relations between the agent and the enterprise are not on an arm's length basis.	Neither will the fact that such a contractor maintains an office in the state. An independent contractor is defined as a commission agent, broker or other independent contractor engaged in selling or soliciting orders for the sale of tangible personal property for more than one principal and who holds himself out as such in the course of his business activities.	transaction, furnishing information, or covering events, or otherwise gathering information. The independent contractor must be a person who acts for more than one principal and who holds himself out as such in the course of his business activities.
Effect of maintaining a	Not a permanent establishment unless acts as a dependent	Not a permanent establishment unless acts as	No provisions	No provisions

subsidiary company in the other state:	agent	a dependent agent		

Should the principles set out in HR1083 be adopted internationally?

If the rules set out in HR1083 were adopted internationally, would disputes as to the existence of a permanent establishment be avoided or more easily resolved? To explore this question, a number of international court cases on the subject have been examined to determine whether, had HR1083 type rules been in operation, the cases might have been decided differently, or perhaps need never have been brought at all. A major limitation of HR1083, that it is only a partial codification of nexus rules, will become apparent. Although HR1083 does not contain any positive indicators of nexus, it must be remembered that many individual state tax regimes include positive indicators of nexus, such as maintaining an office in the state.

The first three cases considered are from India. India's domestic law provisions defining a permanent establishment are drafted in terms of a 'business connection' with India[63]. Certain foreign enterprises, which find that the Indian Tax Authority has asserted the presence there of a permanent establishment, often have no opportunity to mitigate the Indian tax liability by minimising the attribution of any profit to that permanent establishment via allocations of expenses[64]. Partly

[63] Section 9 Income Tax Act 1961 (India). Note that although the existence or not of a permanent establishment is ultimately determined by the provisions of an applicable double tax treaty, the general rule is that a tax treaty can only reduce a taxpayer's liability, not increase it. Thus, if there is no nexus under domestic law, there can be no nexus under any tax treaty.

[64] This is because Rule 10 of the Income Tax Rules 1962 provides for taxation of permanent establishment where no accounts have been kept on a presumptive basis, calculating the tax liability as "such percentage of turnover so accruing or arising as the Assessing Officer may consider to be reasonable" Income Tax Rules 1962, Rule 10(i) (India). Alternatively, an apportionment of the enterprise's global profits on the basis of turnover may be made. There is an

because branches *per se* are not permitted[65], foreign enterprises are sometimes surprised to find that the Indian Tax Authority is asserting the existence of a permanent establishment, often in the form of a services permanent establishment, a dependent agent permanent establishment or that an Indian affiliate is acting as a permanent establishment of the foreign investor. [66]

A decision by the Authority for Advance Rulings caused some consternation in 2002. *Re Sutron Corporation*[67] concerned a US firm which tendered for the installation of remote communications stations in India. Equipment supplied by Sutron under the contracts was delivered to the Indian customer in the US. Air India had been appointed as carriers of the equipment by the customer, the Government of Andhra Pradesh (GOAP). GOAP were responsible for the cost of insurance and freight. Sutron used the services of a 'Country Manager', an Indian national, for the purposes of submitting the tenders which had been prepared in the US. He had authority to submit bids and to sign contracts with the GOAP on behalf of Sutron after having obtained approval from Sutron.

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option for the Indian Tax Authority to calculate the taxable income in any other manner deemed suitable.

[65] India does not permit the use of a branch by a foreign enterprise except for certain classes of activities which are unlikely to be core activities for most firms. The list includes the rendering of professional or consultancy services but excludes manufacturing[65]. Inward investment is normally by way of investment in an Indian resident company, with the maximum permitted shareholding of the non-residents limited according to the type of industry sector. Liaison offices are permitted for the purposes of carrying out activities which might be broadly classified as "preparatory or auxiliary" and these are usually safe from assertions that they constitute a permanent establishment. Temporary project offices are also permitted.

[66] The preponderance of Indian cases arises because:

- It is a developing country which is attracting high volumes of foreign investment
- It has a highly developed tax system
- It bases its double tax treaties on the UN Model but the definition of a permanent establishment adopted in its double tax treaties is normally even wider than that in the UN Model.
- It has a litigious culture so that there is a wealth of case law evidencing the nature and the settlement of tax disputes

[67] AAR No. 603 of 2002 (India: Authority for Advance Rulings)

The Country Manager was paid a fixed monthly remuneration plus expenses and the AAR held that these arrangements, together with the range of activities carried out by him, meant he should be viewed as an employee. Neither was the overall business activity viewed as a mere sale of goods on a principal to principal basis, made outside India.[68] The AAR held that it should be regarded as a turnkey project.[69] Having decided that the Country Manager was an employee the AAR then also arrived at the conclusion that his premises (his private house) constituted a fixed place from which the business of Sutron was partly carried on and thus there was a business connection under Indian domestic law and a permanent establishment under Art 5 of the US-India Double Tax Treaty.

It was the use of this Country Manager which led to the decision that Sutron had a permanent establishment in India.

Relevant facts and the grounds for establishing nexus considered by the court	**Likely effect of HR1083 rules**
The Country Manager was a *de facto* employee of Sutron, although the agreement entered into between the country manager and Sutron expressly stated that he was an independent consultant rather than an employee.	If an employee, HR1083 minimum physical presence requirements met. However, no guidance on definition of an employee in HR1083
The Country Manager's private residence was treated as a fixed place of business.	HR1083 contains no requirement for a fixed place of business in the other state.
Tasks carried out by the country manager:	HR1083 excludes from nexus solicitation of orders where fulfilment of

[68] Under the terms of Circular No.23 dated 23 July 1969, the ITA states that it regards principal to principal sales made between a non-resident and a resident on arm's length terms to be outside the definition of a business connection. Rather surprisingly, the AAR failed to mention this Circular at all.
[69] In this context, a contract for the supply and installation, typically of a large industrial facility where the foreign provider supplies all aspects from physical goods to final installation and the buyer merely has to "turn the key" to commence operating it.

• Collection of information about tenders to supply data and monitoring systems • Submission of proposals prepared in the US by Sutron in response to tenders • Collection of information as to whether or not tender awarded • Submission of bids and signing of contracts with Indian customer after obtaining approval from Sutron in the US.	orders takes place outside the state. Submission of tenders considered to equate to solicitation of orders. HR1083 does not except from nexus the signing of contracts.

Would HR1083 have saved Sutron? Probably not, as the Country Manager's designation as an employee by the AAR would have given rise to a 'services nexus' under HR1083 rules. Even if Sutron had taken care to remunerate the Country Manager in a way less open to interpretation as employment, the HR1083 exclusions concerning agents would not have covered an agent who signed contracts on behalf of an out-of-state principal.[70]

A major case concerning the assertion of a permanent establishment in similar circumstances by the Indian Tax authority is *Rolls Royce Plc v Director of Income Tax.*[71] RRplc (a UK company) was selling engines to the Indian Air Force and used the personnel of RRIL (an Indian affiliate company) to handle its relations with the Air Force. RRIL performed liaison work for RRplc in India and in particular, acted as a filter for communications between the Air Force and RRplc

[70] The logistics of submitting an acceptable tender were such that it would have been extremely difficult for Sutron to submit a valid tender without considerable administrative input from Indian residents (in this case, the Country Manager).
[71] 10 ITLR 327 (2007)

such that requests, quotations and other documents had to be sent first to RRIL for scrutiny and analysis before passing them on to RRplc. The costs of the business premises of RRIL and its salary costs were fully recharged to RRplc and were frequently used by personnel of RRPlc. RRIL received service fees from RRplc of between 5.1% and 6% of the reimbursed expenses. A formal agreement between RRPlc and RRIL purported to set out the range of services to be provided by RRIL to RRPlc, which consisted of support services, media relations, business development and administrative support. However, additional papers were discovered setting out the extent of the role played by senior personnel of RRIL and which indicated that they played a key role in cultivating very close business contacts with the Indian Air Force and in advising RRPlc on not just the generalities of business in India but on the details of specific contract clauses. Internal group papers included a responsibility chart which indicated that staff employed by RRIL were functionally responsible to RRPlc. Contracts were signed outside India but were negotiated within India. The provisions of Article 5 of the India-United Kingdom Income Tax Treaty of 25 January 1993 give a wide definition of a permanent establishment. In addition to the definitions given in the UN Model Convention, it includes a fixed place of business 'used as a sales outlet of for receiving or soliciting orders' and the definition of a dependent agent includes a person who habitually secures orders wholly or almost wholly for the enterprise. [72] The Court's decision was that that RRplc had a permanent establishment in India. [73]

[72] United Kingdom–India Art 5 (2)(f)
[73] The financial consequences of this decision were that RRplc was assessed to Indian corporate tax on 35% of the global profits attributable to the contracts in question under Rule 10 of the Income Tax Rules 1962 (India)

Relevant facts and the grounds for establishing nexus considered by the court	**Likely effect of HR1083 rules**
The premises of RRIL were available to RRPlc on visits by its personnel to India. Although there was no evidence that RRPlc had any legal rights to use the premises, nor that it was doing anything other than visiting the premises for the purpose of liaising with the staff at RRIL, the fact that RRplc reimbursed all the running expenses of the premises appears to have been crucial in leading the Court to decide that RRplc had a fixed place of business in India under Art 5 (1)(f): premises used as a sales outlet or for receiving or soliciting orders.	HR1083 contains no requirement for a fixed place of business in the other state. The fact that RRPlc reimbursed the running costs of the premises of RRIL probably would not lead to RRPlc being considered to be leasing or owning tangible personal or real property in India., although HR1083 does not elaborate on the meaning of 'leasing or owning' .
The activities carried on by RRplc through RRILs premises were more than merely preparatory or auxiliary: they were core activities of marketing, negotiating and selling of the product	Little is said in the case about the activities of RRplc personnel in India. The court had, however, determined that certain key staff on the payroll of RRIL were effectively employees of RRplc as it had been acknowledged that they were functionally responsible to RRplc. Their salary cost was reimbursed by RRplc to RRIL. However, even assuming that the RRIL staff were, in fact employees of RRplc, the activities carried out by them appear to fall into the activity-based exclusions from nexus set out in HR1083: • Solicitation of orders where fulfilment took place outside India • Furnishing information to customers and the Rolls Royce group • Covering events such as trade exhibitions • Gathering information to be used both inside and outside India
RRIL acted almost like a sales office of RRPLC and its group companies	HR1083 contains no requirement for a fixed place of business in the other state.

RRIL and its employees worked wholly and exclusively for RRPLC and its group companies	As set out above, the contractual and payroll arrangements are rather unclear. If RRIL staff were, in law, employees of RRplc, then they would certainly have breached the 15 days limit and, if engaged in other than the excluded activities, nexus would be established.
Employees of Rolls Royce Group were present in various locations in India and they reported to the Director of RRIL in India	Only if these were employees of RRplc itself rather than any other group company, and only if these employees were engaged in activities other than the HR1083 excluded activities would this create nexus.
The personnel located at the premises of RRIL were in fact employees of RRplc	See above
RRIL was a dependent agent of RRplc and therefore a deemed permanent establishment because it habitually secured orders for RRplc	Whether RRplc would be considered an independent contractor in the HR1083 sense would turn upon whether it acted solely for RRplc or for other companies in the RR group as well. Assuming it acted only for RRplc, it would not be regarded as an independent contractor. Even if RRIL was not an independent contractor, whether nexus is created in respect of RRplc would depend on whether RRIL was carrying out activities beyond the HR1083 exclusions.

Overall, the conclusion must be that had HR1083 rules been in place there would have been no nexus for Indian taxation of RRplc's profits. Although, due to the arrangements for reimbursement of salaries and the lines of functional responsibility, there is a case for believing that HR1083's minimum physical presence thresholds have been breached, the extent of the activities carried out in India would not appear to breach the HR1083 thresholds. The crucial question centres around the place where orders were approved or rejected. It was accepted by the Court that RRIL, although a dependent agent of RRplc, had no authority to bind RRplc in contract. The reason RRIL was held to constitute a deemed permanent establishment of RRplc was due to the specific terms of Art 5 para 4(c) of the Indian – United Kingdom treaty which states that a dependent agent will form a deemed permanent establishment if he habitually secures orders for the enterprise (in this case, RRplc). No such provision exists in HR1083. The other main reason for the decision of the Indian court that there was a permanent establishment of RRplc was the existence of a fixed place of business. HR1083 does not contain this test at all, although the existing law on nexus of some states contains similar provisions.

In *DIT(International Taxation), Mumbai v Morgan Stanley & Co.Inc*[74] the question arose as to whether back office functions outsourced to an Indian subsidiary could be held to constitute an Indian permanent establishment of the parent company. This case has been closely followed by the large number of MNEs which have outsourced customer support and other back office operations to Indian subsidiaries. The Authority for Advance Rulings[75] determined that in certain of the circumstances cited by Morgan Stanley there would be a permanent establishment, but on appeal to the Supreme Court the circumstances in which a permanent establishment would be considered to exist were narrowed.

[74] DIT (International Taxation), Mumbai v Morgan Stanley & Co Inc; Morgan Stanley & Co Inc v DIT (International Taxation), Mumbai. Civil Appeal No. 2914 of 2007 (arising out of SLP (c) No 12907 of 2006), also reported as 9 ITLR 1124 (2007)

[75] AAR No 661 of 2005 (New Delhi), also reported as 8 ITLR 916

Nevertheless, this high-profile case cost the taxpayer dearly in terms of legal fees and diversion of resources from more profitable uses.[76]

Morgan Stanley and Co (MSCO), a US company entered into an agreement with an Indian group subsidiary, MSAS, for the provision of support services and outsourcing of some of MSCo's activities. The types of activities involved were equity and fixed income research, account reconciliation and data processing. MSCo used India's system of advance rulings to request a ruling that the activities of MSAS would not bring into being a permanent establishment of MSCo in India. The Indian Authority for Advance Rulings (AAR) held that the back office functions themselves would be regarded as merely preparatory or auxiliary, so that even if the premises of MSAS could be viewed as a fixed place of business of MSco or if MSAS could be viewed as a dependent agent, no permanent establishment would arise. However, a services permanent establishment would arise if MSCo were to second some of its own employees to India for two purposes: firstly to assist in carrying out the tasks allotted to MSAS, for periods of up to two years, after which time they would return to their jobs at MSCo. Secondly, if other staff were sent to India for 'stewardship' purposes: quality control and so on MSCo therefore appealed against this decision to the Indian Supreme Court. The Supreme Court held that as the MSCo staff were sent to MSAS at the request of MSAS on secondment (the word used in the case is 'deputation'), as they were sent at the request of MSAS for their particular expertise in banking and finance and as their

[76] The case also dealt with the question of what profits were to be taxed, if the Indian affiliate was held to constitute a permanent establishment of the parent. The Court decided that provided that the Indian subsidiary had been remunerated on an arm's length basis, there were no additional profits to be taxed in India beyond those declared for Indian tax purposes by the Indian subsidiary. This indicates rejection by India of the OECD's "two taxpayer" notion, but more importantly serves to underline the waste of resources in bringing this case.

tour of duty in India was, on average, two years, a services permanent establishment arose. However, the Supreme Court held that the presence at MSAS of the ‘stewardship’ MSco staff, for short term assignments, and who reported solely to MSCo would not, of themselves, give rise to a services permanent establishment. Table 4 sets out the reasons given by the AAR for its decision that a services permanent establishment could arise and, where appropriate, the decisions of the Supreme Court.

Relevant facts and the grounds for establishing nexus considered by the court	**Likely effect of HR1083 rules**
The AAR considered the activities of MSAS to be of ‘critical relevance’ to MSCo in that they would help MSCo to formulate its business strategy and enhance portfolio values for customers. Hence the activities of MSAS fell outside the Art 5 ‘preparatory or auxiliary’ exclusions. (Note this part of the ruling was overturned by the Supreme Court). Therefore if MSCo had a fixed place of business in India (MSAS premises) or if MSAS was found to be a dependent agent, MSCo might have an Indian permanent establishment.	Would the activities fall within the exceptions from nexus provided in HR1083? The exceptions are: • Soliciting orders • Furnishing of information either to customer within India further afield • Covering events or gathering of information in India, which is used outside the State? Doing more than • Activities directly related to purchasing Conclusion: No protection from nexus under activity based exclusions in HR1083 as the activities off MSAS do not fall within the HR1083 exceptions
Although MSAS was found to be a dependent agent of MSCo, it did not represent a permanent establishment of MSC because it did not satisfy any of the three possible requirements of Art 5 Para 4 of the double tax treaty regarding agents. These are: 1. has and habitually exercises authority to conclude contracts on behalf of the enterprise OR 2. No authority to bind in contract but habitually maintains a stock of goods from which he regularly makes deliveries on behalf of the enterprise OR 3. habitually secures orders in host State wholly or almost wholly for the enterprise.	The particular requirements in the US – India double tax treaty which must be met before a dependent agent can be a deemed permanent establishment are not found in HR1083. The activities conducted by MSAS are outside the excepted activities set out in HR1083 Therefore HR1083 offers less protection against an assertion of nexus than does the US –India treaty
The Supreme court held that ‘deputation’ staff do not become employees of MSAS because MSCo ‘has a lien’ on their services and therefore retains control over their terms and employment. Their services were provided at the request of MSAS. Staff were entitled to return to their jobs	No protection available under HR1083 on grounds of the activities undertaken. No protection from the minimum presence requirements of HR1083 as the employees of MSCo would be present in India for more than 15 days.

with MSCo when secondment to MSAS finished. Therefore the presence of these staff at MSAS represents a services permanent establishment of MSCo	
The Supreme Court held that ‘stewardship’ employees on short term assignments to MSAS, reporting directly to MSCo, would not give rise to a service permanent establishment as services were provided to MSCo itself rather than to any Indian client (e.g. MSAS)	Possible protection under HR1083 if each person present in India for less than 15 days, but it is unclear in HR1083 whether the 15 days limit applies per individual member, individual visit or whether it is the aggregate of one or both of these.

It may be argued that had the HR1083 rules been applied in this case, the outcome would have been even worse for Morgan Stanley. No protection would be afforded by the activity-based exceptions and minimum physical presence requirements in HR1083. Further, the protections offered by Para 4 of Art 5 of the US-India treaty regarding dependent agents would not have been available.

The enthusiasm for asserting that a resident subsidiary company is acting as a permanent establishment of foreign affiliates is not confined to India. In the case of *Uge S.A. v Ufficio IVA di Arezzo*[77] which followed *Philip Morris*[78]*,* representatives of a Panamanian affiliate company (who were directors and shareholders of the Panamanian company) worked in Italy at the premises of an Italian subsidiary, AIT Srl, and were also shareholders and directors of the Italian subsidiary. The Italian subsidiary routinely participated in negotiations on behalf of the Panamanian affiliate, although it did not conclude the contracts. The books

[77] Corte di Cassazione, Case 17206 25 January 2006 (Italy). Also 9 ITLR 345 (2006)
[78] Ministry of Finance (Tax Office) v Philip Morris (GmbH), No 7682/02 (25 May 2002) Corte de Cassazione (Italy)

and records of the Panamanian affiliate were maintained by the Italian subsidiary. Although the case concerned nexus for VAT purposes, the tests used were those of the OECD Model Tax Convention and the Commentary. The importance of this case is that the Italian court carried out its threat to disregard the amendments made to the Commentary on Art 5 Para 6 following the earlier decision in the *Philip Morris* case.[79] Although no final decision is yet available, the Supreme Court remitted the case back to the lower court, instructing it to reach a decision using the principles derived from the *Philip Morris* case, notably that the Italian subsidiary was, in theory, capable of acting as a multiple permanent establishment for all the affiliates worldwide for which it carried out functions which were more than preparatory or auxiliary.

Relevant facts and the grounds for establishing nexus considered by the court	**Likely effect of HR1083 rules**
A ‘substance over form’ approach is appropriate	The ethos of HR1083 is to provide an objective means of determining nexus. ‘Substance over form’ is absent from HR1083.
The principal evidence used to support the proposition that the Italian subsidiary was acting as a permanent establishment of the Panamanian affiliate was the presence of certain banking transactions.	Banking transactions of themselves would not breach HR1083’s minimum physical presence requirements.

Again, it is considered unlikely that the HR1083 rules would have assisted the taxpayer as the activities of the Italian subsidiary are not covered by the list of exclusions set out in HR1083.

[79] Paragraph 41.1 of the Commentary on Article 5, inserted following the *Philip Morris* case, states that the determination of the existence of a permanent establishment must be done separately for each company of the group.

HR1083 contains specific provisions concerning agents and so it is appropriate to attempt to apply its provisions to a leading case on agency permanent establishment. In *American Income Life Insurance Company v Canada*[80] the question was whether any of the extensive networks off Canadian agents selling insurance policies for a US company (AIL) could be held to be permanent establishments of AIL. Two main questions were considered: firstly, did the premises of the Canadian agents form a fixed place of business through which the business of AIL was wholly or partly carried on? Secondly, did any of the agents constitute a dependent agent, thus giving rise to a deemed permanent establishment? The main class of agents worked solely on behalf of AIL. Although the agents owned the premises from which they operated, a customer might have thought he was dealing directly with AIL due to signage and telephone listings in the name of AIL although the agents were not permitted to use the AIL name on any leases or to incur any expenditure in AIL's name. Business cards made it clear that they merely acted as agents for AIL. AIL had no employees based at the agents' premises and it met none of the expenses relating to the premises. The court accepted that there was no fixed place of business of AIL as AIL had no access to the agents' premises in its own right. Whether the Canadian agents were dependent agents such that they would constitute a deemed permanent establishment turned primarily on the question of whether the temporary insurance cover notes by the Canadian agents were could be viewed as the Canadian agents binding AIL in contract. The court concluded that the issue of the cover note (conditional receipt) did not bind AIL in contract and therefore the agents did not represent dependent agent deemed permanent establishments.

[80] 2008 TCC 306 Tax Court of Canada, also reported at 11 ITLR 52

Relevant facts and the grounds for establishing nexus given by the court	Likely effect of HR1083 rules
The agents' premises were a fixed place of business Can premises belonging to agents can be a fixed place of business for their principals?	HR1083 contains no provisions concerning a fixed place of business. It does not consider whether a taxpayer has any legal rights to occupy premises owned or leased by another person. The fact that AIL neither owned nor leased real or tangible personal property in Canada means that nexus under HR1083 rules could only arise through the presence of natural persons (in this case employees or offices of AIL) or agents, either of which would need to be carrying out activities outside the exceptions listed in HR1083.
The agents worked solely for AIL The agents promoted AIL's policies within Canada The agents issued temporary cover notes	The Canadian agents would not be considered 'independent contractors' under HR1083 as they worked solely for AIL The agents would appear to fulfil HR1083's definition of a 'physical presence' as they worked exclusively for AIL and were present in Canada for the purpose of establishing and maintaining the Canadian market for AIL's products. However, their activities would fall within the list of excepted activities and would likely be classed as 'solicitation of orders'.

The provisions in HR1083 concerning leasing of real property would not have assisted in this case and point to the over-simplification of the position taken on real property in HR1083. Although the HR1083 rules would appear to be of help when considering the activities of the agents, the need for clarification of the term 'solicitation of orders' is highlighted.

Conclusions

The continued attempts to introduce legislation at the federal level to partially codify the standard for nexus for the purposes of net income taxes in the US at state level provide a contrast with the lack of any such activity on a multilateral basis in the rest of the world. Even to the extent that the OECD Model Convention might be seen as providing a unifying international standard for nexus, the introduction in the Commentary of provision for a services permanent establishment which differs from the services permanent establishment provisions in the UN Model underlines the lack of coherence at international level. Whilst it is perhaps not so surprising that individual nation states have continued to rely on bilateral agreements as to nexus within their double tax treaties, it is surprising that there have been no efforts to harmonise nexus within free trade blocs, such as the EFTA. [81] Thorny issues of the threat to tax sovereignty are often cited[82] despite the fact that questions of sovereignty are often subordinated to the advantages of free trade.

HR1083 may be viewed as an unsatisfactory product of unsatisfactory case law, the effects of which it seeks to limit. That case law is built upon notions that certain activities ought not to constitute nexus. HR1083 seeks to rectify anomalies and perceived injustices which have accumulated by use of the judicial approach to nexus at state level. A major problem is that the cases have been decided by

[81] European Free Trade Area: the European Union countries Norway, Liechtenstein and Iceland.
[82] See, for example, Panayi (fn 19 above) for a thorough exploration of the obstacles to harmonisation of direct taxation within the EC

reference to judicial interpretations of the US Constitution which may be considered questionable.

By the time the OECD Model Convention emerged in the 1960s, the fundamental concepts of nexus for state tax purposes were already established. The extent to which the League of Nations was influenced by the US state tax practices regarding nexus when drafting the Model Convention is unclear.[83] What we do know is that at the time the permanent establishment threshold was agreed upon, most of the countries party to its development had already entered into bilateral treaties and desired an international standard which conformed to their adopted practices. HR1083 is flawed but the permanent establishment concept adopted in the Model Tax Conventions is also flawed in that it, too, is a reflection of practices extant at its birth rather than a pure theoretical formulation. HR1083 at least has the merit of being a response to business practices of the 21st century rather than to those of the early 20th century.

Art 5 of the OECD Model Convention defines a permanent establishment in both positive and negative ways by setting out guidelines as to what would and what would not be regarded as a permanent establishment. HR1083 simply adopts a list of exclusions from nexus without trying to identify positively situations in which

[83] See, for instance, League of Nations document C.37.M.37.1946.II.A: *Fiscal Committee – Report on the Work of the Tenth Session of the Committee held in London from March 20th to March 26th, 1946. and* League of Nations Document C.2.M.1945.II.A *Fiscal Committee: Model Bilateral Conventions for the Prevention of International Double Taxation and Fiscal Evasion, Second Regional Tax Conference, Mexico, D.F., July 1943.* Geneva. 1945

nexus would exist. The lists provided in the Willis Report[84] are no substitute for proper federal intervention to fully codify nexus for US state tax purposes. A major criticism of HR1083 is that it is couched in purely negative terms, attempting to define what would not be considered sufficient nexus. It is only partial codification. HR1083 is also deficient in that it fails to deal with economic nexus arguments which arose in *Geoffrey* and the other cases concerning intangibles. Rather than providing a federal level comprehensive definition of nexus for state tax purposes, it seeks to rest on top of and, where necessary, to override, certain aspects of each state's statutory and judicial code on nexus. It is a clumsy mechanism. HR1083 fails to align state taxation with international standards by encouraging the states to implement withholding taxes as a means of taxing income from intangibles. This would surely be simpler than the states developing nexus standards based on such imprecise concepts as 'substantial economic presence' or 'exploiting the market'. Because of the absence of state withholding taxes, the arguments as to nexus which were heard in *Geoffrey, Lanco* and scores of other state tax cases as to the question of whether the earning of royalties in a state gives rise to economic nexus are largely superfluous at the international level. In bilateral double tax treaties, contracting countries will either decide to cede taxing rights over intangibles wholly to the country of residence of the beneficial owner or to permit a withholding tax.

On the positive side, many international tax disputes concerning the existence or not of a permanent establishment do involve situations in which a foreign entity

[84] See fn58 above

has a presence in the other country for a relatively short time and some minimum limits such as those proposed in HR1083 may increase certainty for companies.

Theoretically, Congress has the power to enact HR1083, although whether it will choose to use that power remains to be seen. The continuing failure of Congress to impose uniform nexus rules on the individual states would suggest that the likelihood of independent countries reaching agreement on the point is remote. However, until a bill dealing with nexus for state net income taxes is developed which contains proposals which include concepts aimed at positively defining nexus as well as setting out exclusions, which incorporates some of the tried and tested concepts used internationally and, in various guises, in individual state tax codes, such as the 'fixed place of business', it seems unlikely that Congress will act. HR 1083 may be viewed as a uniform patch to be applied to the varying nexus rules of each state, whereas what is really needed is a truly level playing field; a common code for nexus for the purposes for taxes on net business profits imposed by Congress on all the states.

As has been demonstrated in the attempt to apply the rules of HR1083 to a selection of cases on nexus at international level, HR1083 would have been of very limited assistance in increasing certainty for multinational enterprises. The HR1083 approach is aimed at eliminating nexus caused by a brief and impermanent presence in another state or by the presence of intangible assets. The 'lock-in' effect observed in international tax dealings between countries which preserves the status quo probably dictates that any internationally accepted set of nexus rules be based far more closely on OECD and UN norms than on any novel approach. Also, It is considered unlikely that a ‘on size fits all’ approach would be acceptable to developing countries.[85]

The risk of a permanent establishment being unexpectedly asserted by a host country might be reduced by an internationally accepted definition. However, it would be naïve to think that such a definition would ever be interpreted in a uniform manner. The proposals contained in HR1083 are imperfect even in the context of US state taxation. The activity exclusions and the minimum physical presence requirements might be useful if they are further defined so that they are capable of being interpreted objectively. Perhaps the principal lesson to be learned from the developments at US state tax level are that a greater degree of uniformity and objectivity in the determination of the existence of a permanent establishment is difficult to achieve but worth striving for.

[85] Where trading relations between a country and the rest of the world are largely asymmetric in favour of the treaty partner, that country is likely to insist on nexus standards which are more inclusive than would be acceptable to a country with a neutral import/export ratio of capital.