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Are There Any Tax Havens in Electronic Commerce?

*Michelle L. Prettie*¹

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Introduction

Entertainment division of Tax and Legal Services. The author wishes to thank Marc Randazza.

“The digital transaction poses a variation of the old philosophical conundrum: if a tree falls in the forest and no one hears it does it make a sound? In the electronic commerce context, the issue might be posed as follows: if all [] value is created in state R, but all the customers that determine value are in state C, where is the income generated?”² The ability of a state to claim its share of income from an enterprise engaged in e-commerce depends upon its ability to establish that the entity has a sufficient presence in the state to justify the exercise of taxing authority. Under most tax treaties this nexus is defined as “permanent establishment,” or fixed place of business. In the absence of a treaty, however, the less liberal “taxable presence” standard applies.

E-commerce sales do not require a fixed place of business in foreign countries since consumers can order goods by accessing the seller’s website over the Internet. As such, e-commerce permits a foreign company to engage in extensive transactions with U.S. customers without entering the United States. Although such a company is clearly engaged in a trade or business, questions will arise as to whether he is engaged in a trade or business *in the United States*. One of the main elements of any e-commerce

² Richard L. Doernberg, *Electronic Commerce and International Tax Sharing* (Mar. 30, 1998), Tax Analysts, available at <http://www.tax.org/ritp.nsf?OpenDatabase&Start=1&Count=300&Expand=1>. See also O.P. Vaish, *Base Paper for 5th Annual Oration on Taxation - 2000 at the Institute of Chartered Accountants of Sri Lanka*, ISLAND MIDWEEK REVIEW, Nov. 22, 2000, (finding humor in international tax issues in E-commerce and stating “A famous cartoon had two dogs sitting in front of a computer. On the Internet, ran the caption ‘nobody knows you’re a dog.’ Such anonymity poses problems for taxmen.”).

business is the Web server and where it is located - even if it is operated from another country.

The scope of this paper is limited to whether a Web server located in the United States “owned” by a foreign tax haven company will cause income tax liability in the United States when there are no applicable treaties. Does the existence of a computer server in a foreign jurisdiction constitute taxable presence? Part One discusses the current Internal Revenue Code provisions applicable to the taxation of foreign companies and related cases. Part Two discusses possible guidance for taxation of these foreign companies engaging in e-commerce through the use of a server located in the United States and international tax planning options. Part Two also discusses the approaches of other tax authorities on whether a server constitutes a taxable presence.

Part One – Current Internal Revenue Code Provisions

Under Internal Revenue Code §882(a)(1), a foreign corporation engaged in a trade or business within the United States is taxed at graduated rates only on income effectively connected with the conduct of a trade or business within the United States.³ A corporation is a domestic corporation if created or organized in the United States, organized under the laws of any state, or organized under the laws of the United States.⁴ Thus, a foreign

³ I.R.C. 882 (2000) (allowing foreign corporations engaged in a trade or business within the United States to be taxed at the same graduated rates that United States corporations are taxed at if a foreign corporation's income is effectively connected with a trade or business within the United States and allowing foreign corporations to deduct expenses against their effectively connected income).

⁴ I.R.C. 7701(a)(4) (2001); Treas. Reg. § 301.7701-1(d) (as amended in 1996).

corporation is a corporation that is not created or organized under federal or state law. However, the question remains whether an entity is a corporation in the first instance. Corporations include "associations, joint-stock companies, and insurance companies."⁵ Certain domestic and foreign business entities are automatically characterized as corporations and known as "per se" corporations.⁶ A business entity that is not a "per se" corporation can elect its classification for federal tax purposes.⁷ If an entity fails to make an election, the regulations contain certain default provisions that are effective depending on the liability of an entity's members.⁸

"Effectively Connected"

A foreign corporation engaged in U.S. trade or business during the taxable year is taxed on a net basis on its taxable income which is effectively connected with the conduct of that trade or business.⁹ "All income, gain, or loss from sources within the

⁵ I.R.C. 7701(a)(3) (2001).

⁶ Treas. Reg. § 301.7701-2(b)(1)-(8) (as amended in 1999) (containing a list of domestic and foreign business entities that are automatically treated as a corporation and no further election is necessary).

⁷ Treas. Reg. § 301.7701-3(a) (as amended in 1999); Joni L. Walser & Robert E. Culbertson, *Encore Une Fois: Check-the-Box on the International Stage*, 15 TAX NOTES INT'L 53, 54 (1997) (stating that "counting the corporate characteristic angels dancing on classification pinheads was a nearly meaningless exercise that caused increasing frustration among taxpayers and within the government" was what led to the check-the-box regulations).

⁸ Treas. Reg. § 301.7701-3(b) (as amended in 1999).

⁹ I.R.C. 882(a)(2) (2001); I.R.C. 882(c) (2001).

United States shall be treated as effectively connected with the conduct of a trade or business within the United States.”¹⁰

United States Trade or Business

Although the term “trade or business” is not defined in the Internal Revenue Code,¹¹ the Code refers to profit-seeking activities.¹² The concept was developed in the context of conventional types of commerce conducted through identifiable physical locations. Whether a foreign corporation is engaged in U.S. trade or business depends on the facts and circumstances of each particular case.¹³ The determination is left, therefore, “primarily to the legacy of interpretation of the concept in the context of other provisions of the Code and a modest accumulation

¹⁰ I.R.C. 864(c)(3) (2001). Generally, one should first decide whether the foreign company was engaged in a trade or business within the United States. If so, one should then decide the character and source of each item of the foreign company’s income and whether each such item was effectively connected. The scope of the definition for effectively connected covers all the income and gain on sales of inventory and other property held for sale to customers in the ordinary course of business.

¹¹ *But see* I.R.C. 864(b) (2001) (providing statutory guidance for foreign corporations relating to the performance of personal services and trading in securities and commodities).

¹² *See generally* *European Naval Stores Co., S.A. v. Commissioner*, 11 T.C. 127 (1948) (addressing whether the foreign corporation taxpayer was “engaged in a trade or business within the United States” within the meaning of section 231(b) of the 1939 Code, as amended).

¹³ *Treas. Reg. § 1.864-2(e)* (as amended in 1975); *Rev. Rul. 88-3*, 1988-1 C.B. 268 (holding due to the highly factual nature of the inquiry, such a determination is not ordinarily made in an advance ruling); *Continental Trading, Inc. v. Commissioner*, 265 F.2d 40 (9th Cir. 1959) (applying facts and circumstances test).

of judicial decisions and rulings interpreting the term in the international context.”¹⁴ Generally, a U.S. trade or business exists if the activities are “considerable, continuous, and regular.”¹⁵ Isolated or sporadic transactions should not constitute U.S. trade or business.¹⁶ Personal services performed within the United States are included.¹⁷ Therefore, “being engaged in a trade or business *in the United States* is a threshold requirement for the taxation of active business income earned by foreign persons.”¹⁸

“In the United States”

The straightforward analysis involved in determining whether a foreign entity is engaged in a trade or business stands in marked contrast to the question of whether it is so engaged “in the United States.” In *Piedras Negras Broadcasting Co. v.*

¹⁴ CHARLES GUSTAFSON ET AL., TAXATION OF INTERNATIONAL TRANSACTIONS 113 (1997).

¹⁵ See *Pinchot v. Commissioner*, 113 F.2d 718 (2d Cir. 1940).

¹⁶ See BORIS BITTKER & LAWRENCE LOKKEN, FUNDAMENTALS OF INTERNATIONAL TAXATION ¶ 66.3.2 (stating “[i]n effect, the U.S. activities must be judged in isolation, a task straining the imagination if the activities would not have been undertaken absent the foreign business to which they are subservient.”); *Continental Trading Inc.*, 265 F.2d at 45 (9th Cir. 1959) (after taking into account the company’s activities as a whole, the U.S. sales were “casual or incidental transactions” and as such did not constitute a trade or business); *CIR v. Spermacet Whaling & Shipping Co.*, 281 F.2d 646 (6th Cir. 1960) (taxpayer conducting whaling expedition on high seas and selling sperm oil for resale to U.S. refiner not engaged in U.S. business, despite close financial links).

¹⁷ I.R.C. 864(b) (2001).

¹⁸ United States Department of the Treasury, Office of Tax Policy, *Selected Policy Implications of Global Electronic Commerce* (Nov. 1996) ¶ 7.2.1, available at <http://www.ustreas.gov/taxpolicy/library/internet.pdf>.

Commissioner, at question was whether the taxpayer was conducting a trade or business in the United States.¹⁹ The case involved a foreign Mexican corporation that operated a commercial radio station where about ninety-five percent of the income was from American advertisers, and about ninety percent of the listener responses to the advertisers came from the United States.²⁰ The taxpayer had no physical presence in the United States; the necessary plant and equipment for broadcasting the various programs put on the air were located in Mexico.²¹ The Court held that a foreign person not physically present in the United States, who merely solicits orders from within the United States only through advertising and then sends tangible goods to the United States in satisfaction of the orders, is unlikely to be engaged in a trade or business in the United States even though such a person is clearly engaged in a trade or business.²² The Court held that physical presence was lacking because the source of the income was the act of transmission.²³

United States v. Balanovski also involved the question of whether the taxpayer was conducting a trade or business in the United States.²⁴ The taxpayer was an Argentine citizen who came to the United States to obtain offers for the sale of trucks and other equipment.²⁵ Upon receiving the bids, he would submit them at

¹⁹ *Piedras Negras Broadcasting Co. v. United States*, 43 B.T.A. 297 (1941), *aff'd*, 127 F.2d 260 (5th Cir. 1942).

²⁰ *Piedras*, 43 B.T.A. at 303.

²¹ *Id.* at 308.

²² *Id.*

²³ *See Piedras*, 127 F.2d at 261.

²⁴ *United States v. Balanovski*, 236 F.2d 298 (2d Cir. 1956), *cert. denied*, 352 U.S. 968, *reh'g denied*, 352 U.S. 1019 (1957).

²⁵ *Id.* at 300.

markup to the Argentine government.²⁶ He was in the United States soliciting orders, inspecting merchandise, making purchases and completing sales.²⁷ While engaging in these “numerous transactions....[h]e was obviously making important business decisions.”²⁸ The level of the taxpayer’s activities convinced the Court that the taxpayer was engaged in a trade or business and that the trade or business was conducted in the United States rather than in Argentina.

U.S. Trade or Business by Imputation

A foreign company who is not directly engaged in U.S. trade or business nevertheless may be deemed to be engaged in U.S. trade or business as the result of the activities of an agent. The determination will depend upon the functions and activities performed by the agent in the United States on behalf of the otherwise absent foreign person. “The cases hold that profit-oriented activities in the United States, whether carried on by the taxpayer directly or through agents, are a trade or business if they are regular, substantial, and continuous.”²⁹

In *Lewenhaupt v. Commissioner*, the taxpayer, a Swedish resident, was the owner of U.S. real property managed by a U.S. agent.³⁰ The agent was given broad general powers of attorney to buy and sell real property, execute leases, rent properties, collect

²⁶ See *id.*

²⁷ *Id.* at 303.

²⁸ *Id.*

²⁹ BITTKER & LOKKEN, *supra* note 16.

³⁰ *Lewenhaupt v. Commissioner*, 20 T.C. 151, 153 (1953), *aff’d*, 221 F.2d 227 (9th Cir. 1955) (per curiam).

rents, pay taxes and mortgage interest, and arrange for insurance.³¹ These activities were “beyond the scope of mere ownership of real property” and were “considerable, continuous, and regular.”³²

In *InverWorld, Inc. v. CIR*, a Cayman Islands company was engaged in providing investment management and financial services through the office of its United States subsidiary.³³ The court found the subsidiary to be acting as the taxpayer’s agent. Because substantially all of the operations of the company were carried on in Texas, the court found the taxpayer’s operation to constitute U.S. trade or business. Consequently, the company was found to be taxable in the United States on all its services income.

Impact of Tax Treaties - Permanent Establishment Concept

The provisions of the Code “shall be applied to any taxpayer with due regard to any treaty obligation of the United States which applies to such taxpayer.”³⁴ An income tax treaty is an agreement between two countries composed of “a set of mutual adjustments and concessions between the tax laws and treasuries” of the countries.³⁵ The primary reasons the United States enters into treaties with foreign countries are to prevent double taxation of income from international transactions and to reduce tax

³¹ *Id.* at 154.

³² *Id.* at 163.

³³ *InverWorld, Inc. v. CIR*, 1996 Tax Ct. Memo LEXIS 291, at *12 (1996), *reconsideration denied*, 73 T.C.M. (CCH) 2777 (1997).

³⁴ I.R.C. 894(a)(1) (2001).

³⁵ JOSEPH ISENBERGH, *INTERNATIONAL TAXATION: U.S. TAXATION OF FOREIGN PERSONS AND FOREIGN INCOME* ¶ 55.1 (2d ed. Supp. 1997).

evasion. Currently, the United States has bilateral income tax treaties with more than fifty countries.³⁶

“One of the most important concepts in tax treaties is that of permanent establishment,”³⁷ a different and generally higher threshold for a basis of taxation. Treaties usually bar the United States from taxing the business profits of a foreign corporation unless the corporation has a permanent establishment in the United States; if the corporation has a permanent establishment, only profits attributable to the permanent establishment may be taxed by the United States.³⁸ A permanent establishment is a fixed place of business through which the business of an enterprise is wholly or partly carried on, although it can also arise by imputation from the

³⁶ Internal Revenue Service, *US Tax Treaties* (IRS Tax Publication) (last revised April 2001), available at

http://www.irs.ustreas.gov/prod/forms_pubs/pubs/p901toc.htm (listing treaties with the following fifty-two countries: Australia, Austria, Barbados, Belgium, Canada, China, Commonwealth of Independent States, Cyprus, Czech Republic, Denmark, Egypt, Estonia, Finland, France, Germany, Greece, Hungary, Iceland, India, Indonesia, Ireland, Israel, Italy, Jamaica, Japan, Kazakhstan, Republic of Korea, Latvia, Lithuania, Luxembourg, Mexico, Morocco, Netherlands, New Zealand, Norway, Pakistan, Philippines, Poland, Portugal, Romania, Russia, Slovak Republic, South Africa, Spain, Sweden, Switzerland, Thailand, Trinidad and Tobago, Tunisia, Turkey, United Kingdom and Venezuela).

³⁷ United States Department of the Treasury, Office of Tax Policy, *supra* note 18, at ¶ 6.

³⁸ BITTKER & LOKKEN, *supra* note 16, at ¶ 65-14. *But see* I.R.C. 894(b) (2001) (stating a foreign corporation shall be deemed not to have a permanent establishment in the United States at any time during the taxable year in regards to income which is not effectively connected with the conduct of a trade or business within the United States).

activities of an agent.³⁹ “[I]t has come to be accepted in international fiscal matters that until an enterprise of one State sets up a permanent establishment in another State it should not properly be regarded as participating in the economic life of that other State to such an extent that it comes within the jurisdiction of that other State’s taxing rights.”⁴⁰ A permanent establishment may be shown by the presence of an office, branch, factory, and use of dependent agents.⁴¹ It cannot be shown solely by maintaining a fixed place of business solely to carry on preparatory or auxiliary services.⁴² Thus, traditional mail order sales from the United States to foreign countries do not generate foreign income tax liabilities because these sales do not require a physical presence within the source country. Some measure of geographical and temporal permanence is required. The issue is whether the taxpayer has the premises “at its constant disposal.”⁴³

No Tax Treaty

When the United States does not have a tax treaty with a foreign country, the permanent establishment concept is replaced by the domestic law concept of “engaged in the conduct of a U.S. trade or business.”⁴⁴ A foreign corporation that is not entitled to

³⁹ United States Department of the Treasury, United States Model Income Tax Convention of September 20, 1996, art. 5, ¶¶ 1 and 5, *available at* <http://www.ustreas.gov/taxpolicy/t0txmod1.html> (text updated Oct. 21, 1996).

⁴⁰ OECD, *Model Tax Convention on Income and Capital*, OECD Committee on Fiscal Affairs (1995), commentary to art. 7, at ¶ 3.

⁴¹ See United States Department of the Treasury, *supra* note 39.

⁴² *Id.* at art. 5, ¶ 4.

⁴³ OECD, *supra* note 40, commentary to art. 5, ¶ 4.

⁴⁴ I.R.C. 882(a)(1) (2001).

treaty benefits will be taxed at the graduated United States tax rate on all net income that is “effectively connected” with its U.S. trade or business.⁴⁵ Between the United States and a tax haven country, there may be no applicable treaties.⁴⁶ Tax havens and low-tax jurisdictions typically lack tax treaty networks and cannot provide important treaty benefits, such as reduced withholding tax rates and competent authority relief.⁴⁷

While not directly relevant in non-treaty situations, the analysis of the effect a computer server has on a company’s permanent establishment may also provide guidance on potential taxability when there is no tax treaty. Exploiting the difference between treaty and non-treaty situations shows the following: appreciation for the difficulties in attaching the concepts of

⁴⁵ *Id.*

⁴⁶ OECD, *Progress in Identifying and Eliminating Harmful Tax Practices* (June 26, 2000), available at <http://www.oecd.org/media/release/nw00-66a.htm> (maintaining the following blacklist of tax haven countries and territories: Andorra, Anguilla, Antigua and Barbuda, Aruba, Commonwealth of the Bahamas, Bahrain, Barbados, Belize, British Virgin Islands, Cook Islands, The Commonwealth of Dominica, Gibraltar, Grenada, Guernsey/Sark/Alderney, Isle of Man, Jersey, Liberia, the Principality of Liechtenstein, the Republic of the Maldives, the Republic of the Marshall Islands, the Principality of Monaco, Montserrat, the Republic of Nauru, Netherlands Antilles, Niue, Panama, Samoa, the Republic of the Seychelles, St. Lucia, the Federation of St. Christopher & Nevis, St. Vincent and the Grenadines, Tonga, Turks & Caicos, U.S. Virgin Islands, and the Republic of Vanuatu). OECD also provides standards for low-tax jurisdictions hoping to avoid the blacklist by adopting international tax standards for transparency, exchange of information and fair tax competition.

⁴⁷ Linda Ng, *News Analysis: Singapore Offers Tax Incentives and Advantages to E-Businesses* (June 22, 2000), Tax Analysts, available at <http://www.tax.org/ritp.nsf/2e553e534ac6bd2c852567320075febe/035b46ffeb9f683d852569ff00706ea2> (citing Singapore as an advantageous location over tax havens and low-tax jurisdictions for E-businesses).

permanent establishment and taxable presence to computer servers; the necessity for one concept; and the thresholds for identifying when computer servers would constitute a taxable presence.

Part Two – Possible Guidance

Overview

A crucial aspect in determining when a source country can apply its income tax to a cross-border transaction lies in determining whether a taxable presence exists within that source country. Would the existence of a computer server located in a foreign jurisdiction elicit such a presence? A preliminary consideration of the technical aspects of computer servers is necessary prior to considering the application of current tax principles to electronic commerce. The current “trade or business within the United States” criterion for a tax nexus is ineffective when it comes to e-commerce taxation. The applicable Internal Revenue Code provisions and previous cases mentioned above relating to these concepts were developed in the context of conventional types of commerce conducted through identifiable physical locations. However, electronic commerce, from a certain perspective, “doesn’t seem to occur in any physical location but instead takes place in the nebulous world of ‘cyberspace.’”⁴⁸ The Internet Tax Freedom Act provides some protection from e-commerce taxation while allowing for the necessary time to address this situation. In the meantime, the United States Treasury

⁴⁸ United States Department of the Treasury, Office of Tax Policy, *supra* note 18, at ¶ 7.2.3.1.

Department and the Organisation for Economic Co-operation and Development provide some guidance.

There are international tax planning options available to taxpayers regarding taxable presence. The tax authorities of some states and foreign countries have already indicated whether servers may constitute a taxable presence, "thus potentially triggering double taxation as the U.S. and foreign tax authorities squabble over who has the right to tax the profits associated with the e-commerce sale."⁴⁹

Computer Servers

A computer server is the computer that stores the pages of a website.⁵⁰ Any computer can be turned into a Web server by installing server software and connecting the machine to the Internet.⁵¹ A fully automated Web server can potentially perform many functions through its software programs, including: product storage, product display, sales solicitation, credit verification,

⁴⁹ Arthur Cockfield, *Tax Compliance Issues for U.S. Companies with International Electronic Commerce Transactions* (Dec. 22, 1999), Tax Analysts, available at

<http://www.tax.org/ritp.nsf/2e553e534ac6bd2c852567320075febe/1d600b7e404aa64d852569ff006ee640>.

⁵⁰ Howard E. Abrams and Richard L. Doernberg, *How Electronic Commerce Works* (May 12, 1997), Tax Analysts, available at

<http://www.tax.org/ritp.nsf/2e553e534ac6bd2c852567320075febe/7fa06eb86a46ef1985256732007a3698> (focusing on "those technological aspects that are relevant to demystifying the technology that makes electronic commerce work" to apply existing tax principles intelligently to electronic commerce).

⁵¹ Webopedia Online Dictionary, Definition of "Web server," at http://webopedia.internet.com/TERM/W/Web_server.html (last modified May 19, 1998).

contract conclusion, payment processing, transmission of digitized products online, product delivery, data collection and third party advertising.⁵²

Mirror servers utilize a backup server that duplicates all the processes and transactions of the primary server.⁵³ They are effective for achieving fault tolerance should the primary server fail.⁵⁴ The use by an offshore company of a mirror server located outside the United States may make international sales difficult or impossible for the United States to reach for tax purposes. "Indeed, if a buyer cannot tell where the seller's server is located, this may prevent the tax authorities from effectively auditing international sales activities."⁵⁵

While users are indifferent to the location of computer servers, the server's location is not without relevancy. Although webpages can reside anywhere, the location of the server greatly affects cost and performance. To ensure that pages are viewed at the optimal speed and at the minimal housing cost, servers can be located in a high bandwidth location, such as in the United States.⁵⁶ Bandwidth is the rate at which data is -- or can be -- sent

⁵² Bradley A. Smith, *International Taxation of Electronic Commerce – Outline*, at <http://www.intltaxlaw.com/e-commerce/OUTLINE/ITEC.HTM> (last visited October 21, 2001).

⁵³ Lycos Tech Glossary, Definition of "mirror site" at http://webopedia.lycos.com/TERM/m/mirror_site.html (last visited Apr. 21, 2001).

⁵⁴ *Id.*

⁵⁵ International Law Systems, *E-Commerce and Internet Trading, E-commerce Offshore*, at <http://www.intlawsys.com/> (visited October 21, 2001).

⁵⁶ *Id.*

across a particular connection or pathway.⁵⁷ Bandwidth issues are less of a problem in the United States. For example, by placing a computer server in the United States, rather than Jersey, one eliminates problems of restricted bandwidth.⁵⁸ Furthermore, the United States is an attractive choice for foreign corporations to locate their servers because the communication paths are fast and few, the Internet “backbone” is located here, and computer and communications costs are the lowest in the world.⁵⁹

In contrast, this efficiency is lacking in tax haven countries. “At present, cable connections do not support efficient operation of such remote servers. However, satellite transmissions, the next advancement, have this capability.”⁶⁰

Internet Tax Freedom Act

In October of 1998, quite aware of the revenue potential of the Internet, Congress took the initiative to temporarily prevent potential tax problems by approving the Internet Tax Freedom Act as part of the 1998 Omnibus Consolidated Appropriations Bill. The Act establishes a three-year moratorium, originally expiring on October 21, 2001, during which states and local governments may not impose, assess, collect or attempt to collect discriminatory

⁵⁷ Creative Technology Solutions, Glossary of Technical Terms: Definition of “Bandwidth”, at <http://www.cts-net.com/glossary.htm> (last revised Nov. 1, 1997).

⁵⁸ International Law Systems, *supra* note 55.

⁵⁹ Infothai CM Co., *The Overwhelming Advantages of a USA-based Web Server*, at <http://www.infothai.com/infothai/whyusa.htm> (last updated Apr. 23, 2001). Infothai CM provides host services through a United States computer server.

⁶⁰ PriceWaterhouseCoopers, *E-Commerce is Bending Cross-Border Tax Rules* (Mar. 15, 2000) (International Tax Bulletin), at <http://www.taxnews.com/tnn/tnnpubs.nsf/International>.

taxes on electronic commerce.⁶¹ A tax is considered discriminatory if it includes the use of a computer server by a remote seller as a factor in determining a remote seller's tax collection obligation.⁶² The Act states that it is the sense of Congress that no federal taxes on the Internet or Internet access should be enacted during the three-year moratorium.⁶³ "In other words, the federal government should not tax the Internet at the same time that it is prohibiting state and local jurisdictions from doing so."⁶⁴

Treasury Report

The United States Treasury Department indicates that it is preferable to apply existing international tax principles to e-commerce.⁶⁵ When attempting to clarify these concepts, the Treasury Department stresses the importance of considering "the extent to which electronic commerce simply represents an extension of current means of doing business, the tax consequences

⁶¹ Tom Squitieri, *Net Tax Ban Survives for Another Five Years*, USA TODAY, May 11, 2000, at A1. The primary debate does not concern whether the moratorium should be extended, but for how long. On November 28, 2001, President Bush extended the ban on state Internet taxation for another two years. See Kelly Wallace, *Bush Extends Tax Break for Online Access* (Nov. 28, 2001), at <http://www.cnn.com/2001/ALLPOLITICS/11/28/bush.internet.tax/>.

⁶² H.R. REP. NO. 105-808 (I) (1998).

⁶³ Omnibus Consolidated and Emergency Supplemental Appropriations Act of 1999, Pub. L. No. 105-277, 112 Stat. 2681, at § 1201.

⁶⁴ Eric J. Sinrod and Jeffrey W. Reyna, *Sweet Land of E-Liberty: The Internet Tax Freedom Act*, J. INTERNET L., Jan. 1999, available at http://www.gcwf.com/articles/journal/jil_jan99_1.html.

⁶⁵ United States Department of the Treasury, Office of Tax Policy, *supra* note 18, at ¶ 1.

of which are understood.”⁶⁶ For example, electronic commerce activities that are equivalent to mere solicitation, without any other U.S. activity, are not appropriately treated as U.S. trade or business activities.⁶⁷ The presence of a Web server may be disregarded when it is only a “communications device, not a true business location.”⁶⁸ The Court in *Piedras*, after considering previous case law whereby solicitation of a sale by a foreign company was held not to be a business transaction in a state, concluded that broadcasting could also not be considered as creating a tax nexus. If *Piedras* stands as a benchmark for e-commerce, identifying the “act of transmission” is crucial. There the “source of the income” was in the “act of transmission” via radio broadcast. Similarly, a computer server’s mere solicitation of sales over the Internet should not create a taxable presence, even if the server is physically located in the United States.

The concept of permanent establishment is not relevant between the United States and a tax-haven country when there is no tax treaty. To avoid having that tax-haven company’s profits taxed by the United States, the evidence must show the absence of a U.S. trade or business. Specifically, the evidence must show that the operations were neither substantial nor “considerable, continuous, and regular.”

The Treasury Department notes the difficulties in determining whether a foreign person is engaged in a trade or

⁶⁶ United States Department of the Treasury, Office of Tax Policy, *supra* note 18, at ¶ 7.2.3.1.

⁶⁷ *Id.* See also *Piedras Negras Broadcasting Co. v. United States*, 43 B.T.A. 297 (1941), *aff’d*, 127 F.2d 260 (5th Cir. 1942).

⁶⁸ David Hardesty, *Can a Web Server Alone Cause Taxability in a Country?* (Feb. 20, 2000), E-Commerce Tax News, at <http://www.ecommercetax.com/doc/022000.htm>.

business in the United States. It has suggested that this is a reason to consider replacing the Internal Revenue Code's "U.S. trade or business" standard with the permanent establishment concept found in U.S. tax treaties and the domestic laws of many of our trading partners.⁶⁹ The rules relating to the determination of a permanent establishment are not directly relevant to tax haven countries. Nonetheless using the same analysis (applying permanent establishment concepts) may also provide guidance on potential taxability where there is no tax treaty.

The Treasury Department suggests that Congress should review the treatment of existing, traditional commercial activities and consider whether any exclusions from permanent establishment should apply.⁷⁰ For example, a server's functions can be analogized to a warehouse for information. Usage of facilities for the purpose of storage, display, or delivery of goods or merchandise does not create a permanent establishment under the definition in tax treaties.⁷¹ Nor do preparatory or auxiliary activities.⁷² Thus, the further a foreign corporation goes beyond advertising, collection of information, and purchasing of goods, the more likely it will be deemed to have a permanent establishment.

A U.S. trade or business or permanent establishment can also arise by imputation from an agent's activities. Sophisticated computer programs can perform functions similar to those performed by agents, thus, increasing the risk that the server will constitute a taxable presence. For example, programs can

⁶⁹ United States Department of the Treasury, Office of Tax Policy, *supra* note 18, at n. 52.

⁷⁰ *Id.* at ¶ 7.2.4.

⁷¹ United States Department of the Treasury, *supra* note 39, at art. 5, ¶ 4(a); OECD, *supra* note 40, at art. 5, ¶ 4(a).

⁷² United States Department of the Treasury, *supra* note 39, at art. 5, ¶ 4(e).

send e-mail to specific target audiences; provide detailed information on digitized products (or services) to customers; provide for an electronic order form; retrieve and transmit the requested product to the customer; process the sale and the collection of electronic cash (or verify credit information if a credit card is used); communicate with the accounting software at head office to provide it with data necessary to record the sale; direct the electronic cash for deposit to the appropriate financial institution; and send e-mail to the customer informing the customer of upgrades or soliciting business for other products.⁷³

Essentially, servers can actively conduct the entire sales transaction from beginning to end. For each additional function a server performs that resembles the work done by traditional dependent agents, the more likely it is that a foreign corporation using such a server will be deemed to be “in the United States.”

Fully automated computer servers may be similar in many ways to agents for tax purposes. The only difference is the lack of human operators. Just as an agent’s substantial activities in the United States would be considered “U.S. trade or business,” so should a server’s activities when “considerable, continuous, and regular” under the Internal Revenue Code.

The Treasury Department suggests that computer servers should not be taken into account for purposes of determining

⁷³ Pierre J. Bourgeois and Luc Blanchette, *Income-taxes.ca.com: The Internet, Electronic Commerce and Taxes -- Some Reflections: Part 2*, 45 CAN. TAX J. 1379, 1391 (1997).

whether a U.S. trade or business exists. Specifically, it states that “[i]t is *possible* that such a server, or similar equipment, is not a sufficiently significant element” in the determination.⁷⁴ The Treasury Department is validly concerned that should the existence of a U.S. based server be taken into account, foreign persons will simply utilize servers located outside the United States.⁷⁵

Organisation for Economic Cooperation and Development

The Organisation for Economic Co-operation and Development (OECD) has published a model treaty which serves as the basis for most of the tax treaties around the world.⁷⁶ Although the United States has not used it and has expressed disagreement with some of its articles, it nonetheless has greatly influenced tax treaty policy in the United States; the language in many of the articles in U.S. tax treaties is very similar to language in the OECD Model Tax Convention. The OECD periodically issues commentaries related to the Model Tax Convention for proper interpretation of its articles. The 1999 commentaries on Article 5 relating to permanent establishment discussed the possibility that gaming and vending machines may result in a permanent establishment in the country where they are located.⁷⁷

⁷⁴ United States Department of the Treasury, Office of Tax Policy, *supra* note 18, at ¶ 7.2.3.1 (emphasis added).

⁷⁵ *Id.*

⁷⁶ OECD, *Articles of the OECD Model Tax Convention on Income and on Capital* (Apr. 29, 2000), available at http://www.oecd.org/daf/fa/material/mat_07.htm#material_Model_articles.

⁷⁷ Hardesty, *supra* note 68.

Some commentators correctly suggested that this reference might be expanded to include a web server.⁷⁸

The OECD has issued a draft of recommendations with respect to whether a Web server in a particular jurisdiction will cause a foreign company to be liable for tax purposes in that country. The OECD is an organization composed of the world's most developed countries; the United States has treaties in force with all of these countries.⁷⁹ Consequently, the draft addresses treaty countries only. It does not address the issue of whether a Web server in a country causes a tax haven country company to be subject to tax where there is no tax treaty.

A server is tangible property since it takes the form of equipment and has a physical location. Thus, it may constitute a "fixed place of business" for the enterprise that operates that server.⁸⁰ What is relevant is not the possibility of the server being moved, but whether it is in fact moved. A server must remain in a certain place "for a sufficient period of time" before it will constitute a permanent establishment.⁸¹

⁷⁸ *Id.* (discussing two commentators' oppositions to the OECD proposed rules prior to the more recent December 2000 OECD changes).

⁷⁹ OECD, *What is OECD?*, available at <http://www.oecd.org/about/general/index.htm> (last updated Aug. 2, 2001) (stating membership is limited only by a country's commitment to a market economy and a pluralistic democracy); see also OECD, *Membership*, available at <http://www.oecd.org/about/general/member-countries.htm> (last updated October 1, 2001) (listing member countries).

⁸⁰ OECD, *Clarification on the Application of the Permanent Establishment definition in E-Commerce: Changes to the Commentary on the Model Tax Convention on Article 5* (Dec. 22, 2000), ¶ 42.2, available at http://www.oecd.org/daf/fa/e_com/ec_1_PE_Eng.pdf.

⁸¹ *Id.* at ¶ 42.4.

The elusiveness of taxing income that does not necessarily have a physical nexus is increased by technological capabilities. The OECD notes that a server could be located not only in a building where the enterprise has no other presence, but the website could automatically transfer itself electronically at fixed intervals to new servers in different buildings, cities or countries, and furthermore, mirror sites could be set up to direct customers to different servers depending on the level of traffic at any given time.⁸² Typically, mirror servers would only be routed through as a backup for a matter of minutes or at most hours.⁸³ This is hardly a sufficient period of time to constitute a permanent establishment.

Mere use of a Web server under an agreement whereby the hosting company maintains control will not, by itself, constitute a permanent establishment.⁸⁴ However, if the enterprise carrying on business through a website has the server at its own disposal, (for example, if it owns or leases and operates the server on which the website is stored and used), the place where that server is located could constitute a permanent establishment of the enterprise.⁸⁵

Consequently, within the OECD's draft of recommendations there appears to be a safe harbor for companies wishing to avoid a permanent establishment status. This safe harbor applies when a foreign website is hosted on a computer owned or rented by another entity. Instead of renting a computer, a company "can find a host company that will acquire exactly the type of server the company wants, and maintain the server for the

⁸² OECD, *Electronic Commerce: The Challenges to Tax Authorities and Taxpayers* (1997) at ¶ 97, available at http://www.oecd.org//daf/fa/e_com/turku_e.pdf.

⁸³ International Law Systems, *supra* note 55.

⁸⁴ OECD, *supra* note 80, at ¶ 42.3.

⁸⁵ *Id.*

exclusive use of the company.”⁸⁶ In this way it avoids creating a permanent establishment by virtue of the hosting arrangement. Since servers can be operated successfully from remote locations, the only companies that would have a permanent establishment would be those few that are required to maintain their own facilities.⁸⁷

Electronic commerce operations carried on through computer servers beyond preparatory or auxiliary activities may cause a permanent establishment to exist.⁸⁸ In general, these are activities that are essential, significant and core functions of the business activity.⁸⁹ For example, concluding the contract with the customer and processing payment and delivery (if performed automatically through the server) are typical functions relating to the sale and are not preparatory or auxiliary.⁹⁰ Preparatory or auxiliary activities include providing a communications link, advertising, displaying a catalogue of products, supplying information, relaying information through a mirror server, and gathering data.⁹¹

Again, in agreement with the Treasury Department, the OECD would find activities that go beyond advertising, collection

⁸⁶ David Hardesty, *Web Server in Another Country -- Proposed Rules* (Oct. 20, 1999), E-Commerce Tax News, at <http://www.ecommercetax.com/doc/102099.htm>.

⁸⁷ *Id.*

⁸⁸ OECD, *supra* note 80, at ¶ 42.7.

⁸⁹ *Id.* at ¶¶ 42.8--42.9 (stating what constitutes core functions for a particular enterprise clearly depends on the nature of the business carried on by that enterprise).

⁹⁰ *Id.* at ¶ 42.9 (stating the nature of the activity performed at a given location must be examined in light of the business carried on by that enterprise).

⁹¹ *Id.*

of information, and purchasing of goods to be factors most likely to indicate a foreign corporation has a permanent establishment.

International Tax Planning Options

Server Located Outside the United States

A foreign company's website stored on a server located outside of the U.S. and accessed by customers within the U.S. could be considered similar to an advertisement and solicitation for sales. Therefore, it is not a sufficient enough taxable presence to be deemed to have a trade or business within the U.S. No tax would result from these activities alone. Although clearly engaged in a trade or business, a foreign company's advertising and solicitation activities are not considered to be engaged "in the United States."

Advertising, furnishing of information and other activities that are preliminary or auxiliary in nature are exempt from permanent establishment treatment under article 5, paragraph 4 of the U.S. Model Treaty and the tax treaties into which the United States has entered.⁹² Therefore, a foreign company's website hosted by a server located outside the United States should not constitute a taxable presence.

Server Located Within the United States

The mere use of a server located in the United States to host a website may not create a taxable presence. This is because under article 5, paragraph 4 of the U.S. Model Treaty there are

⁹² GUSTAFSON ET AL., *supra* note 14, at 903.

certain exceptions to the permanent establishment definition. These include collecting information and the storage, display, delivery, or purchase of goods.⁹³

If, however, the Web server has features whereby important business decisions of the enterprise are carried out, a taxable presence may exist. The Web server could be considered as acting within the scope of an agent's authority through which the U.S. trade or business is carried out. Examples include sending e-mail to specific target audiences; processing the sale and the collecting of electronic cash (or verification of credit approval); communicating with the accounting software at head office to provide it with data necessary to record the sale; depositing the sales proceeds; and sending e-mail to the customer informing the customer of upgrades or soliciting business for other products. The closer the server is to performing fully automated activities, the greater the chance that it will constitute a taxable presence.

Guidance to Avoid a Taxable Presence in the United States

To be absolutely certain that a taxable presence will not be created by virtue of a server being located in the United States, the foreign company should place all of its servers outside the United States. Servers should perform as few functions as possible that go beyond preparatory or auxiliary activities like advertising or the collection of information and those that resemble work conducted by dependent agents. Use by the offshore company of a mirror server located outside the United States may make international sales difficult or impossible for the United States to reach for tax purposes. Use of two or more servers, one in the United States

⁹³ *Id.*

acting as a warehouse site which displays the products of a company and a second offshore where the orders are accepted and processed, credit is verified, and acceptance of the contract for the sale of goods or services takes place, would be unlikely to create a taxable presence.⁹⁴ The absence of a treaty would not appear to jeopardize these positions. A United States trade or business definitely exists if the server permits sales to take place on it.

Locating in a Tax Haven Country

Two primary concerns of corporations regarding tax-haven countries are the inadequacy of telecommunications infrastructure and the absence of treaties. However, many e-commerce companies consider locating their Web servers in tax-haven countries in an attempt to avoid taxation. Much of the revenues generated from Internet sales can be moved out of the federal tax system by locating a computer server in a tax have country. Companies attempt to take advantage of these countries by incorporating subsidiaries there and by transferring certain operations to them. The goal is for these subsidiary companies to earn as much profit as possible that is not subject to United States taxation. Here a taxpayer would want to argue for a taxable presence within the tax-haven country, which is in contrast to the above-mentioned goal.

⁹⁴ International Law Systems, *supra* note 55.

*Other Tax Authorities' Approaches**Web Server Does Not Create a Nexus in Virginia*

An out of state taxpayer with no physical presence in Virginia other than its Web server did not create a tax nexus in Virginia.⁹⁵ Physical presence requires the maintenance of an office, warehouse, or place of business or the solicitation of business in Virginia by employees, independent contractors or agents.⁹⁶ However, Virginia's opinion on the nexus effect of a Web server may not be shared by other states; the state's governor is on record as being "staunchly opposed to all forms of Internet Taxation." In addition, Virginia is home of America Online and has been recognized as "one of the more Web-friendly states."⁹⁷

Japan

The issue of whether sales via the Internet could give rise to a permanent establishment is "basically unexplored at present in Japan."⁹⁸ However, "in informal comments, some [Japanese tax

⁹⁵ Va. Ruling of Comm'r, 2000 Va. Tax LEXIS 75 (Apr. 14, 2000). The ruling was requested for a sales and use tax determination, not for federal income tax purposes. The ruling was based in part on Virginia's interpretation of the Internet Tax Freedom Act, under which a tax based on a computer server is discriminatory and not allowed.

⁹⁶ *Id.*

⁹⁷ Hardesty, *Web Server Does Not Create Nexus in Virginia* (July 30, 2000), E-Commerce Tax News, available at <http://www.ecommercetax.com/doc/073000.htm>.

⁹⁸ Dow Famulak et al., Baker and McKenzie, *Taxation of Electronic Commerce: Asia-Pacific*, Tax Analysts, (1999) (stating Japanese authorities have made no

authority] personnel have suggested that the presence of a server in Japan might give rise to a permanent establishment.”⁹⁹ Generally, the personnel “analogize servers to the example given in the OECD guidelines of a vending machine potentially constituting a permanent establishment.”¹⁰⁰ A server is not treated like a vending machine, however, because a server’s location is not tied down to its ability to serve particular customers.

United Kingdom

In the United Kingdom, a server is insufficient by itself to constitute a permanent establishment of a business, regardless of whether the server is owned, rented or otherwise at the disposal of the business.¹⁰¹ When the functions performed at that place are significant as well as an essential or core part of the business activity of the enterprise, the server may cause a permanent establishment to exist.

Australia

Under Australia’s tax treaties, “[a] web site located on a server that is fixed in time and location, and through which business is carried on may constitute a [permanent

formal announcements nor made any amendments to existing law regarding the taxation of electronic commerce).

⁹⁹ *Id.*

¹⁰⁰ *Id.*

¹⁰¹ Press Release, Department of Inland Revenue (United Kingdom), Electronic Commerce: Tax Status of Web Sites and Servers (Apr. 11, 2000), *available at* <http://www.inlandrevenue.gov.uk/e-commerce/ecom15.htm>.

establishment].”¹⁰² Australia recognizes, however, the problems inherent in determining whether a non-resident has an Australian permanent establishment. It is acutely aware the problems may not even arise if the removal of present bandwidth limitations allows all or most of the functions of an Internet business to be located in an offshore web site such as a tax-haven country.¹⁰³ It fears taxpayers choosing tax havens for server locations may result in a net loss of revenue from permanent establishments.¹⁰⁴ “Thus, measures to catch [websites] as [permanent establishments] may only provide revenue benefit in the short term and could force them offshore in the long term.”¹⁰⁵

Singapore

The mere presence of a server in Singapore would not cause a company to have Singapore-source income, since it is simply a communication tool and in itself does not constitute a business presence in Singapore.¹⁰⁶ However, this assumes the “website merely facilitates the conduct of [electronic commerce] and the substantial part of the business activities such as manufacture of products, provision of product information for the

¹⁰² Australian Tax Office, *Tax and the Internet: Discussion Report of the Australian Tax Office Electronic Commerce Project* (Aug. 1997), available at <http://www.intltaxlaw.com/e-commerce/atoecp.pdf>.

¹⁰³ *Id.* at ¶ 7.2.15.

¹⁰⁴ *Id.*

¹⁰⁵ *Id.* at ¶ 7.2.16.

¹⁰⁶ Ajit Prabhu and Chua Eng Khong, *New Guidelines Shed Light on E-commerce* (Nov. 2000), Deloitte Touche Tohmatsu, available at <http://www.tax.deloitte.com/wta/wta1100.pdf> (discussing guidelines published by the Inland Revenue Authority of Singapore on the taxation of E-commerce based on three common business models).

website, completion of obligations and delivery are made from the Company outside Singapore.”¹⁰⁷ The fundamental assumption appears to be a low-level server that merely provides advertising and stores data. Thus, such income would not be considered as sourced in Singapore, and not subject to tax in Singapore.

Conclusion

Electronic commerce threatens to erode the U.S. federal income tax base. If large amounts of tax revenue simply vanish into cyberspace, other revenue sources will have to be found to pay for a continuing level of governmental services.¹⁰⁸ As some commentators have proposed,

[o]ne solution would be to tax more heavily spending with an unavoidable physical presence, namely property. In days gone by, kings used to collect most of their revenue from land taxes. As recently as 1913, 60% of American taxes came from property, against around 10% now. How ironic it would be if the computer age required the post-industrial world to go back to a pre-industrial tax system.¹⁰⁹

It is possible that if the existence of a U.S.-based server is taken into account for trade or business purposes, foreign persons

¹⁰⁷ Inland Revenue Authority of Singapore, Income Tax Guide on E-Commerce (Feb. 23, 2001) at ¶ 7.1.2, *available at* <http://www.iras.gov.sg/ETaxGuides/Pdf/ITECGuideE2.pdf>.

¹⁰⁸ J. Clifton Fleming, Jr., *Electronic Commerce and the State and Federal Tax Bases*, 2000 BYU L. REV. 1 (2000).

¹⁰⁹ *The Tap Runs Dry*, THE ECONOMIST, May 31, 1997, at 21.

will simply utilize servers outside the United States. By forcing computer servers to locate in low-tax jurisdictions, such as tax-haven countries, United States tax revenue diminishes.

Consequently, "[t]he highly mobile nature of Web servers may result in policy determinations that tax laws should be friendly to in-country Web servers operated by foreign companies."¹¹⁰

Until new principles are developed, "[t]axpayers that reside in non-treaty countries still face substantial uncertainty as to whether a server causes taxability in a country."¹¹¹ Under existing principles, taxing rights will be established using the source of the income as the basis. Income is thus allocated to particular countries when a business has a taxable presence there. The threshold for business activities in the United States to constitute a U.S. trade or business (taxable presence) is low.

Until there is a better alternative, there is no reason to depart from the current taxable presence and permanent establishment standards. Foreign companies are taxed on income effectively connected with the conduct of a trade or business in the United States. However, if a treaty is applicable, the foreign company will not be taxed unless it has a permanent establishment in the United States. Clearly the permanent establishment clause of tax treaties provides additional protection against U.S. taxation. While it is not directly relevant in non-treaty situations, the analysis of the effect a computer server has on a company's permanent establishment may also provide guidance on potential taxability when there is no tax treaty. Understanding the differences between treaty (permanent establishment) and non-treaty (taxable presence) situations shows the difficulties

¹¹⁰ Hardesty, *supra* note 86.

¹¹¹ *Id.*

encountered when attaching the respective concepts to computer servers, the necessity for one concept and the thresholds for identifying when computer servers would be subject taxation.

Under either permanent establishment or taxable presence, there will be a U.S. trade or business if the server is fully automated and permits sales to take place on it. In contrast, under either standard there will not be a U.S. trade or business if the server is merely providing solicitations or advertisements. Between these two extremes lies the confusion where "facts and circumstances dictate." The exclusions from the definition of permanent establishment would seem to cover many of the activities capable of being performed by a computer server.

International cooperation is recommended. It is crucial that taxpayers know where the borderlines are and not be put in a position to have a taxable presence in a country without even knowing that they have a business presence in that country. In the midst of the confusion, international tax planning options are available for taxpayers no matter what their preferred strategies regarding taxable presence.

So, if a tree falls in the forest and no one hears it does it make a sound? In the electronic commerce context, income taxation depends upon whether the activities conducted by the computer server rise to a level sufficient to constitute a taxable presence. Consequently, a Web server located in the United States "owned" by a foreign tax haven company may cause income tax liability in the United States when there are no applicable treaties.