

Anne Schäfer

**International Company Taxation in the Era of Information  
and Communication Technologies**

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Anne Schäfer

# **International Company Taxation in the Era of Information and Communication Technologies**

Issues and Options for Reform

With a foreword by Prof. Dr. Dr. h.c. mult. Otto H. Jacobs

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Dedicated to my parents

## Foreword

The increased use of information and communication technologies (ICT) is leading to noticeable changes within the organisational structure of the economy. Geographical distances within companies as well as between companies and their customers can be bridged more easily with the use of ICT. Thus, economic activities are less dependent on time and place. Taking into account the manifold changes in the economic structures, it has to be questioned whether and to what extent the current rules of international company taxation are still applicable in a reasonable way. With regard to this issue, a need for the development of suitable reform approaches covering the whole system of international taxation still existed. The doctoral thesis of Mrs. Schäfer provides a major contribution to fulfill this need.

Mrs. Schäfer has worked out in a very comprehensive way the creation of new organizational structures as well as the resulting implications on tax law and the system of international taxation. Moreover, the existing literature on the subject at hand has been analyzed in a competent way. The special merit of the doctoral thesis of Mrs. Schäfer consists in elaborating reform proposals for international company taxation which cover the different relevant issues of international taxation. More in detail, reform proposals for the definition of a company's residence, the definition of the permanent establishment, the possibilities of profit allocation as well as the methods of avoiding international double taxation are covered by the analysis. Thereby, the interrelation between these issues is taken into account. The reform proposals are methodically well-founded and feasible in practice.

The doctoral thesis of Mrs. Schäfer is a diversified and well-founded work. It fulfills both methodical and tax law requirements and covers complex issues of international company taxation. The doctoral thesis of Mrs. Schäfer constitutes a major contribution to the discussion of the economic and tax implications of information and communication technologies as well as to the methodical development of international company taxation. It is not only of particular importance for international research in this field, but also of special interest for national governments as well as supranational organizations dealing with this issue, such as the OECD or the Commission of the European Communities. I therefore highly recommend the doctoral thesis of Mrs. Schäfer to this audience.

Prof. Dr. Dr. h.c. mult. Otto H. Jacobs

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Anne Schäfer

## Overview of Contents

	<b>Page</b>
1. Introduction	1
1.1. Motivation	1
1.2. Aim of the Thesis and Subject Under Investigation	4
1.3. Approach and Organisation of the Thesis	7
2. Changes to Economic Structures Through ICT	9
2.1. Defining ICT	9
2.2. Theories on the Organisational Structures of Firms	10
2.3. The Impact of ICT on the Main Factors Influencing Doing Business Abroad	14
2.4. ICT-Induced Changes in the Organisational Structures of Companies and Markets	18
2.5. Summary	30
3. Fundamental Concepts of International Taxation	31
3.1. The Tax Framework for International Company Taxation	31
3.2. Jurisdiction to Tax	33
3.3. Allocation of Profits	37
3.4. Methods to Avoid Double Taxation	44
4. International Tax Planning in the Era of ICT	47
4.1. Theory of the International Tax Planning of Companies	47
4.2. The Impact of ICT on International Tax Planning	52
4.3. Implications for the Allocation of the International Tax Base Between Different Jurisdictions	73
4.4. Implications for a Systematic Analysis	77
5. Normative Criteria for Optimal Taxation	78
5.1. Equity	78
5.2. Efficiency and Neutrality	81
5.3. Feasibility	85



6.	Application of International Tax Law to the Changed Organisational Structures	87
6.1.	Taxation in the Residence Country: Localisation of a Company's Residence According to the Place of Management	87
6.2.	Tax Attributes in the Source Country: Defining a Permanent Establishment	95
6.3.	Profit Allocation	113
6.4.	Taxation According to the Source Principle or the Residence Principle	126
7.	Reforming International Taxation	132
7.1.	Reforming the Criteria to Determine a Company's Residence	132
7.2.	A Reform of the Permanent Establishment Definition	141
7.3.	Reforming the Allocation of the Taxable Base	157
7.4.	Source Principle Versus Residence Principle	189
8.	Summary	191

**Table of Contents**

	<b>Page</b>
Overview of Contents	XI
Table of Contents	XIII
List of Figures	XIX
List of Tables	XIX
Abbreviations	XXI
<b>1. Introduction</b>	<b>1</b>
1.1. <i>Motivation</i>	1
1.2. <i>Aim of the Thesis and Subject Under Investigation</i>	4
1.3. <i>Approach and Organisation of the Thesis</i>	7
<b>2. Changes to Economic Structures Through ICT</b>	<b>9</b>
2.1. <i>Defining ICT</i>	9
2.2. <i>Theories on the Organisational Structure of Firms</i>	10
2.3. <i>The Impact of ICT on the Main Factors Influencing Doing Business Abroad</i>	14
2.3.1. <i>The Geographical Location</i>	14
2.3.2. <i>The Choice of the Organisational Form Between Different Firms and Within a Company</i>	15
2.3.3. <i>The Main Factors for the Creation of Value</i>	17
2.4. <i>ICT-Induced Changes in the Organisational Structures of Companies and Markets</i>	18
2.4.1. <i>Subject Under Investigation</i>	18
2.4.2. <i>Extra-Organisational Changes: Digital Markets</i>	19
2.4.3. <i>Intra-Organisational Changes</i>	22
2.4.4. <i>Changes with Regard to the Relations between Different Organisations</i>	26
2.4.5. <i>Typical Patterns of Doing Business with the Advent of ICT</i>	28
2.5. <i>Summary</i>	30
<b>3. Fundamental Concepts of International Taxation</b>	<b>31</b>
3.1. <i>The Tax Framework for International Company Taxation</i>	31
3.2. <i>Jurisdiction to Tax</i>	33

3.2.1. Tax Attributes in the Residence Country	33
3.2.2. Taxation in the Source Country	35
3.3. <i>Allocation of Profits</i>	37
3.3.1. General Overview	37
3.3.2. Methods of Profit Allocation within a Multinational Group	39
3.3.2.1. The Separate Entity Approach and the Arm's Length Principle	39
3.3.2.2. The Consolidation and Apportionment Approach	41
3.3.3. Methods of Profit Allocation to a Permanent Establishment	42
3.3.4. Transfer of Assets	44
3.4. <i>Methods to Avoid Double Taxation</i>	44
<b>4. International Tax Planning in the Era of ICT</b>	<b>47</b>
4.1. <i>Theory of the International Tax Planning of Companies</i>	47
4.1.1. Defining International Tax Planning	47
4.1.2. Minimising the Effective Tax Rate	48
4.2. <i>The Impact of ICT on International Tax Planning</i>	52
4.2.1. Choice of Location and Relocation of Residence	53
4.2.2. Allocating the Tax Base	56
4.2.2.1. Optimising the Allocation of Functions and Risks	56
4.2.2.2. Implementation of an Optimal Transfer Pricing System	60
4.2.3. Planning the Legal Structure of the Organisation	61
4.2.3.1. Optimising the Internal Legal Structure of a Company	61
4.2.3.1.1. Doing Direct Business	61
4.2.3.1.2. Investing in the Form of a Permanent Establishment	62
4.2.3.1.3. Direct Investments in the Form of a Subsidiary	64
4.2.3.1.4. Limitations on Investing Abroad	65
4.2.3.1.5. Comparison of the Investment Alternatives and Location Decisions	68
4.2.3.2. New Forms of Enterprise Co-Operation	70
4.2.4. Summary of the Relevant Changes in International Tax Planning and Derivation of the Main Taxation Issues	71
4.3. <i>Implications for the Allocation of the International Tax Base Between Different Jurisdictions</i>	73
4.3.1. Shift in the Taxable Base from Source Countries to Residence Countries	73
4.3.2. Shift in Tax Revenues Based on Location Factors	75
4.3.3. Summary	76
4.4. <i>Implications for a Systematic Analysis</i>	77

<b>5. Normative Criteria for Optimal Taxation</b>	<b>78</b>
5.1. <i>Equity</i>	78
5.1.1. Taxpayer Equity	78
5.1.2. Inter-Nation Equity	79
5.2. <i>Efficiency and Neutrality</i>	81
5.3. <i>Feasibility</i>	85
<b>6. Application of International Tax Law to the Changed Organisational Structures</b>	<b>87</b>
6.1. <i>Taxation in the Residence Country: Localisation of a Company's Residence According to the Place of Management</i>	87
6.1.1. Identifying the Persons Responsible for Management	88
6.1.2. Determination of the Place of Decision-Making of the Managers	91
6.1.3. Assessment of the Current Tax Rules in Light of the Evaluation Criteria	93
6.1.4. Conclusion	94
6.2. <i>Tax Attributes in the Source Country: Defining a Permanent Establishment</i>	95
6.2.1. The Impact of ICT on the General Attributes of the Permanent Establishment Definition	95
6.2.1.1. The General Attributes of the Permanent Establishment Definition	95
6.2.1.2. The Impact of ICT on the Tests Underlying the Permanent Establishment Definition	98
6.2.2. Internal Organisation	100
6.2.2.1. Organisational and Regional Decentralisation Within a Company	100
6.2.2.1.1. Application of the Current Tax Law	100
6.2.2.1.2. Assessment on the Basis of the Evaluation Criteria	102
6.2.2.2. Telecommuting: Employees Working Distantly from the Company	103
6.2.2.2.1. Application of the Current Tax Law	103
6.2.2.2.1.1. Basic-Rule Permanent Establishment	104
6.2.2.2.1.2. Agent Rule	105
6.2.2.2.2. Assessment on the Basis of the Evaluation Criteria	106
6.2.3. Organisation of Markets	109
6.2.3.1. Doing Business Without a Physical Presence	109
6.2.3.1.1. Application of the Current Tax Law	109
6.2.3.1.2. Evaluation in Light of the Evaluation Criteria	109
6.2.3.2. Alternative Attributes	111
6.2.3.2.1. Application of Current Tax Law	111
6.2.3.2.2. Evaluation in Light of the Evaluation Criteria	111
6.2.4. Conclusion	112

6.3. <i>Profit Allocation</i>	113
6.3.1. Profit Allocation Within Multinational Groups According to the Arm's Length Principle	113
6.3.1.1. Applying the Arm's Length Principle to the Changed Economic Structures	114
6.3.1.1.1. The Theoretical Rationale of the Arm's Length Principle and the Issue of Non-Comparability of Controlled and Uncontrolled Transactions	114
6.3.1.1.2. The Impact of Organisational Changes on Comparability	117
6.3.1.1.3. The Impact of ICT on the Identification of Transactions	118
6.3.1.1.4. The Impact of ICT on Cost-Effectiveness	119
6.3.1.1.5. The Impact of ICT on Profit Shifting	119
6.3.1.1.6. Double Taxation	120
6.3.1.2. Assessment of the Arm's Length Principle in Light of the Evaluation Criteria	120
6.3.2. Profit Attribution to a Permanent Establishment	123
6.3.2.1. Application of the Current Tax Law	123
6.3.2.2. Evaluation in Light of the Evaluation Criteria	124
6.3.3. Conclusion	125
6.4. <i>Taxation According to the Source Principle or the Residence Principle</i>	126
6.4.1. Introduction	126
6.4.2. Discussion of the Two Principles in Light of the Evaluation Criteria	126
6.4.3. Summary	131
<b>7. Reforming International Taxation</b>	<b>132</b>
7.1. <i>Reforming the Criteria to Determine a Company's Residence</i>	132
7.1.1. Refinement of the Place of Management Definition	133
7.1.2. Alternative Criteria	136
7.1.3. A Hierarchy of Tests to Identify a Company's Residence	139
7.1.4. Summary	140
7.2. <i>A Reform of the Permanent Establishment Definition</i>	141
7.2.1. Internal Organisation	141
7.2.1.1. Fragmentation of Business	141
7.2.1.1.1. Elimination of the Threshold Inherent in the Business Activity Test	142
7.2.1.1.2. Preparatory or Auxiliary Activities as the only Exemption Rule	142
7.2.1.1.3. Modifying the Business Connection Test by Adding a Force-of-Attraction Rule	144

7.2.1.1.3.1	Formulation of a Reform Proposal	144
7.2.1.1.3.2	Evaluation in Light of the Evaluation Criteria	145
7.2.1.2.	Telecommuting: Employees Working Distantly from the Company	146
7.2.1.2.1.	Formulation of a Reform Proposal	146
7.2.1.2.2.	Evaluation of the Proposal in Light of the Evaluation Criteria	148
7.2.2.	Organisational Changes of Market Structures	150
7.2.2.1.	Excluding Specific ICT-Related Items from the Permanent Establishment Definition	150
7.2.2.1.1.	Reform Proposal	150
7.2.2.1.2.	Evaluation of the Proposal in Light of the Evaluation Criteria	151
7.2.2.2.	Further Extension of the Source Country's Jurisdiction to Tax	152
7.2.2.2.1.	Introducing a Virtual Permanent Establishment as an Alternative Nexus	152
7.2.2.2.1.1	Reform Proposal	152
7.2.2.2.1.2	Evaluation of the Reform Proposal in Light of the Evaluation Criteria	153
7.2.2.2.2.	Implementing a Withholding Tax According to the Base Erosion Approach	154
7.2.2.2.2.1	Reform Proposal	154
7.2.2.2.2.2	Evaluation in Light of the Evaluation Criteria	155
7.2.3.	Summary of Reforms for the Permanent Establishment Definition	156
7.3.	<i>Reforming the Allocation of the Taxable Base</i>	157
7.3.1.	Transactional Profit Methods	158
7.3.2.	Consolidated Tax Base and Apportionment of Income	160
7.3.2.1.	General Attributes of the Consolidation and Apportionment Approach	160
7.3.2.2.	The Delimitation of the Consolidated Tax Base	164
7.3.2.2.1.	Defining the Consolidated Group	164
7.3.2.2.1.1	Description of the General Approaches	165
7.3.2.2.1.2	Assessment of the Approaches in Light of the Evaluation Criteria	166
7.3.2.2.1.3	Conclusion	168
7.3.2.2.2.	The Tax Base Distinguished from the Apportionable Tax Base	168
7.3.2.3.	The Jurisdiction Entitled to Tax a Part of the Consolidated Tax Base	169
7.3.2.4.	The Factors to be Included in the Formula	171
7.3.2.4.1.	Payroll Factor	172
7.3.2.4.2.	Property Factor	173

## XVIII

7.3.2.4.3. Sales Factor	177
7.3.2.4.4. Summary on the Design of the Formula	180
7.3.2.4.5. Apportionment Based on a Value Added Key	182
7.3.2.4.5.1 Description of the Approach	182
7.3.2.4.5.2 Assessment of the Approach in Light of the Evaluation Criteria	184
7.3.2.4.6. Comparing the Value Added Approach to Formula Apportionment based on Different Factors	185
7.3.3. Comparison Between the Formula Apportionment Approach and the Arm's Length Principle	186
7.4. <i>Source Principle Versus Residence Principle</i>	189
7.4.1. Remedies for Issues Discussed Under the Arm's Length Principle	189
7.4.2. Source-Based Taxation Under a Consolidation and Apportionment Approach	189
<b>8. Summary</b>	<b>191</b>
References	197
Laws, Jurisprudence, Directives and Other Documents	227

**List of Figures**

	<b>Page</b>	
Figure 1.1	Motivation of the Thesis	3
Figure 1.2	Aim of the Thesis	6
Figure 1.3	Approach of the Thesis	8
Figure 2.1	ICT-Induced Changes in the Factors Influencing the Way of Doing Business Abroad	18
Figure 2.2	Economic Structure of the M Group	28
Figure 2.3	Economic Structure of the C Company	29
Figure 3.1	The System of International Taxation	33
Figure 4.1	Link between ICT and Tax Planning	53
Figure 5.1	Evaluation Criteria	78
Figure 6.1	Tests Underlying the Permanent Establishment Definition	98
Figure 7.1	A Hierarchy of Tests to Identify a Company's Residence	140
Figure 7.2	Stages to Implement the Consolidation and Apportionment Approach	164

**List of Tables**

	<b>Page</b>	
Table 4.1	Tax Reconciliation for the Purpose of Calculating the Effective Tax Rate	50
Table 4.2	Overview of the most Relevant Changes Regarding Different Tax Planning Instruments	71



**Abbreviations**

AG	Aktiengesellschaft
APA	Advanced Pricing Agreement
ASP	Application Service Providing
B2B	Business to Business
B2C	Business to Consumer
BB	Betriebs-Berater (Journal)
BIFD	Bulletin for International Fiscal Documentation (Journal)
BStBl	Bundessteuerblatt
B.T.R.	British Tax Review (Journal)
CACM	Communications of the ACM (Journal)
CCBT	Common Consolidated Base Taxation
CDFI	Cahiers de Droit Fiscal International (Journal)
CESifo	Centre for Economic Studies Institut für Wirtschaftsforschung
CFC	Controlled Foreign Company
CHTB	Compulsory Harmonised Tax Base
CPM	Cost Plus Method
CTJ	Canadian Tax Journal (Journal)
CUPM	Comparable Uncontrolled Price Method
DB	Der Betrieb (Journal)
DBW	Die Betriebswirtschaft (Journal)
DIHK	Deutscher Industrie- und Handelskammertag
DSJG	Deutsche Steuerjuristische Gesellschaft e. V.
DStRE	Deutsche Steuerrecht Entscheidungsdienst (Journal)
DStZ	Deutsche Steuerzeitung (Journal)
e.g.	For example
ECJ	European Court of Justice
e-commerce	electronic commerce
Ed.	Editor
Eds.	Editors
ET	European Taxation (Journal)
Et al.	Et alii
EU	European Union
EUCIT	European Union Company Income Tax
FA	FinanzArchiv (Journal)
FB	Finanz Betrieb (Journal)
FDI	Foreign Direct Investment
FR	Finanzrundschau (Journal)
GATT	General Agreement on Tariffs and Trade
GDP	Gross Domestic Product

GmbHR	GmbH-Rundschau (Journal)
HBR	Harvard Business Review (Journal)
HST	Home State Taxation
IAS	International Accounting Standards
IBFD	International Bureau of Fiscal Documentation
ibid.	ibidem
ICRT	International Communications Round Table
ICT	Information and Communication Technologies
IFRS	International Financial Reporting Standards
IJEC	International Journal of Electronic Commerce (Journal)
ISI	Institut für Systemtechnik und Innovationsforschung
ISP	Internet Service Provider
IStR	Internationales Steuerrecht (Journal)
IT	Information Technology
ITPF	International Tax and Public Finance (Journal)
IWB	Internationale Wirtschafts-Briefe (Journal)
JEP	Journal of Economic Perspectives (Journal)
JIBS	Journal of International Business Studies (Journal)
JILT	Journal of Information, Law & Technology (Journal)
JITE	Journal of Institutional and Theoretical Economics (Journal)
K&R	Kommunikation und Recht (Journal)
LAN	Local Area Network
mir	Management International Review (Journal)
MIT	Massachusetts Institute of Technology
No.	Number
NTJ	National Tax Journal (Journal)
OECD	Organization for Economic Cooperation and Development
OECD Model	OECD Model Tax Convention
p.	page
pp.	pages
PC	Personal Computer
R&D	Research and Development
RIW	Recht der Internationalen Wirtschaft (Journal)
RJF	Revue de Jurisprudence Fiscale (Journal)
RPM	Resale Price Method
SEC	Staff of the European Commission
SME	Small and Medium-Sized Enterprises
StbJb	Steuerberater-Jahrbuch (Journal)
StuB	Steuern und Bilanzen (Journal)
StuW	Steuern und Wirtschaft (Journal)
TLR	Tax Law Review (Journal)

TN	Tax Notes (Journal)
TNI	Tax Notes International (Journal)
TNMM	Transactional Net Margin Method
TPI	Tax Planning International (Journal)
TPI e-commerce	Tax Planning International e-commerce (Journal)
TPI Transfer Pricing	Tax Planning International Transfer Pricing (Journal)
TPSM	Transactional Profit Split Method
UK	United Kingdom
UN	United Nations
UN Model	UN Model Tax Convention
VAT	Value Added Tax
WiSt	Wirtschaftswissenschaftliches Studium (Journal)
WISU	Das Wirtschaftsstudium (Journal)
WPg	Die Wirtschaftsprüfung (Journal)
ZEW	Zentrum für Europäische Wirtschaftsforschung
ZfB	Zeitschrift für Betriebswirtschaft (Journal)
zfbf	Zeitschrift für betriebswirtschaftliche Forschung (Journal)
ZfCM	Zeitschrift für Controlling und Management (Journal)
zfo	Zeitschrift für Führung und Organisation (Journal)

## 1. Introduction

### 1.1. Motivation

In the last few years, *Information and Communication Technologies* (ICT) have spread with increasing speed in both private and business sectors. For example, in 2002, 64,9% of private households and 83,9% of businesses in Germany used the Internet.<sup>1</sup> The ICT sector contributed close to 10% of OECD business GDP in 2001 and employed over 6% of business employment.<sup>2</sup> In 2002, ICT goods represented 14% of total trade.<sup>3</sup>

The implementation of ICT is leading to noticeable changes within the organisational structure of the economy, such as in the market organisation and in the internal organisation of enterprises. *Market transactions* carried out by enterprises can be processed either completely or in part by ICT, thus creating digital markets. It is possible to participate in these markets from all over the world and the geographic distances between the participants become rather irrelevant. With respect to the *internal organisation* of a company, the implementation of ICT can lead to regional decentralisation, since the process of producing goods and services makes use of production factors situated in various locations. Also, organisational decentralisation can be observed within the enterprise, as a modularisation of the value added chain takes place. In addition, the application of ICT entails the creation of *hybrid forms of enterprise co-operation*, such as virtual organisations. Thus, the companies' boundaries are becoming blurred. To summarise, due to the utilisation of ICT, economic activities are becoming more mobile and international.

In general, international tax law is applied to the underlying organisational structures of the economy. Given the manifold ICT-induced economic changes outlined above, the question is raised whether and to what extent these changes have an impact on the *applicability of current international tax law*. The main developments influencing international taxation are, above all, the increasing regional independence and mobility of companies and their production factors as well as the increasing importance of firm-specific intangible assets and services. In addition, the data required for taxation may not always be available.

When applying international company tax law to the underlying economic structure, the tax law in general has to be consistent with the economic structure in question in order to arrive at a reasonable taxation. The tax system is considered to be reasonable when it meets various *normative criteria for optimal taxation*. For example, the tax system must provide efficiency and neutrality,

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<sup>1</sup> See *OECD*, 2003b.

<sup>2</sup> See *OECD*, 2004b, p. 3.

<sup>3</sup> See *OECD*, 2004b, p. 4.

equity between different taxpayers and between different jurisdictions as well as feasibility in practice.

However, since the use of ICT has an impact on the organisational structures of the economy, the current tax system may not always be in line with these modified business structures. Contrary to the often mobile, geographically independent and international activities of companies, the tax system is intended to be applied rather to traditional economic activities. Thus, the economic assumptions underlying tax law can differ from the real economic circumstances. For example, tax law is in part based on the assumption of immobile business activities, such as in the case of the definition of a permanent establishment or the place of effective management. Moreover, it is assumed that the business activities are normally conducted in a physical way. For instance, physical objects, whose location can be determined easily, serve as tax attributes, such as in the case of the definition of a permanent establishment. However, in contrast, the business structures changed by the use of ICT are less often based on physical attributes and tend to be rather mobile. In addition, some new business structures or ways of doing business may have to be incorporated into existing international tax law. Possible examples are new forms of co-operation or new forms of doing business on digital markets. To sum up, the famous quote “business goes global, taxes stay local” highlights the gap between tax law and the economic reality.<sup>4</sup>

In light of these discrepancies between the international tax system and the underlying economic structures, various *consequences* may arise regarding the applicability of current international company taxation. Some aspects of the international tax system may prove to be more difficult to apply to the changed economic structure, or their application may lead to unreasonable results. Thus, with regard to various normative criteria for optimal taxation, international taxation may be less feasible or may not provide a neutral and equitable taxation. For example, inequalities between different taxpayers or increased incentives for tax planning and manipulation of the tax law may arise. In addition, an allocation of tax revenues that is not consistent with inter-nation equity may result. In extreme cases, the whole system of company income taxation may be deemed to be no longer applicable in a reasonable way.

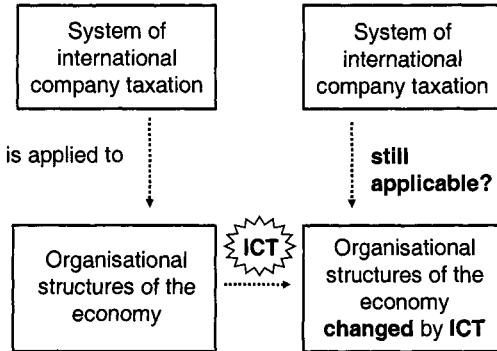
Thus, since a tax system has to arrive at a taxation in accordance with normative criteria for optimal taxation, the possible incompatibility of international tax law with the underlying economic structures and the resulting scenario of an inefficient, unequal or unfeasible taxation constitutes a problem which might require the development of adequate modifications. Consequently, as shown in figure 1.1, if the economic structures change as outlined above, it is debatable whether and to

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<sup>4</sup> Inter alia, see *Endres*, 1996, p. 92. See also *Spence*, 1997, p. 146, who states that the implication of ICT for the tax

what extent a revaluation of the existing system of international company taxation will be required to ensure that taxation is in line with general taxation principles. Thus, to what extent the current system of international taxation can be upheld and to what extent modifications will be required to provide a reasonable taxation must be examined.

Figure 1.1: Motivation of the Thesis



Previous debate on the impact of ICT on the suitability of international tax law has been conducted by the economic and legal scientific communities, international organisations, such as the OECD and the European Commission, and national jurisdictions.<sup>5</sup> The vast range of contributions shows that the subject-matter in question is up to date and relevant to a broad community. Still, previous contributions on ICT and international tax law can be completed with regard to different aspects as outlined below.

Firstly, regarding the subject under investigation, previous analyses have often focussed on one or only a few aspects of international taxation. For example, only issues regarding tax attributes in the source and the residence country or exclusively problems of transfer pricing have been considered.<sup>6</sup> These analyses are all meaningful and have their own rationale. However, the various tax fields interfere with each other and they are all part of the system of international taxation. Thus, when developing possible reforms for a specific tax field, some taxation issues may be shifted to another

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treatment of internationally active business is considered to be the most challenging strategic taxation issue.

<sup>5</sup> See the quotations in footnotes 6 to 14.

<sup>6</sup> For a focus on tax attributes in the source country, see inter alia *Utescher*, 1999; *OECD*, 2000; *ibid.*, 2001c; *ibid.*, 2003; *Pinto*, 2003. *Peter*, 2002, extended the analysis to tax attributes in the residence country. A comprehensive analysis is provided in *Brunsbach*, 2003, since the analysis of both the tax attributes in the source and in the residence country is further extended to an analysis of the choice between the source and the residence principle. For examinations focussed on issues regarding profit allocation, see *Kaminski*, 2001; *OECD*, 2001a; *ibid.*, 2001b; *Graf*, 2003.

tax field. For example, a re-definition of the permanent establishment may cope with the issues inherent to this tax attribute, but new issues with regard to profit allocation to a permanent establishment may then arise. Consequently, it is almost impossible to consider one tax field and to develop possible reforms without taking into account the interrelations with and the impact on other tax fields. This argument especially holds with regard to the underlying question of whether the tax system is still applicable. Therefore, it is reasonable and necessary to consider the whole system of international tax law consisting of different tax fields and to take their respective interrelations into account.<sup>7</sup>

Secondly, since the scope of the fiscal analysis may be restricted to specific fields, the economic analysis with regard to ICT-induced economic changes sometimes also considers only partial aspects. However, it is necessary to take the whole range of economic changes into account in order to provide a detailed analysis of the impact of ICT on international company taxation. Some systematisations of ICT-induced economic changes have already been developed<sup>8</sup> and can be extended to produce a systematic analysis of the impact of ICT on international taxation.

Thirdly, also with regard to the evaluation criteria underlying the fiscal analysis, some of the previous analyses on ICT and international tax law have focussed on a restricted range of criteria.<sup>9</sup> Thus, the analyses based on a diversified range of evaluation criteria still can be completed.<sup>10</sup>

Fourthly, and most importantly, although scientific debates on taxation issues raised by the advent of ICT have already been going on for some time, the search for suitable reforms still needs to be completed. Thus, even if several possible reforms for the various taxation issues have already been suggested,<sup>11</sup> further research is still required, especially with regard to the question of whether the whole system of international company taxation is still applicable.

## 1.2. Aim of the Thesis and Subject Under Investigation

In accordance with the underlying purpose and previous debates outlined above, the *aim* of the thesis first involves compiling the principal effects and issues of international company taxation resulting from the increased use of ICT. In a second step, the main aim of the thesis is to develop suitable reforms if required.

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<sup>7</sup> Examples for analyses including various tax fields are *Doernberg / Hinnekens / Hellerstein / Li*, 2001; *Li*, 2003.

<sup>8</sup> For example, see *Brunsbach*, 2003, pp. 19-34; *Li*, 2003, pp. 2-17; *Knödler*, 2004, pp. 15-40.

<sup>9</sup> For example, some analyses are more focussed on legal aspects. Inter alia, see *Fetzer*, 2000; *Spatscheck*, 2000; *Volckens*, 2001.

<sup>10</sup> Some examples of studies conducted on the basis of several evaluation criteria are *Utescher*, 1999; *Brunsbach*, 2003; *Li*, 2003; *OECD*, 2003.

<sup>11</sup> Inter alia, see *United States Department of the Treasury*, 1996; *Utescher*, 1999; *Indian Ministry of Finance* (Ed.), 2001; *Kaminski*, 2001; *Brunsbach*, 2003; *Graf*, 2003; *Li*, 2003; *OECD*, 2003; *Pinto*, 2003; *Knödler*, 2004.

In order to achieve this aim, the impact of the changed organisational structures on the international tax planning activities of companies under the current tax system must first be examined. The goal of this step is to determine the relevant taxation issues resulting from the ICT-induced economic changes within the current international tax system. Based on these findings, each relevant taxation issue is analysed in relation to the evaluation criteria underlying the analysis. It is examined whether or not the application of the current tax system to the changed economic structures entails a taxation that is consistent with normative criteria for optimal taxation. The evaluation criteria considered here are efficiency and neutrality, equity among different taxpayers, inter-nation equity, which calls for an equitable division of tax revenues between the jurisdictions, and feasibility, meaning that the tax system has to be practicable and workable in an effective way. This stage of the analysis is necessary to find out whether or not the current international taxation regulations can be upheld and how far-reaching possible reform measures have to be. For example, it has at times been concluded that the current system of corporate income taxation is no longer workable with the advent of ICT and, therefore, should be replaced by a tax system based on a tax on consumption, e.g. a Bit-Tax on transactions.<sup>12</sup> Whether the tax issues are really that far-reaching can be established at the end of this stage.

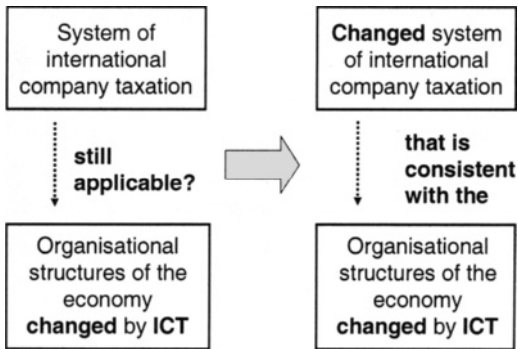
Based on the compilation of the most important fiscal issues resulting from the organisational changes, the main focus and aim of the thesis consists in developing suitable reform scenarios for international company taxation. As shown in figure 1.2, the reform concepts have to be consistent with the underlying economic structure and must guarantee a taxation that is in line with the aforementioned evaluation criteria. At the same time, the analysis of possible reform scenarios should include the considerations developed in other countries or by supranational institutions, such as the European Commission or the OECD.

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<sup>12</sup> This idea has first been presented by Cordell. See *Cordell, 1996; Soete / Kamp, 1996* for a detailed analysis and further quotations; *Ammann, 1999*, and the discussion in *ICRT, 1997; Fischer, 1998*, p. 12; *Basu, 2004*. See also *Rose, 1991*, pp. 7-34; *Wagner, 1999*, pp. 15-35; *ibid.*, 2003, pp. 369-390, who argue in general in favour of a consumption tax.



Figure 1.2: Aim of the Thesis



Bearing the aim of the thesis in mind, the analysis does not focus on the detailed examination of several international tax aspects, but rather, the outcome of the thesis involves a systematic analysis contributing to the debate on whether the entire system of international company taxation is still workable in the age of ICT and to what extent modifications are necessary in order to provide a reasonable and workable system of international company taxation. The outcome of the thesis is of importance to various parties. Firstly, the impact of an increased use of ICT on international taxation has implications for companies doing business internationally, as the possibilities for international tax planning may increase, but so may the tax risks. Secondly, with regard to the governments' point of view, the allocation of the tax base between different jurisdictions may change and, thus, some countries may worry about maintaining their tax base. Thirdly, since a tax system should be consistent with various normative criteria for optimal taxation, there are implications for national and international legislators and organisations as regards reforming national and international tax law.

With regard to the *subject under investigation*, the analysis includes the following *fields of international taxation*: the definition and location of the tax attributes in the source country and in the residence country, the assignment of profits to the respective income category, the methods of profit and asset allocation between taxable entities, and, finally, the choice between a taxation according to the residence principle or to the source principle, i.e. the choice of methods to avoid double taxation. Both current and non-current aspects of international taxation are included in the analysis. Since the focus is on income taxation, issues related to VAT are not included here.<sup>13</sup>

<sup>13</sup> For a detailed analysis of issues related to ICT and VAT, see *Spatscheck*, 2000, pp. 42-67; *Doernberg / Hinnekens / Hellerstein / Li*, 2001, pp. 93-161, 394-588; *Knödler*, 2004, pp. 177-238.