Policy Forum: Comments on *International Taxation in the Age of Electronic Commerce: A Comparative Study*, by Jinyan Li

Editor’s note. One of the most fundamental judgments every country must make in designing its income tax is what persons and income to subject to its jurisdiction to tax. When persons carry on their activities in more than one country, and when income results from transactions that have crossed national boundaries, a related judgment that must be made involves determining the appropriate amount of tax to impose on such persons and income. In spite of the magnitude and complexities of international trade and commerce, and in spite of the diversities of domestic income tax regimes, the tax rules that apply to international transactions are surprisingly similar in most countries. Furthermore, they rest upon the use of a relatively small number of concepts: the residence of individuals and legal constructs such as corporations in determining who is subject to tax; similar criteria in determining the source of business and investment income; the categorization of investment income in determining its source and the tax to be levied; the use of the concept of permanent establishment in establishing the economic nexus required to assert jurisdiction to tax business profits; and the use of the arm’s-length standard or separate accounting method in allocating business profits among taxing jurisdictions.

Some commentators have suggested that it is nothing short of a miracle that a consensus emerged among developed countries in the post-war period about the use of these concepts in guiding the allocation of worldwide income among the Organisation for Economic Co-operation and Development (OECD) countries. Other, more cynical commentators have argued that this apparent OECD consensus was really a Washington consensus and that the concepts largely served the self-interest of large capital-exporting countries. But whatever the political forces that accounted for and shaped the concepts, over the past 40 years they have come under increasing critical scrutiny in the light of the internationalization of most markets, changing technologies, aggressive tax planning, and concerns over the equitable allocation of worldwide income among capital-exporting and capital-importing countries.

The widespread use of the Internet for conducting and facilitating business activities is the most recent technological innovation to spur questions about the rules of international tax. Jinyan Li’s *International Taxation in the Age of Electronic Commerce: A Comparative Study* (Toronto: Canadian Tax Foundation, 2003) is a comprehensive and ambitious attempt to assess the continued validity of these rules in a digital world. Li concludes that the concepts underlying the OECD consensus were always flawed, but that those flaws have become much more apparent with the advent of electronic commerce. Her book begins by thoroughly describing and
analyzing the basic concepts and principles of international tax; it then reviews how the rules have been applied to electronic commerce in six different countries; it concludes by critically evaluating the problems of international tax in a digital world and by proposing a comprehensive set of reforms. Basically, her suggested reforms involve dividing all income into two broad categories: portfolio income and business profits. Portfolio income would be subject to a uniform withholding tax in the country in which it had its source; profits of integrated businesses would be apportioned among countries on the basis of a formula. Thus, under her proposals, the present number of categories of income would be greatly reduced; the concept of residence would be significant only for portfolio income; and the concepts of permanent establishment and the arm’s-length standard that are at present used for allocating business income would be jettisoned. Although these proposed reforms might seem to be a radical break from the OECD consensus, Li argues that they in fact represent evolutionary changes dictated by pragmatic considerations.

In his comments on the book, Dov Begun notes that readers of Jinyan Li’s book “will be treated to a thoughtful and well-articulated discussion of the most fundamental principles underlying international taxation, as well as some innovative and progressive ideas for reform.” He summarizes the major themes of the book and reviews its basic structure. He observes that it can be read on several different levels: as a handbook on international tax; as a reference source; as a study of comparative law; and as a policy manual and guide to future developments.

Arthur Cockfield is equally magnanimous in his praise of the book: “This is an excellent book—well written, thoroughly researched, and filled with insightful and original views on many international tax issues.” However, he takes issue with one of its central recommendations, namely, that the use of the arm’s-length standard for allocating corporate profits between nations be replaced with a system of allocating profits by the use of a formula based upon factors such as payroll, property, and sales.

In his defence of the continued validity of the existing concepts of international tax, Cockfield divides disputants on this issue into three camps: Doubting Thomases, Purists, and Pragmatists. Doubting Thomases take the view that the problems created by electronic commerce are not serious enough to justify changes in the traditional conceptual basis of international taxation. Purists, such as Jinyan Li, seek solutions to the problems posed by electronic commerce by replacing existing international tax concepts with concepts that are more conceptually pure. Pragmatists, a label Cockfield applies to himself, concede that the proposals advocated by the Purists are “both sound and theoretically attractive,” but doubt that these solutions could be effectively implemented. In addition to noting a number of technical issues that would have to be resolved in developing a formulary approach, he points out that the adoption of some kind of a system for apportioning the worldwide tax base of a group of related corporations on the basis of a formula would require an implausible degree of cooperation between nations and, since the method would require a substantial degree of harmonization of the tax base, would require them to surrender a considerable amount of sovereignty over their own tax
rules. He observes that “[t]he path of international law is directed by three main drivers: tax sovereignty concerns, practical administrative concerns, and guiding international tax principles.” He argues that “[i]t may be preferable to adopt a reform approach that protects tax sovereignty, relies on the current transactional arm’s-length regime, and is technically feasible.” He suggests, for example, that a possible incremental reform that would solve a number of problems posed by electronic commerce would be to deem businesses that had sales over a certain amount—say, gross revenues in excess of $1 million—in a country as having a deemed permanent establishment in that jurisdiction.

Li’s reform proposals are premised on an ability to distinguish between business profits, which would be subject to a formulary apportionment regime, and royalties, which would be subject to a withholding regime. Niv Tadmor argues that although this distinction has always been difficult to make, in the context of electronic commerce it has become impossible. In her book, Li suggests that proposed OECD guidelines simplify this characterization problem and provide a degree of certainty. In the course of thoroughly reviewing the OECD guidelines, Tadmor demonstrates that they in fact do not provide reliable bright-line tests for distinguishing between business profits and royalties in all sorts of increasingly common transactions. He then reviews the historical reasons for distinguishing between business profits and royalties and concludes that although the distinction never had a strong rationale, in the context of electronic commerce the same reasons that justify the source-based taxation of business profits also justify the source-based taxation of royalties. In both cases, “[the source state] provides the communications infrastructure that facilitates the trade online; it offers the market where demand exists; and most important, it provides the protections that shield the value of the digital supplies by the non-resident.” He concludes by summarizing other adverse implications and the enforcement problems entailed in retaining a distinction between royalties and business profits in taxing income from electronic commerce.

In her response to these comments, Li reiterates that she regards her proposed reforms of the international tax system as being not only theoretically more coherent than the present rules but also “evolutionary and pragmatic.” She concedes that there would be numerous administrative difficulties in implementing them, including the need to continue to distinguish between royalties and business profits, but thinks these difficulties are no greater, and probably considerably less, than the difficulties confronted in administering the present rules. She deals at some length with the objection that her proposals would require countries to relinquish a considerable amount of sovereignty over the formulation of their own tax rules. She notes that even under the present rules, several factors have caused countries to more closely align their tax rules. She concludes by observing that “[t]he growing convergence or coordination of national tax rules gives tax ‘purists,’ such as myself, reason to hope that the sovereignty hurdle to international tax reform could be removed in the near future.”