Further Discussion on Income Characterization

Niv Tadmore*

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INTRODUCTION

In the foreword to Jinyan Li’s study, Brian Arnold accurately observes that the book is much more than just another text on electronic commerce and tax. The book presents a thoughtful and informative journey through the web of issues arising from the interaction between tax and electronic commerce. As Li indicates, electronic commerce creates a most suitable context in which the core theories, principles, rules, and policies of international taxation can be examined, challenged, and reconsidered. The book starts with basic principles and theories, and then continues through a review of current positions, comparative analysis, and a critical examination of existing rules. Li concludes by presenting a comprehensive set of reform proposals concerning international taxation in general, and not only electronic commerce.

* Of Clayton Utz Lawyers, Melbourne, and a senior research fellow, Taxation Law and Policy Research Institute, Deakin University, Melbourne. I wish to thank Rick Krever for his valuable comments on an earlier draft of this paper. The views expressed in the paper are solely my own.

1 Jinyan Li, International Taxation in the Age of Electronic Commerce: A Comparative Study (Toronto: Canadian Tax Foundation, 2003), xxi.
This comment focuses on income characterization, a context in which electronic commerce pushes the principles and rules of international taxation to their logical limits and beyond. The distinction between business profits (including income from services) and royalties is important. Under existing rules, since a Web site, by itself, does not constitute a permanent establishment, electronic commerce business profits generated by non-residents who have no physical presence or dependent agents in the source state are not subject to source taxation. By contrast, under many tax treaties and national laws, royalties are subject to gross taxation at source.

The literature on income characterization in respect of royalties has focused on “how,” rather than “why”—that is, on the application of existing rules to electronic commerce transactions. The theories, policies, and principles concerning the taxation of royalties have received little attention, even though a vast amount of literature has been published following the advent of electronic commerce. Li’s book makes an important contribution to the literature on the issue of royalties.

As Li points out, income characterization, or the classification and assignment of income method, was adopted as the backbone of tax treaties by the League of Nations in the 1920s and has been the basis for bilateral divisions of taxing powers since then. Her discussion of the income characterization issue logically commences with a review of the views of the Organisation for Economic Co-operation and Development (OECD), as set out in the OECD income characterization report and the commentary on the OECD model convention (“the OECD guidelines”). Li then moves on to a broader discussion of the concept of income characterization. Li argues (in my view, correctly) that electronic commerce has blurred the traditional distinction between the form of delivery and the substance of what is delivered. Yet the reform she proposes maintains the distinction between royalties and business profits. The reform is based on the introduction of a uniform withholding tax and the application of the global profit split method. The uniform withholding tax would be

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2 This comment is based in part on a doctorate paper I recently completed under the supervision of Rick Krever.
4 For present purposes, “source state” refers to the state in which the purchaser of the supplies resides. It is acknowledged that existing source rules could lead to different results where the state in which the vendor resides (the residence state) is the state in which the income is sourced.
7 Li, supra note 1, at 513-16.
a final tax if the taxpayer was not subject to residence-based taxation on the same income, and a creditable tax if the income was taxed by the residence state. Li proposes to divide income into two broad categories. “Business profits” would include payments of portfolio income between related corporations, and “portfolio income” would include dividends, interest, rent, capital gains, and importantly, royalties. However, Li does not explain how royalties may be distinguished from “active” business profits or suggest specific rules by reference to which this distinction could be made. In the electronic commerce context, such rules are obviously vital to the effective implementation, operation, and administration of any reform that preserves the distinction between royalties and business profits.

It seems that the reform proposed by Li is intended to rely on the OECD guidelines. In relation to these guidelines, Li notes:

According to the OECD, e-commerce transactions give rise to business income, unless the transaction involves the transfer of a copyright right (mostly referring to the right to reproduce the copyrighted material for commercial exploitation purposes). Three out of 28 “typical” types of transactions are characterized as resulting in royalties. The main advantage of this approach is that it simplifies the characterization problem and provides more certainty to taxpayers. The main disadvantage is the potential erosion of source taxation.

Li suggests that traditional concepts of income characterization will inevitably cause uncertainty, but also contends that it is reasonable to predict that the OECD guidelines will provide a useful reference to national tax authorities in applying treaty and domestic rules.

The purpose of this comment is to expand the discussion and debate, and in addition, to argue that income characterization and, in particular, the OECD guidelines, require further consideration. The OECD guidelines have significant drawbacks. Moreover, no bright-line criteria may be available to distinguish between royalties and business profits from electronic commerce. “Rough and ready” guidelines may address some issues, but they will not resolve the practical and conceptual difficulties triggered by a distinction that lacks a sound basis.

REVIEW OF THE OECD GUIDELINES

The discussion below focuses on the OECD’s views on copyright and knowhow, and explores some of the strengths and weaknesses of the OECD’s approach.

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8 Ibid., at 589.
9 Ibid., at 444 (emphasis added).
10 Ibid., at 445.
11 Ibid., at 444.
12 The OECD income characterization report also discussed technical fees and payments for the use of, or the right to use, industrial, commercial, or scientific equipment. The scope of this
Payments for the Use of, or the Right To Use, a Copyright

The OECD income characterization report indicates that one of the most important characterization issues arising from electronic commerce is the distinction between business profits and payments for the use of, or the right to use, a copyright. The definition of royalties in the OECD model convention\(^\text{13}\) applies to “payment for” an item listed in the definition. The OECD guidelines thus suggest that the distinction is based on the identification of the consideration for the payment. Since electronic commerce transactions inevitably involve the use of copyright (mainly by reproduction), it is necessary to determine what is the essence of the consideration. The income characterization report sets out the following guideline:

Where the essential consideration is for something other than the use of, or the right to use, rights in the copyright (such as to acquire other types of contractual rights, data or services), and the use of copyright is limited to such rights as are required to enable downloading, storage and operation on the customer’s computer, network or other storage, performance or display device, such use of copyright should be disregarded in the analysis of the character of the payment for treaty purposes.\(^\text{14}\)

That guideline was incorporated into the commentary on the OECD model convention, which states:

In deciding whether or not payments arising in [transactions concerning digital products] constitute royalties, the main question to be addressed is the identification of that for which the payment is essentially made.\(^\text{15}\)

Although the rationale of a substantive test is attractive, the task of identifying the essence of the consideration can be fraught with difficulties. The essence of the consideration test involves questions that are to be determined in the context of the transaction itself, thus connoting subjective elements, and hence inherent ambiguity and uncertainty. A simple and commonly used example may illustrate the point. Assume that the proposed tax law distinguishes (as does the current tax law) between business profits from the sale of inventory, which is not taxable in the customer’s country in the absence of a permanent establishment of the vendor, and royalties, which are subject to gross withholding tax in the customer’s country. The customer may purchase 10 DVDs of a football match, 10 electronic copies of the event, or 1 DVD with the right to reproduce 9 additional copies on DVD. If the customer chooses the third option, what will be the essence of the consideration? The payment

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\(^\text{13}\) Article 12 of the OECD model convention.

\(^\text{14}\) OECD income characterization report, at paragraph 14 (emphasis added).

\(^\text{15}\) Paragraph 17.1 of the commentary on article 12 of the OECD model convention (emphasis added).
may be a royalty since it concerns the acquisition of the right to reproduce 9 copies (which reproduction is not an incidental mechanical consequence of the delivery process, such as capturing, storing, and displaying the data). On the other hand, it may be argued that reproduction is merely a convenient way of acquiring 10 copies, which acquisition is the essence of the consideration. Both possible answers lead to undesirable policy outcomes. If the payment is a royalty, neutrality will be offended since the technical mode of delivery should not dictate the tax results. Also, the integrity of the test will be eroded since the customer can readily avoid withholding tax by purchasing the DVDs. If the payment is not a royalty, the question is really about limits. If a significant use of copyright, such as the making of 10 copies, can be disregarded, what other significant instances of use of copyright can likewise be disregarded? The boundaries of the OECD test could be pushed to unintended extremes, perhaps even to the point where the copyright royalty definition would be almost insignificant. And this is only one simple example. Obviously, transactions that involve more sophisticated products and more complex circumstances will complicate matters further, and the ability to identify the essence of the payments with sufficient certainty will be further undermined. If mixed contracts are involved, the process will be further burdened by troublesome questions of valuation.

As suggested in a report on electronic commerce and tax by the Australian Taxation Office, released before the OECD guidelines were issued, “the application of traditional tax principles to digital products may lead to impractical results, with minor differences in the nature or mode of delivery of a product leading to significantly different tax results.” The OECD guidelines have not solved this problem. A test that is based on the essence of the consideration gives tax administrators and taxpayers one of those opportunities where well-crafted and reasonable factual arguments can be raised both ways, depending on the desired outcome. This approach does not promote certainty, simplicity, or neutrality. Rather, it opens the door to ample tax-planning opportunities, inconsistent results, and high compliance costs.

The drafters of the OECD guidelines were clearly mindful of these issues. The guidelines attempt to narrow the scope of the inevitable complexity and uncertainty by distinguishing between own-use and commercial exploitation of copyright. The OECD guidelines suggest that if the customer (which may be an enterprise) downloads digital products for his or her (or its) own use or enjoyment, use of copyright should not give rise to a royalty. By contrast, the commercial exploitation of the copyright would give rise to a royalty. This approach seems, at first glance, logical and practical. Importantly, it also bypasses the difficulties associated with imposing unrealistic compliance liabilities on private consumers. Consumers in mass markets

17 Paragraph 17.3 of the commentary on article 12 of the OECD model convention.
18 Paragraph 17.4 of the commentary on article 12 of the OECD model convention; and annex 2, category 3 of the OECD income characterization report.
are unlikely to expend time and resources on questions such as what is the essence of the consideration of the thing purchased. In addition, the business-to-consumer market is at present relatively small. An OECD study indicated that business-to-consumer transactions represent only about 20 percent of total electronic commerce transactions, and that most business-to-consumer commerce takes place within the consumer’s own jurisdiction.19

This approach, however, marks a considerable departure from the language of the definition of royalties in the OECD model convention, which makes no reference to any distinction on the basis of own use or enjoyment and commercial exploitation purposes. The definition simply refers to the use of copyright or the right to use copyright.

Moreover, the distinction between private and business consumers is likely to further undermine neutrality. There are no assurances that the business-to-consumer market will not expand. To the contrary, it is reasonable to expect that considerable growth of this market will occur in the mass-consumption industries, such as entertainment and gaming. The dotcom shakeout does not mean that electronic commerce has run its course or that its commercial potential has been exhausted. One would also expect that the growth of the electronic commerce consumer market will be further accelerated when consumption patterns adjust to evolving technologies, and when technologies, such as security of payment, bandwidth, digital TV, and Internet-enabled cellular/mobile devices, advance to workable, efficient, and affordable levels. What will happen if the ratio between the business-to-consumer and business-to-business markets is not 20:80, but, say, 35:65? The OECD’s approach means that the growth of the business-to-consumer market will create an ongoing pressure on neutrality. For example, tax consequences will vary across industries (such as business consultancy versus entertainment) and products (such as accounting software versus gaming software). Furthermore, the distinction is really about own-use rather than private consumption. If one adds to that transactions in which enterprises buy digital products for their own use, the impact on neutrality will be more severe. For example, an enterprise may buy, for its own use, 50,000 software copies for all its employees. Would it make sense to distinguish such a transaction from one in which someone buys 10,000 copies for commercial exploitation purposes?

Payments for Knowhow/Provision of Services
The second important distinction discussed in the OECD guidelines is between payments for services and payments for the provision of knowhow. The distinction can be made by reference to the following general criteria:20

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20 Paragraph 11.3 of the commentary on article 12 of the OECD model convention.
- Contracts for the supply of knowhow concern information that already exists or that has already been developed or created, and contain provisions dealing with the confidentiality of such information.\textsuperscript{21}
- Under contracts for the provision of services, the supplier undertakes to perform services that may require the supplier to use special knowledge, skill, and expertise, but not to transfer knowhow.
- Most contracts for the supply of knowhow do not impose on the supplier additional substantial obligations subsequent to supply. By contrast, under most contracts for the performance of services, the supplier is required to incur during the term a considerable level of expenditure.\textsuperscript{22}

A similar approach may be used to distinguish between payments for the provision of services and payments for assets.\textsuperscript{23} In general, a transaction will involve the provision of services if, after that transaction, the customer owns the property but the property was not acquired from the provider. For instance, the customer may engage the provider to create an item of property that the customer will own from the moment of creation, such as a computer program or video images. By contrast, if the customer acquires valuable property, such as an investment report that was not created specifically for the customer, the transaction will be a sale of property.

Again, the approach taken by the OECD appears, at first glance, practical and logical. However, since the criteria are based on normal or usual contractual arrangements and transaction patterns, it will be difficult to apply them to transactions that do not follow the usual pattern. In addition, the applicability of the royalty article under this category relies heavily on the particular terms of the relevant contract, which reliance may give rise, yet again, to ample tax-planning opportunities, inconsistent results, and high compliance costs.

Moreover, terms such as “knowhow,” “information concerning industrial, commercial, or scientific experience,” and “trade secrets” are, by their nature, vague and incoherent. Courts have found it particularly difficult to apply such terms in practice, and domestic laws can vary significantly in relation to confidential information and

\textsuperscript{21} In the particular case of a contract involving the provision of information concerning computer programming, as a general rule the payment will be considered to be made in consideration for the provision of such information so as to constitute knowhow only where (1) the payment is made to acquire information constituting ideas and principles underlying the program, such as logic, algorithms, or programming languages or techniques; (2) this information is provided under the condition that the customer not disclose it without authorization; and (3) the information is subject to any available trade secret protection. See paragraph 11.5 of the commentary on article 12 of the OECD model convention.

\textsuperscript{22} Where contracts concern both the supply of knowhow and the supply of services, a reasonable apportionment should be made, unless one part of the supply is ancillary and largely unimportant in the context of the supply, in which case it should be disregarded. See paragraph 11.6 of the commentary on article 12 of the OECD model convention.

\textsuperscript{23} See the detailed discussion in paragraphs 32 to 35 of the OECD income characterization report.
trade secrets. The definition of knowhow adopted in the OECD commentary, for example, refers to

all the undivulged technical information, whether capable of being patented or not, that is necessary for the industrial reproduction of a product or process, directly and under the same conditions; insomuch as it is derived from experience, know-how represents what a manufacturer cannot know from mere examination of the product and mere knowledge of the progress of technique.24

While obvious examples may be readily determined, there are many instances where it is unclear whether the information concerned is knowhow or not—for example, whether information is “necessary,” or, say, just “relevant,” for industrial reproduction, or what a hypothetical manufacturer could or could not know from mere examination and knowledge. A distinction that is based on such factually involved yet vague concepts will echo their ambiguous characteristics and hence create uncertainty.

Furthermore, the distinction gives rise to a number of challenging questions. Why does it matter whether the supplier sold services or knowhow? Is not the derivation of profit the issue? If so, should that profit be treated differently if, say, the supplier sells an available investment report or writes a new investment report for a particular customer? Why should any fiscal difference be drawn from the fact that the supplier sells information that is not technical, commercial, or scientific in nature? Should a purely commercial decision on the ownership of the intellectual property, which may vary from contract to contract, drastically change the tax consequences?

The OECD guidelines do not address such questions, nor do they seek to clarify or explain the policy behind the distinction, although such an explanation would surely throw more light on the issues involved and assist taxpayers and tax administrators in dealing with vexed questions of fact and law. Rather, the OECD guidelines adopt a mechanistic and technical approach that leads on to a position where one may not always be able to see the forest for the trees. Indeed, all those fine distinctions—between knowhow and general information; transfer of knowledge and use of knowledge; the creation of property for a customer before and after the transaction; the existence of confidentiality provisions and ongoing obligations of the supplier; or valuable and less valuable property—demonstrate that knowhow and services can be so intertwined that it would be artificial to draw a line between business profits and royalties in the electronic commerce context.

The distinction and its operation under the OECD guidelines sit quite uncomfortably in a fiscal framework that is supposed to achieve reasonable levels of neutrality, certainty, and simplicity. While commercial entities have been dealing with such questions for many years, these issues will become even more challenging

24 Paragraph 11 of the commentary on article 12 of the OECD model convention.
in the electronic commerce context, where private consumption mass markets are growing, where the range of products and services is enormous, and where technologies and business models change and evolve all the time.

THE DISTINCTION BETWEEN ROYALTIES AND BUSINESS PROFITS: BACKGROUND AND RATIONALE

The drawbacks of the OECD guidelines do not flow from the inability of international tax experts to tackle the issue effectively. To the contrary, the OECD guidelines probably represent a sound outcome, having regard to the scope of the mandate given to the Technical Advisory Group on Treaty Characterisation of Electronic Commerce Payments. This mandate did not allow the formation of new policies or changes to the OECD model convention. Rather, the mandate was narrow in scope and technical in nature, concentrating on interpretation and application of existing rules. For this reason, the OECD guidelines do not address the broader question of whether or not the distinction between royalties and business profits in the electronic commerce context should be preserved. Also, for this reason, the OECD guidelines are bound to deal merely with symptoms, rather than causes.

As discussed earlier, and as Li points out, income characterization, as a model on which tax treaties are based, is more a historical hangover than a well-considered policy decision. Indeed, the League of Nation’s group of technical experts openly noted that their recommendation was based on “purely practical purposes and no inference in regard to economic theory or doctrine should be drawn from this fact.” The model recommended by the technical experts was commonly used in central European states before and after the First World War. The model did not mark any significant departure from existing practice and norms. As Edwin Seligman noted, the recommendation of the technical experts was strongly influenced by political considerations: “When... the technical experts came together, their concern was primarily to enter into some arrangement which would be politically agreeable

25 The objectives were (1) to identify different types of electronic commerce transactions and the particular characteristics of such transactions that might enable distinctions to be drawn between payments for services and income from sales or leasing of property; (2) to identify characteristics of electronic commerce transactions that might enable distinctions to be drawn between business profits and royalties and, in particular, the circumstances, if any, in which electronic commerce payments may be considered to be payments for use of copyright or use of knowhow; (3) to comment on whether there are reasons for preferring one characterization to another; and (4) to identify the circumstances in which electronic commerce transactions can be considered to give rise to payments for industrial, commercial, or scientific equipment. See annex 3 of the OECD income characterization report.

to their respective governments.”

Yet it is important to note that in an earlier report to the League of Nations, which considered issues of policy, theory, and doctrine, the four economists who prepared the report did not recommend the income characterization method as the basis for allocating taxing powers. While they acknowledged that, on pure economic allegiance grounds, the method “would be the soundest,” they nevertheless rejected it because it would be “almost impossible in economic theory to get a direct assignment of a quantitative character of finally resultant income amongst all the national agents who may be said to have had a finger in the pie.”

Obviously, hundreds of tax treaties based on the income characterization model have been operating quite effectively for decades. However, one also has to bear in mind that, as far as passive income is concerned, tax treaties do not seek to be precise in assigning revenue rights. Rather, they are bilateral arrangements based on the “rough and ready” solution underpinned by the imposition of reduced-rate withholding taxes.

The view of the four economists, although expressed more than 80 years ago, echoes even louder in the modern context of electronic commerce and the distinction between royalties and business profits. This is because, in this particular context, there is no sound justification for the distinction itself. Li examined some of the theories that justify source taxation, and it may be helpful to further develop the conceptual basis of royalty taxation and electronic commerce profits.

The modern definition of royalties found in tax treaties does not typically include income from immovable property, and the OECD model convention also omits the reference to industrial, commercial, or scientific equipment. The objective is to have an income category based upon the realization of value embodied in intangible property, or, as noted in an OECD report, “income from intangibles with a substantial intellectual content.” This objective is central to the understanding of the rationalization of the distinction between business profits and royalties.

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30 Ibid.

31 Supra note 1, at 49-57.

Although meaningful access to a market in a state traditionally required some degree of physical presence of the non-resident in the state, the theories of benefit and entitlement do not require physical presence as a prerequisite of tax jurisdiction over non-residents. These theories warrant source taxation without physical presence on the basis of use of benefits, facilities, and business environment that enable the non-resident to derive profits from sources in the state. For example, in the US Supreme Court decision in *Quill Corp. v. North Dakota*, White J, in his dissenting judgment, said with respect to mail orders:

> These advantages include laws establishing sound local banking institutions to support credit transactions; courts to ensure collection of the purchase price from the seller’s customers; means of waste disposal from garbage generated by mail-order solicitations; and creation and enforcement of consumer protection laws, which protect buyers and sellers alike, the former by ensuring that they will have a ready means of protecting against fraud, and the latter by creating a climate of consumer confidence that inures to the benefit of reputable dealers in mail-order transactions.33

It can be argued that source taxation of royalties is distinguishable since there is typically a lesser direct use of physical benefits and facilities by the non-resident. For example, an OECD report on the taxation of software suggested that, in the absence of a permanent establishment, the connection between the non-resident and the source state is not a significant one:

> Taxation on a gross basis occurs only in the absence of a permanent establishment; if a royalty is effectively connected with a permanent establishment, the effect of Article 7 together with paragraph 3 of Article 12 is to ensure taxation on a net basis. *Paradoxically the less the connection of the payee with the State of source, the greater his tax burden there.*34

Indeed, the OECD model convention definitely reflects the view that royalties do not connote a sufficient fiscal connection with the source state, and allows no source taxation of royalties. However, many OECD and non-OECD countries do impose withholding tax on royalties.35 Apart from the obvious revenue allocation

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35 No fewer than 12 OECD members have entered a reservation against the zero royalty withholding tax suggested by the OECD model treaty (see paragraphs 32 to 48 of the commentary on article 12 of the OECD model convention, and paragraphs 16 to 17 of the OECD equipment report, supra note 32). The “Non-Member Countries’ Positions on the OECD Model Tax Convention” (see supra note 6, at 311-39) sets out the position of non-OECD members in relation to the OECD model treaty and commentary. With respect to article 12, 24 non-members reserve the right to tax royalties at source. The UN model convention allows the source state to impose royalty withholding tax (see article 12(2) of the United Nations Model
bargains and considerations involved, the source taxation of royalties also has a sound basis under the benefit and entitlement theories. This basis involves the systems that operate to protect intellectual property rights, and thus the value of the intangibles with respect to which payments are made to the non-resident:

The services and protections provided by the government of the country in which the licensee uses the property are quite obviously more important for this income than are the services and protections provided to the licensor by the country of his residence, the country in which the license is made or any other country that may be touched by the license transaction. *Intellectual property derives its value from the right of the owner to exclude others from using it.* The income from a particular use therefore is, at least to some extent, a product of the laws that provide the right to exclude others from using the property at that place and time. *The laws and legal system at the place of use constitute, in sum, the governmental services and protections of greatest consequence for royalty income.*

The economic allegiance theory also does not require physical presence to warrant source taxation. Economic allegiance is to be determined by reference to a number of questions, one of which is: where is the yield physically or *economically* produced? The four economists reporting to the League of Nations had no difficulty in concluding that the latter overrides the former:

The true economic location is to be distinguished from the physical location, usually termed *situs.* Frequently, of course, these coincide. But in the case of many classes of wealth the temporary *situs* may be quite distinct from the true economic location. . . . Physical *situs* is one thing; origin or economic location is quite another thing: they do not necessarily coincide. *Physical situs is of importance in economic allegiance only to the extent that it reinforces economic location.*

Moreover, the acquisition of wealth, and the creation of value, can be based upon demand. The four economists illustrated the point as follows:

The oranges upon the trees in California are not acquired wealth until they are picked, and not even at that stage until they are packed, and not even at that stage until they are transported to the place where *demand exists* and until they are put where the consumer can use them.

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Double Taxation Convention Between Developed and Developing Countries, UN publication no. ST/ESA/102, 1980). The US model convention, under which no royalty withholding tax is imposed, is a notable exception (see article 12(1) of the United States Model Income Tax Convention of September 20, 1996).


37 Supra note 28, Report on Double Taxation, at 25 (emphasis added).

38 Ibid., at 24-25 (emphasis added).

39 Ibid., at 23 (emphasis added).
Thus, under the benefit, entitlement, and economic allegiance theories, the source state has strong fiscal claims in relation to royalties. In a perfect world, the taxing rights should be divided in accordance with the respective strengths of the fiscal claims made by the states. But this is not a perfect world, and such a division is obviously impossible. A “rough and ready” division of taxing rights may be the only feasible reflection of the operation of strength and competing claims. This is basically the function fulfilled by gross taxation in the form of royalty withholding tax. The royalty withholding tax mechanism lends itself to a concrete and practical negotiation process, enabling concessions and decisions to be made on the rate of tax, rather than the right to tax.40

In the context of the traditional sale of goods or provision of services (without physical presence or agency in the source state), the fiscal claims of the residence state would typically be much stronger than those of the source state. Royalties, on the other hand, give rise to different and more powerful source claims, which are too substantial to be superseded by the claims of the residence state. The application of this reasoning to electronic commerce business profits results in the conclusion that the distinction between royalties and business profits loses much of its relevance and validity in the context of electronic commerce. The reasons that justify source taxation of royalties also justify the source taxation of electronic commerce business profits. The source state has strong fiscal claims in relation to electronic commerce profits: it 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. The attributes of electronic commerce create a situation where business profits are more similar to royalties than to traditional business profits generated without physical presence. As a result, the source state has sound reasons (and a strong desire) to tax the profits from electronic commerce.

RELIANCE UPON THE OECD GUIDELINES: FURTHER IMPLICATIONS

The above examination of the conceptual basis of royalty taxation at source may assist in putting matters in perspective. As noted above, the inherent problem underpinning the OECD guidelines is that the mandate of the technical advisory group did not allow for consideration of such core conceptual and policy issues. Although there is always a gap between theory and rules in international taxation,

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40 Paragraph 9 of the commentary on article 12 of the UN model convention, supra note 35, refers to the factors influencing the withholding tax rate, which include (1) tax revenue, which includes the flow of royalties between the states; (2) foreign exchange rates; (3) the extent of assistance provided by the developed state to the developing state; (4) lessening tax evasion; (5) encouraging the flow of technology between the states; and, of course, (6) the relevance of the royalty issue in the context of the treaty.
there is a point where the gap is so wide that the rules start to make less and less sense, where their application becomes more and more complex and artificial, and where the allocation of revenue under a treaty becomes less and less acceptable to one of the contracting states. The approach of the OECD, focusing on the clarification of existing rules rather than the distinction itself, may bring about such results, for the following reasons:

- The OECD guidelines may require ongoing adjustments, or else their relevance will be eroded. Technologies, business models, transactional structures, and market behaviour will continue to evolve. The OECD’s conclusions on interpretation and categorization thus have a limited life because they are based upon contemporary business models and technologies, which may become outdated in the near to medium term.
- As Li notes, the OECD’s guidelines may operate in favour of the residence state. While it makes sense to disregard inconsequential instances of copyright use that would otherwise be subject to royalty withholding tax, the guidelines exclude private consumption and own-use transactions from the scope of the royalty definition. This exclusion could trigger significant reallocations of revenue under tax treaties. Although it is difficult to estimate the resulting revenue implications, revenue considerations are likely to make it harder for states that consume more than they sell to accept this approach. The flip side of the OECD’s approach is undertaxation. Electronic commerce creates a whole new spectrum of opportunities to structure the flow of profits through low-tax jurisdictions. Where the attribution rules of the “ultimate” residence state are incapable of dealing effectively with offshore electronic commerce structures, or where the “ultimate” residence state has no attribution rules at all, the OECD’s approach would result in greater incentives to engage in harmful tax practices and hence in undertaxation of the income concerned.
- It is questionable whether the OECD guidelines promote certainty and simplicity. They address some key issues, but overall, they do not lay down clear lines separating royalties from business profits. Given the narrow mandate given to the technical advisory group, the guidelines can do no more than to reinforce the argument that the distinction between royalties and electronic commerce business profits is both blurry and artificial. Tax authorities, taxpayers, and tax practitioners may attach different weight to the various considerations, tests, and factors discussed in the OECD guidelines.
- Li suggests that the OECD guidelines may provide a useful reference to national tax authorities in applying treaty and domestic rules. However, such usefulness may be limited to jurisdictions whose laws are similar to those discussed

41 Supra note 1, at 444.
42 Ibid., at 444.
in the guidelines. As distinct from, say, the permanent establishment definition, the definition of royalties differs among treaties. In addition, domestic rules differ significantly with respect to basic concepts of source and their application to concepts such as services and intellectual property rights. A recent survey noted, for example, that “[e]ven a cursory review of the various national reports shows that there is widely divergent treatment of the taxation of service revenue around the world.” Given the inconsistency and diversity of domestic rules, the operation of the OECD guidelines at the national level would not necessarily be consistent, relevant, or useful.

Moreover, it is doubtful whether the OECD guidelines will be supported by broad international consensus. The OECD guidelines involve the balancing of a complicated set of factors, contractual provisions, and assumptions. Such an exercise, by its very nature, lacks certainty and can often produce different results in similar factual settings. Simplicity may be compromised, and distortions will likely result, undermining equity and neutrality. Different tax authorities, motivated by different notions of simplicity, equity, and neutrality, and by different revenue considerations, could readily arrive at different views in relation to similar transactions. For example, an Indian Ministry of Finance report took a position different from that of the OECD in relation to 13 of the 28 relatively straightforward categorization examples discussed in the income characterization report. Leaving aside technical arguments that may be subject to further debate, this example illustrates the main point argued here—that the OECD guidelines are likely to produce inconsistency and uncertainty.

CONCLUSION

In her book, Li reviews a broad range of views on tax, electronic commerce, and tax reform. Her proposed characterization of income into two classes may go a long way toward addressing many acute problems created by the current system of international taxation and the characterization of income into numerous classes producing different tax results. However, the reform she suggests maintains the

43 For example, the Australian definition of royalties is quite broad and can cover much more than the use of, or the right to use, copyright. For example, it applies to the reception of, or the right to receive, visual images or sounds, or both, transmitted to the public by satellite or cable, optic fibre, or similar technology. See section 6(1) of the Australian Income Tax Assessment Act 1936, as amended. See also Niv Tadmor, “Aspects of Electronic Commerce Taxation in Australia” (2003) vol. 57, no. 8/9 Bulletin for International Fiscal Documentation 422-30.


distinction between royalties and business profits. In the electronic commerce context, this could trigger many negative and unintended implications. Reliance on the OECD guidelines may not resolve matters. The limited mandate that underlies the guidelines means that they can merely suggest cosmetic treatments, without examining the cause of the problems, which is the distinction itself.

The reform suggested by Li may thus require a further consideration of this issue. A new set of guidelines based on existing rules may not suffice. It appears safe to assume that a re-examination of interpretation solutions would not produce clearer or better guidelines than those devised by the learned and experienced drafters of the OECD guidelines. This is because the clarification of the existing rules can only go so far. If the issue is really the distinction itself, then reform should address that particular issue.

The difficulty that would arise from the elimination of the distinction is obvious. Even if a very low withholding tax is imposed on electronic commerce payments, what do we do with non-deductible payments? As contended above, their exclusion would create acute neutrality, as well as revenue and undertaxation consequences. On the other hand, how would we go about asking a teenager who downloads a video game from the Internet to withhold tax and comply with all associated requirements? The reform suggested by Li does not deal specifically with “questions of technical administration.”46 Li acknowledges that this is a limitation of her proposal. Indeed, the attributes of electronic commerce mean that the conversion of international taxation policy objectives into rules must be made on the basis of sound enforceability mechanisms. In other words, policy and tax administration are so intertwined that both are equally central to coherent and comprehensive reform.

Enforcement will give rise to a considerable challenge to the extent that the obligation to withhold is imposed upon private consumers who have little interest in complying with such an obligation, and little incentive or ability to do so. Whatever benefit, entitlement, or economic allegiance nexus the source state may have, however fair its claim about its diminishing tax base and however convincing the neutrality considerations may be, as Thomas Adams remarked, “[T]ax should not be assigned to a jurisdiction which cannot effectively administer and collect the tax.”47

Li refers to some recent studies on the issue of enforcement.48 These studies should be explored. The solutions could be similar to those currently being designed to deal with similar difficulties in the context of value-added taxation—for example, enhanced technologies, collection by financial institutions, or reverse-charge mechanisms.

46 Supra note 1, at 590.
48 Supra note 1, at 623, note 42.
Be that as it may, if it is recognized that the distinction between royalties and business profits is highly problematic, and if enforcement issues make it difficult to give effect to that recognition, then the focus should be on enforcement, not on an artificial distinction between two classes of income. This focus could add a concrete layer of support to the reform proposed by Li and generate further discussion on the issue of income characterization. And a broader OECD mandate could pave the way for balanced and workable answers to these challenges.