Source in the Digital Age

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This article examines the theory, history and operation of the question of income "source" from the perspective of the taxation of intellectual property rights and intellectual content ("intellectual supplies") under tax treaties, and its implications and possible evolution in the e-commerce context and the digital age.2 This article concludes that, although reform is presently pre-mature, a new framework for the taxation of intellectual supplies will be required, and proposes a new framework for the taxation of digital intellectual supplies.

The Theory of Source Taxation of Intellectual Supplies

The conceptual frameworks of tax jurisdiction are central to comprehending the relative strength of the fiscal assertions made by states and the relationships between tax jurisdictions and tax treaties. The discussion below examines the key doctrines dealing with the assertion of taxing rights by a "source state" with respect to income derived from intellectual supplies to a resident of a purchaser state by a resident of a "residence state" who has no presence in the purchaser state.3

The Sovereignty Doctrine

The Sovereignty doctrine is based on the notion that sovereignty is the collection of rights and competences which go to make up the state. Jurisdiction is the right and competence of the state to affect the rights of persons through the exercise of judicial, legislative and administrative powers, which includes the power to make and enforce laws, including tax laws.4 Since

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1 Partner, Clayton Utz Lawyers, Australia. The views expressed in this article are those of the author. This article is based on a paper entitled "The Interaction Between Tax Treaties and E-Commerce Re-Examined", which I submitted in July 2003 in fulfilment of the requirements for the degree of Doctor of Juridical Science, Deakin University, Melbourne, Australia. I wish to thank Professor Rick Krever, Taxation Law and Policy Research Institute, Department of Business Law and Taxation, Monash University, Melbourne, Australia for his supervision of my doctorate and comments on an earlier draft of this article.

2 In this article, the term “e-commerce” refers to transactions facilitated through or by the use of the internet or similar media, and “e-commerce context” refers to e-commerce transactions where the seller and the purchaser are not residents of the same tax jurisdiction and the seller has no physical presence or agents in the tax jurisdiction of the purchaser in connection with the transaction. E-commerce may also involve the disposal of property (e.g. falling under the scope of Article 13(4) of the OECD Model), which is less common and is not dealt with specifically in this article.

3 In this article, the term "source state" refers to the state where the purchaser resides and obtains the supply, and the term “residence state” refers to the state where the non-resident supplier resides and makes the supply. Thus these terms may not necessarily overlap with domestic or treaties source and residency rules.

jurisdiction derives from sovereignty, jurisdiction can only extend as far as sovereignty exists.\(^5\)

And since the power to make and enforce tax laws is a subset of jurisdiction, tax jurisdiction must also have limits:

“...if jurisdiction is an attribute of sovereignty, then it is necessary so that the limits of fiscal jurisdiction are similar to those national sovereignty. Consequently, identifying the limits of sovereignty is tantamount to identifying the limits of every type of jurisdiction, including tax or fiscal jurisdiction.”\(^6\)

The scope of the state’s fiscal jurisdiction depends on the aspect of sovereignty concerned.

There are two aspects to sovereignty. National sovereignty applies to citizens and residents of the state. National sovereignty allows the state to apply its jurisdiction, including the imposition of taxes, on its citizens and residents wherever they might be.\(^7\) Territorial sovereignty, by contrast, is defined by reference to the geographical boundaries of a state, by reference to which the state can make fiscal assertions over non-residents:

“The taxation of aliens must therefore depend upon the physical presence of the alien within the territory of the taxing state or upon the existence there of some property or interest belonging to him upon which the tax may be levied.”\(^8\)

The connecting factor of “some property or interest” may only refer to a legal nexus, rather than a general economic or commercial nexus.\(^9\) Yet this may suffice to assert far-reaching fiscal claims. The state, through its national laws, is entitled to determine questions of \textit{situs} of rights and property.\(^10\) It can, for instance, determine that certain legal interests are located within its borders, thereby creating adequate fiscal links with non-residents. Accordingly, the state is entitled to assert fiscal claims over non-residents who have no presence in the state and who sell goods or services, including intellectual supplies, through the internet to its residents, for example by basing its fiscal claims on the \textit{situs} of rights supplied, the debt payable to the non-resident, or plainly, the payment itself.

\textbf{The Benefit Doctrine}

The core principle of the benefit doctrine is that the state has the right to tax those who derive income using the benefits it offers:

“A large part of the cost of government is traceable to the necessity of maintaining a suitable business environment...Business is responsible for much of the work which occupies the courts, the police, the fire department, the army, and the navy...The relationship between private business and the cost of

\(^{5}\text{Jeffery (1999), p. 26; Martha (1989), pp. 13-14.}\)

\(^{6}\text{Martha (1989), p. 32.}\)


\(^{8}\text{Albrecht (1952), p. 152.}\)


\(^{10}\text{See e.g., Christianson J, Langer v Packard 40 N.D. 182 (1918), pp. 197-198.}\)
government is a loose one, much like the relationship between the expenses of a railroad and the amount of traffic which it carries. The connection, however, is real, and, in the long run, the more business the greater will be certain fundamental costs to government...business ought to be taxed because it costs money to maintain a market and those costs should in some way be distributed over all beneficiaries of that market... a market is a valuable asset to the social group which maintains it and communities ought to charge for the use of community assets.”

The question that arises in relation to non-residents is what would be sufficient to fiscally link the state with the non-resident. Traditionally, meaningful access to a market in a state required some degree of physical presence of a non-resident in the state, which in turn usually required use of at least some public goods and services. However, this does not preclude claims based on the use of other benefits that are independent of physical presence:

“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.”

This line of reasoning is especially compelling when applied to e-commerce, where markets become more accessible and physical presence becomes less critical. Furthermore, a state from which revenue is sourced may invest heavily in telecommunications infrastructure which renders electronic commerce possible. Most importantly perhaps, the source state provides protection of intellectual property rights. This protection does not depend on whether the vendor has a physical presence in the source state, but is nonetheless vital to dealings in intangibles, particularly intellectual supplies. It protects the value of the supplies. Without such protection, intellectual supplies may be copied, duplicated, reverse-engineered and manipulated to the extent that no real value could be preserved, and thus, no profits could be secured by the unshielded non-resident vendor.


13 White J, Quill Corp. v North Dakota, 504 U.S. 298 (1992), 328 (dissenting judgement).

The Economic Allegiance Doctrine

After the First World War, there was a growing concern that double taxation would harm the growth of international trade and commerce. As a result, in 1921, the Financial Committee of the League of Nations invited four leading economists to prepare a report on double taxation ("League of Nations 1923 Report"). One of the tasks assigned was to formulate, essentially for the first time, the “general principles as the basis for an international convention to remove the evil consequences of double taxation.” The four economists focused upon the concept of economic allegiance:

“A part of the total sum paid according to the ability of a person ought to reach the competing authorities according to his economic interest under each authority. The ideal solution is that the individual’s whole faculty should be taxed, but that it should be taxed only once, and that liability should be divided among the tax districts according to his relative interests in each.”

The four economists outlined the following four questions by reference to which economic allegiance is to be determined:

- Where is the yield physically or economically produced?
- Where are the final results of the process as a complete production of wealth actually to be found?
- Where can the rights to the handing-over of these results be enforced?
- Where is the wealth spent or consumed or otherwise disposed of?

In its purest form, the economic allegiance doctrine would allocate tax revenue to each state that rightfully claims economic allegiance with a person. Nevertheless, the economists conceded that “income is such a composite product and such a complex conception that even theoretically it is not easy to assign in a quantitative sense proportions of allegiance of the different countries interested.” They concluded that economic allegiance should be determined by reference to the first and the fourth questions, which essentially correspond to the concepts of source and residence.

The economic allegiance doctrine does not require physical presence in a state to sanction taxation. Production of wealth focuses upon “the community the economic life of which makes possible the yield.” The production of yield may have one physical location and another economic location. Moreover, the latter overrides the former:

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15 Professor Bruins, Professor Einaudi, Professor Seligman and Sir Josiah Stamp.
17 Id, Introduction.
18 Id, p. 20.
19 Id, p. 25.
20 Id, p. 27.
21 Id, p. 23.
“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.”

On this basis, the place of consumption - the market or the place of demand - can be an essential part of wealth production, and thus give rise to economic allegiance even if there is no physical presence:

“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.”

The non-resident may owe significant economic allegiance to the residence state, but this does not justify, in principle, exclusion of source taxation. The question is not about valid fiscal assertions, but rather, about revenue allocation between states which are entitled to assert. This logic applies to oranges, and likewise, to intellectual supplies through the internet.

The Realistic Doctrine

The sovereignty doctrine suggests that without jurisdiction there is no power to tax. The realistic doctrine suggests the opposite, namely without the power to tax there is no jurisdiction. “No rules of international law exist to limit the extent of any country’s tax jurisdiction”, and therefore, a state’s tax jurisdiction is effectively defined by reference to its enforcement competence:

“In formulating the circumstances in which a state will tax when confronted with a foreign element that state is not concerned with the question whether or not it should exercise fiscal jurisdiction - it in fact assumes that. Operating from this premise it is concerned with exercising its jurisdiction in an effective manner.”

The realistic doctrine has been subject to fierce criticism. It was argued that the doctrine ignores the important distinction between jurisdiction and power, that it justifies taxes that are inconsistent with international norms, and that it undermines international trade and co-operation. However, there are stronger counter arguments. The realistic doctrine does not ignore the distinction between jurisdiction and power - it equates them. More importantly, it is true that the doctrine, if strictly applied, can give rise to unfair, draconian and absurd results. But that can also and equally be said about all other fiscal doctrines, which, as shown above, are flexible enough to tax non-residents in an extremely broad range of circumstances.

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22 Id, pp. 24-25 (emphasis added).
23 Id, p. 23.
26 Skaar, p. 20.
27 Jeffery, p. 43.
Furthermore, the realistic doctrine, due to its very nature, connotes pragmatism, and may be best understood on that basis. The world, according to the realistic doctrine, “is not one of total chaos or the complete antithesis of reason, but rather a competitive environment where state astuteness is the order.”

States do not exercise tax jurisdiction in a vacuum, and the ability to enforce or collect does not necessarily entail assertion, enactment or enforcement. States must co-exist and exercise self-restraint, and thus must also place a limit on their tax jurisdiction. Other theories may have more economic depth, but the realistic doctrine may best explain the actual dynamics of international taxation, as Sasseville observed:

“While there can be endless discussions about what should constitute a sufficient link between an enterprise and a country for that country to have a legitimate claim to tax the profits of that enterprise, the truth is that tax authorities are probably more concerned about enforcing and collecting taxes with a minimal disruption of economic activities, than they are about what constitutes sufficient ‘economic allegiance.’”

Given that states do not, in general, enforce each other’s fiscal assertions or judgments, under the realistic doctrine the taxation of non-residents (who have no physical presence or readily accessible assets in the taxing state) often relies on withholding tax. Withholding tax has been regarded as an effective enforcement method that enables the state to pursue assertions against non-residents by imposing intra-territorial measures:

“The physical presence of taxpayers within the boundaries of the taxing authority is seen as increasing the probability of full satisfaction of their tax obligations since it is much easier to audit their accounts and enforce tax deficiencies against them. At the present time, however, this belief is of limited validity as the widespread use of withholding taxes imposed at the source on gross remittance, with liability imposed on the remitter for failure to withhold, has greatly diminished the importance of the taxpayer’s physical presence, especially where the withholding tax represents the sole or maximum tax imposed by the source country.”

Since the doctrine is based on actual competence to collect taxes, source taxation of intellectual supplies may be qualified. As discussed below, whereas collection from local enterprises is not problematic, collection from end-users or consumers stretches the competence of withholding taxes to its limits.

28 Skaar, pp. 21-22.
29 Qureshi, p. 18.
Intellectual Supplies and Tax Treaties - The Distinction Between Royalties and Business Profits

The historical analysis of the taxation of intellectual supplies coincides with the taxation of royalties. In other words, taxation of intellectual supplies has been concerned predominantly with intellectual property rights rather than intellectual content. Royalty taxation is a direct derivative of the distinction between royalties and business profits, which has been shaped by historical processes and pragmatism more than coherent theory. Nevertheless, the distinction is not without some theoretical foundations, although not necessarily compelling or convincing.

The Broad Historical Context - Income Categorisation

As mentioned above, the League of Nations 1923 Report was commissioned to address “the evil consequences of double taxation.” The underlying question was “[w]hich Government should give up revenue, and to what extent?” The four economists explored four methods to determine that question:

- **Deduction for income from abroad** - The residence state deducts from the tax due from its residents any tax paid by them in the source state. The four economists rejected this method on the basis that it would be unfair to the residence state in that it “throws the whole burden of increased taxation in debtor countries upon the creditor country.”

- **Exemption for income going abroad** - The source state gives up its right to tax non-residents. This method found more favour with the four economists. It reflected what governments were doing to attract foreign investment, it accorded with the economic interests of those who invest in the source state, and it did not require complex allocations of income. They thus concluded that this method was “the most desirable practical method of avoiding the evils of double taxation and should be adopted wherever countries feel in a position to do so.”

- **Division of the tax** - This method concerns the division of taxes between the states on a formula basis, so that a portion is allocated to the source state and the remainder to the residence state, which should give relief by reference to a definite amount that has been levied in the source state. The economists noted the attractive simplicity of this method and asked whether this simplicity should override economic theory, thus whether they should “not attempt to get the exact elements of economic allegiance but to adopt a broad line and say that where double taxation of income is involved each country shall give up a flat or fixed proportion of the sum due to it.” However, the economists rejected this method because of the practicalities involved in actually applying it. They considered that different tax systems, different tax rates, different treatment of corporate income,

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34 Id, p. 40.
35 Id, p. 41.
36 Id, p. 51.
37 Id, p. 45.
administrative difficulties and limited access to information would render this method unworkable overall.

- **Classification and assignment of income** - Income is classified into classes, and the two states allocate revenue on the basis of this classification. The four economists, who apparently favoured residence-based taxation, stated unequivocally that on pure economic allegiance grounds, this method “would be the soundest.” However, they rejected this method because they considered that, in the real world, the classification of income and the resulting allocation of taxing rights would be fraught with difficulties. They concluded that the classification and assignment of income method is extremely limited and impractical, because “simplicity only exists in a minority of cases involving income tax and that we soon get into the region of impracticability if we attempt to apply [this method] in precision.”

The work of the four economists was supposed to be the basis upon which a group of nominated technical experts would draft a model tax treaty for the League of Nations. The technical experts produced their first report in 1925 ("League of Nations 1925 Report"). They did not follow the recommendations, or the reasoning, of the four economists. Rather, the technical experts chose to draft a model treaty on the basis of the classification and assignment of income method. They proposed that personal taxes (income taxes) be allocated to the residence state, and impersonal taxes (or impôts rées) be allocated to the source state. The technical experts openly stated that their conclusion was made “for purely practical purposes and no inference in regard to economic theory or doctrine should be drawn from this fact.”

There were a few practical considerations. The first consideration concerned collection and administration. It is easier for the source state to collect impersonal taxes than personal taxes because the collection of impersonal taxes does not involve the declaration by the taxpayer of total income. The second consideration related to the interests of the source state, and the composition of the group of technical experts. One of most important background facts of the League of Nations process was that three of the four economists came from creditor nations, whereas most of the technical experts came from debtor nations. Naturally, as distinct from the economists who favoured exclusive residence taxation, the technical experts had a different take on source: “New countries which need foreign capital for their general development desire to have a share in the taxes levied on income arising in their territory.”

Thirdly, the model recommended was based on precedent. It was commonly used in central European states before and after the First World War. It was a familiar model. It did not mark any significant departure from existing practice and norms. The technical experts, as distinct from the economists, did not seek novel solutions, but rather, a solution that would be acceptable to the various members of the League of Nations. As Seligman noted:

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38 Id, p. 45.
39 Id, p. 45.
41 Id, p. 15.
42 Id, p. 15.
“When…the technical experts came together, their concern was primarily to enter into some arrangement which would be politically agreeable to their respective governments.”

The model suggested by the technical experts - impersonal taxation by the source state and personal taxation by the residence state - was incorporated into the first model treaty produced by the League of Nations in 1927. Subsequent drafts, issued in 1928, did not distinguish between personal and impersonal taxes, but rather, identified specific tax categories, and allocated them (each draft on a different basis) to the source or residence state. The rest is indeed history. The classification and assignment of income method prevailed. The work of the League of Nations continued to be based on the classification and assignment of income. When the OECD picked up the development of model tax treaties from the League of Nations, it retained the method and based its models upon it. The method is now reflected in the OECD Model, the UN Model, the US Model Treaty, and tax treaties the world over.

Evolution of Royalty Taxation at Source - the Ongoing Tension Between Source and Residence

Royalties were, initially, not as important as other income categories. When the economists discussed the intangible personal property and incorporeal movable category, they did not even mention royalties. They confined the discussion to real estate mortgages, corporate securities, government bonds and private credits, which were the “most important classes in this category.” The early League of Nations drafts did not contain a specific royalty income category. Under a 1928 draft, for instance, royalties were taxable by the residence state under the "other income" provision. A royalty category subsequently appeared in the League of Nations 1931 draft, which provided that in the absence of a permanent establishment ("PE") in the source state, income from patent rights were taxable exclusively by the residence state. In 1933, another League of Nations draft treaty was produced, containing a separate category of royalties, which is not dissimilar to modern definitions in that it captured the use of, or rights to use, intellectual property rights and even intellectual content:

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43 Id, p. 12.
48 League of Nations 1923 Report, p. 34.
49 League of Nations 1928 Report, Article 8, Draft 1c.
“Rentals or royalties arising from leasing personal property or from any interest in such property, including rentals or royalties for the use of, or for the privilege of using, patents, copyrights, secret processes and formulae, goodwill, trademarks, trade brands, franchises and other like property, provided the enterprise is not engaged in dealing in such property.”

There is little information on the early development of royalty taxation under tax treaties, yet it appears that this specific reference to royalty income seems to have followed the emergence of royalties as a stand-alone income category in tax treaties in the 1930s. This process lacked the relative uniformity that underpinned the development of the PE concept, although in many instances the residence state obtained exclusive taxing rights.

The interplay between source and residence in the particular context of royalties became a major issue in subsequent League of Nations work. Following two conferences in Mexico, dominated by representatives of Latin American states, in 1943 the League of Nations issued a new model treaty ("Mexico Model"), which placed considerable emphasis on source taxation. Article X(2) of the Mexico Model provided:

"Royalties and amounts received as a consideration for the right to use a patent, a secret process or formula, a trademark or other analogous right shall be taxable only in the state where such right is exploited."

In 1946, the Fiscal Committee of the League of Nations convened in London to review the Mexico Model, and submitted a new model treaty ("London Model"). The strong emphasis of the Mexico Model upon source taxation was effectively reversed under the London Model. Article X(2) of the London Model thus stated:

"Royalties derived from one of the contracting states by an individual, corporation or other entity of the other contracting state for the right to use a patent, a secret process or formula, a trademark or other analogous right shall not be taxed in the former state."

The Fiscal Committee acknowledged that the provisions of the Mexico Model might appear more attractive to some states, and that there was a divergence between the Mexico and London Models in relation to the royalties category, which "has always been in dispute."
The dispute about the right to tax royalties has all but disappeared. The current operation of royalties as a category that divides and allocates taxing rights under a tax treaty is best understood by reference to the distinction between business profits and royalties. The term "business profits" typically refers to profits from commercial and industrial activities, e.g., the sale of goods. Under the OECD Model Tax Convention on Income and on Capital ("OECD Model"),\(^{56}\) the term also includes profits from independent personal services.\(^{57}\) Under Article 7 of the OECD Model, the source state may only tax business profits which are attributable to a PE.\(^{58}\) A PE will exist if one of two tests is met i.e. the general "fixed place of business" test, or the "dependant agent" test.\(^{59}\) In broad terms, the general test requires a fixed place of business through which the business of an enterprise is wholly or partly carried on, and the agency test requires a person in the source state who is the long arm of the non-resident. When business profits are subject to source taxation, they are taxed on a net basis allowing deductions to be taken into account.

The term "royalties" is defined in Article 12(2) of the OECD Model as follows:

> "The term ‘royalties’ as used in this Article means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience."

The OECD Model provides that where the non-resident has no PE in the source state, royalty payments will not be subject to source withholding tax.\(^ {61}\) However, this has not been extensively accepted, even by OECD members, and tax treaties in general impose royalty withholding tax on a gross and final basis.\(^ {62}\) The residence state is responsible to prevent double taxation, usually by way of credit (no higher than the amount of tax imposed at source). In practice, therefore, the

\(^{56}\) 15 July 2005.

\(^{57}\) Income from professional services or other activities of an independent character is now dealt with under Article 7 on the basis that there are no intended differences between the PE concept and the fixed base concept of the old Article 14.

\(^{58}\) Article 7(1) and 7(3), OECD Model.

\(^{59}\) Article 5, OECD Model.

\(^{60}\) Article 12(2), OECD Model.

\(^{61}\) Article 12(1). If the property or right the subject matter of the royalties is "effectively connected" with a PE in the source state, Article 7 will apply (Article 12(3)).

\(^{62}\) No fewer than 12 OECD Members have entered a reservation against the zero royalty withholding tax suggested by the OECD Model Treaty (see OECD Commentaries on the Articles of the Model Tax Convention (15 July 2005) ("OECD Commentary") on Article 12). The OECD Non-Members Positions Report sets out the position of 17 non-OECD Members in relation to the OECD Model Treaty and Commentary. With respect to Article 12, all 17 Non-Members reserved the right to tax royalties at source (refer to paras 3-4). The UN Model allows the source state to impose royalty withholding tax (Article 12(2)). The United States Model Income Tax Convention of September 20, 1996, under which no royalty withholding tax is imposed, is a notable exception (clause 12(1)).
real compromise concerns the rate of the royalty withholding tax, not the waiver of the right to tax.  

Conceptual Examination of the Distinction

The distinction between business profits and royalties is not, in principle, supported by the sovereignty or realistic doctrines. The sovereignty doctrine focuses on the existence of some legal property or legal interest within a state’s boundaries. This has little to do with the category of the income concerned. Rather, the sovereignty doctrine would have to deal with the particular difficulties associated with the *situs* of such interest or property. As long as the source state has jurisdiction over rights, debts or payments, it can assert fiscal jurisdiction. Income categorisation is also irrelevant to the realistic doctrine. The ability or inability of the state to compel its resident to withhold tax on behalf of the non-resident is indifferent to the category of the income concerned. Withholding tax, with the notable challenges that it raises in the private consumer market, will vest fiscal jurisdiction.

On the other hand, the benefit and economic allegiance doctrines directly support income categorisation. The rationale adopted by the OECD in disallowing source taxation of royalties assumes that the totality of the royalty payment has a much stronger connection with the residence state. This rationale is stated in the OECD Software Report:

> “Taxation on a gross basis occurs only in the absence of a PE; if a royalty is effectively connected with a PE, 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.”

As to the PE concept, the OECD Commentary says:

> “…it 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.”

The OECD’s position on the PE concept is sound and obvious. Under all conceptual bases, a nexus that is based on immovable property, such as land or a fixed place of business situated in a state, is very strong. Under the realistic doctrine, immovable property provides the state with sound enforcement and collection abilities, as it be readily accessed, attached and seized. As far as the sovereignty doctrine is concerned, immovable property unquestionably falls within the

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63 The UN Commentary on Article 12, at para 9, refers to the factors influencing the withholding tax rate and tax revenue, which include the flow of royalties between the states, foreign exchange rates, the extent of assistance provided by the developed state to the developing state, lessening tax evasion, and encouraging the flow of technology between the states, and of course, the relative relevance of the royalty issue in the context of the treaty. See also Avery Jones, p. 3.


65 OECD Commentary, Article 7, para. 3.
state’s territorial sovereignty; a threshold based on immovable property provides certainty in that it avoids questions on the *situs* of other types of property. The benefit doctrine would also favour a compromise based on physical presence as such presence entails a sufficient level of use of public goods and services. Under the economic allegiance doctrine, in the case of business enterprises that depend directly on the land, the source state is the place generating the stronger claim of economic allegiance.66

However, the OECD's rationale for the non-imposition of source taxation on royalties is not necessarily correct. A royalty payment can be divided into three types of compensation: (a) for the reduction in the value of the underlying property caused by the granting of the right to use, and the use of, that property, (b) for maintaining the underlying property, and in most cases of periodic payments, bearing the risk throughout the period of the grant, and (c) for return on the licensed capital. The first and second types of compensation have their economic source in the residence state (where the acquisition or creation of the underlying property and its ongoing development take place), whereas the third type of compensation has its economic source in the source state (where the licensee uses the property):

“...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.”67

Thus, both the residence and the source state may have a strong claim to tax royalties under the economic allegiance and benefit doctrines. 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. As a result, a "rough and ready" approach may be warranted, which is precisely the function fulfilled by gross taxation in the form of royalty withholding tax.

The requirement to have a threshold for source taxation of business profits, and not royalties, may be understood against that background. In the context of a mere sale of goods without a PE, the fiscal claims of the residence state would typically be much stronger than those of the source state, that could merely assert fiscal rights on the basis of market demand. On the other hand,

royalties give rise to powerful source claims. The source state protects the intellectual supply and preserves its value. The source state's claim over the non-resident is too substantial to be superseded by residence claims. Accordingly, the ability of the source state to tax business profits in the e-commerce context should not depend on the existence of a PE.

A Passive/Active Income Rationale for the Distinction?

It has been argued that, broadly speaking, tax treaties seek to allocate active income to the source state and passive income to the residence state.68 Central to the distinction between active and passive income is an (unverified) assertion that generally passive income is primarily derived directly by individuals, or closely held entities, and active income is primarily derived by large corporations.69 The distinction between active and passive income is, by and large, based upon the considerations concerning the type of taxpayer, that is, whether the taxpayer is an individual or a corporation.

Residence-based taxation of individuals is justifiable for a number of reasons.70 First, residency of individuals can be readily ascertained. Second, since most individuals are part of only one society, distributional concerns can be addressed most effectively by the residence state. Third, residence often overlaps with political allegiance, and in democratic jurisdictions, residence-based taxation is a proxy for taxation with representation. Taxation of corporations, on the other hand, gives rise to considerations warranting taxation at source. First, the fiscal connections, especially under the benefit doctrine, warrant taxation by the source state once the non-resident meets a threshold indicating a critical level of use of local benefits when deriving active income there. Second, residence of corporations is a rather artificial concept, which lends itself to manipulation. Third, the relationship between a corporation and its place of residence does not necessarily accord with the relationship between an individual and his or her state of residence.

Another layer of considerations distinguishing between passive and active income concerns the theories of capital export neutrality ("CEN") and capital import neutrality ("CIN").71 In brief, under CEN, worldwide efficiency in the allocation of resources would be achieved if taxes do not affect the decision of where to invest. This goal can be achieved if a resident of any nation pays the same marginal tax rate no matter where the investment is made. CEN, therefore, focuses upon residence taxation. Yet since, in theory, it does not matter which state collects the

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70 See Avi-Yonah (1997), pp. 519-520.
71 For further discussion on these theories refer to Musgrave and Musgrave; Graetz; Vogel; Frisch Daniel J, “The Economics of International Tax Policy: Some Old and New Approaches”, (1990) 47 Tax Notes 581 ("Frisch").
tax revenue, CEN can also be achieved if the residence state grants a credit (in theory, a full credit) for the tax collected by the source state. CIN, on the other hand, focuses upon neutrality in the state where the investment is made. Competitiveness in that state requires that all investments be subject to the same marginal tax rate regardless of the investor’s place of residence. CIN therefore implies source-based taxation and exemption from foreign tax granted by the residence state.

Taxation of passive investment, especially portfolio investment by individuals, better accords with CEN. If a foreign equity or debt market offers an investor a better return than the domestic market, the investor should invest accordingly, as foreign taxation should not affect the ability to access the higher foreign return. By contrast, taxation of active and direct investment by corporations better accords with CIN. Whereas investors can readily shift portfolio investments across jurisdictions in accordance with the returns offered, it is often not efficient or practical to shift direct investment, which often requires time to produce returns. The ability to compete in the state in which direct investment is made is therefore important. However, it seems that the rationalization of the general distinction between active and passive income may apply to passive income that is debt or equity investment, but not in a framework in which the passive income is royalties. The factual assertion that most passive investment is made by individuals is not extended to royalties. Thus, the set of factors that distinguish residence/individual taxation and source/corporate taxation is simply inapplicable to royalties. Likewise, the CIN/CEN arguments supporting that distinction lose force when applied to royalties (as distinct from portfolio investment). Royalties are based on contractual arrangements specifying duration, and other terms and conditions which render income derivation a completely different exercise in terms of commitment, mobility, maintenance and ongoing performance of obligations. Thus, the active income/passive income rationale does not appear to prove a sound theoretical basis to justify the distinction between royalties and business profits.

**Intellectual Supplies in the Digital Age - Operation of Existing Rules**

The advent of e-commerce and the internet has had a dramatic impact on intellectual supplies. This impact has been driven by a number of factors. First, intellectual content can now be readily digitised. Thus, intellectual content can be efficiently, rapidly and effectively transferred over the internet, and then stored, copied or otherwise processed or manipulated. Second, e-
commerce enables enterprises to adopt business models that do not rely on intermediaries, but rather, focus on the direct provision of intellectual supplies. Third, the basic ingredients of e-commerce - speed, bandwidth, software, hardware and applications - have started to achieve appropriate and workable levels. Consequently, access to the internet, and thus to e-commerce, is increasing rapidly. Fourth, enterprises that make intellectual supplies require little infrastructure. They do not have to operate from their "original jurisdiction", and can easily shift their operations to locations that offer a more favourable environment, including low-tax jurisdictions.

Application of Existing Rules

In 1988, the OECD embarked upon a comprehensive review and examination of various issues concerning the interaction between taxation and electronic commerce. The first part of the OECD's review concerned the application of existing rules to e-commerce, rather than broader taxation policies and objectives. The second part concerned policy issues.

As part of its review of the application of existing rules, the OECD examined two key questions. The first is whether a website can, without more, give rise to a PE, and thus enable a source state to tax the business profits attributable to the website. The second concerns the categorisation of payments arising from e-commerce transactions, and more specifically, whether a particular payment is a royalty or business profit. The conclusions are now incorporated into the OECD Commentary on Articles 5 and 12, and in December 2005, the OECD issued a report entitled "Are the Current Treaty Rules for Taxing Business Profits Appropriate for E-Commerce? Final Report" ("OECD Final Report").

As to the PE question, the OECD concluded that under existing rules a website cannot, without more, be a PE. First, the general PE definition cannot be satisfied because a website cannot be "a fixed place of business". Second, a website cannot satisfy the dependant agent test since no matter how sophisticated and "intelligent" the technology involved might be, a website is not a person.

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78 OECD, Committee on Fiscal Affairs, Clarification of the Application of the Permanent Establishment Definition in E-Commerce: Changes to the Commentary on the Model Tax Convention on Article 5 (22 December 2000)
80 OECD Commentary on Article 5, para. 42.2.
81 Id, para 42.10.
As to income characterisation, a number of sub-distinctions were considered. One of the most important ones in the e-commerce context is the sub-distinction between business profits and royalties which are payments for the use of, or the right to use, a copyright. The OECD's position is that, since e-commerce almost inevitably involves the use of copyright, the focus should be on the essence of the transaction:

“Under the relevant legislation of some countries, transactions which permit the customer to electronically download digital products may give rise to use of copyright by the customer, e.g. because a right to make one or more copies of the digital content is granted under the contract. Where the essential consideration is for something other than for the use of, or 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 not affect the analysis of the character of the payment for purposes of applying the definition of "royalties."  

A distinction is also made between private use and commercial exploitation of copyright:

“This is the case for transactions that permit the customer (which may be an enterprise) to electronically download digital products (such as software, images, sounds or text) for that customer's own use or enjoyment. In these transactions, the payment is made to acquire data transmitted in the form of a digital signal and therefore does not constitute royalties… By contrast, transactions where the essential consideration for the payment is the granting of the right to use a copyright in a digital product that is electronically downloaded for that purpose will give rise to royalties.”

Another sub-distinction is the one between payments for services and the provision of know-how. The distinction, it is suggested, can be made by reference to a number of guidelines.

First, contracts for the supply of know-how concern information which already exists or which has already been developed or created, and contain provisions dealing with the confidentiality of such information. Second, under contracts for the provision of services, the supplier undertakes to perform services which may require the supplier to use special knowledge, skill and expertise, but not to transfer know-how. Third, most contracts for the supply of know-how 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 of supply a considerable level of expenditure. A similar approach may be used to distinguish between the provision of services and payments for assets. 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.

82 OECD Commentary on Article 12, para. 17.2.
83 Id, 17.3-17.4.
84 Id, para. 11.3.
85 See detailed discussion in OECD Characterisation Report, paras. 32-35.
Revenue Reallocation

Some 60 years after the Mexico and London Models, the dispute between source and resident states has assumed a new dimension, and has intensified, due to the advent of e-commerce. When the OECD embarked on the review of e-commerce, one of the core objectives was to ensure a fair revenue allocation. The Ottawa Report stated:

“All arrangements for the application of these principles to e-commerce adopted domestically and any adaptation of existing international taxation principles should be structured to maintain the fiscal sovereignty of countries, to achieve a fair sharing of the tax base from e-commerce between countries and to avoid double taxation and unintentional non taxation.”

However, the overall effect of the OECD’s conclusions on the PE and the income characterisation issues operate in favour of the residence state. Business profits would be typically untaxed by the source state because the vendor has no PE in the source state, and payments which may technically give rise to royalties (typically subject to withholding tax) may now be categorised as business profits and thus escape source taxation. Where the OECD Model is fully adopted and royalties are not taxed at source at all, e-commerce income would be almost exclusively taxed by the residence state.

The OECD Final Report noted in response to revenue reallocation concerns that it is premature to revolutionise tax treaties on the mere basis of a potential revenue reallocation:

“Depending on where the disappearing functions were previously performed, a country’s tax base could either benefit or lose from these changes. More likely than not, each country’s tax base will gain and lose to some extent and it is impossible, at this time, to predict what will be the net effect for any given country.”

“Unsurprisingly, there does not appear to be any evidence yet of a significant reduction of the direct tax revenues of a country that could be attributed to e-commerce. The TAG agreed that it would not be advisable to suggest any tax policy change on the basis of perceived losses of tax revenues that have not been established but it also agreed that there was a need to monitor the evolution of the impact of e-commerce on tax revenues.”

However, other comments made in the OECD Final Report seem to mark a departure from the OECD Ottawa Report's emphasis on achieving a fair sharing of the tax base:

“No member of the TAG argued that tax rules should be modified to shield countries from the effect of technological developments on their tax base. Countries do not have a right to a particular level of tax revenues regardless of where business profits originate.”

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86 Para. 6.
88 Para. 118.
89 Para. 112.
90 Para. 118.
The question was asked, however, whether or not maintaining a balance in the sharing of the tax revenues should be a general principle that the rules should promote. This, however, raises issues of international politics rather than tax policy which the TAG did not consider.\textsuperscript{91} Such comments are somewhat surprising. At the end of the day, a tax treaty is a bargain, a deal between two states on the allocation of revenue from trade and commerce between them. If a post-deal significant phenomenon, such as the advent of e-commerce, operates to materially realign revenue allocation, the loser state is unlikely to agree that the deal should simply continue. If the loser state believes that it is being denied its fair share of tax revenue, it may resort to unilateral action.\textsuperscript{92} Unilateral action may result in double taxation of e-commerce, it may be uncoordinated and non-uniform, it may develop into a range of incompatible systems varying in form and substance, and, like other tax measures, it may be difficult to change or uproot. It is likely that if unilateral measures are adopted, further disorder will occur, as residence states are likely to take their own unilateral action, for example, refuse to grant relief.\textsuperscript{93} The possibility of unilateral measures was contemplated in the OECD Final Report as well:

\begin{quote}
"In the absence of a consensus with respect to the appropriate rules for taxing business profits, it is therefore certainly possible that some countries could decide to adopt unilateral solutions and hope that, with time, these become the new international norm. Whilst these countries may consider that this is the only way to adapt the international norms to changing circumstances, this would certainly increase the risks of double taxation and non-taxation as well as compliance burdens...These countries may feel, however, that such risks are the price to pay to change rules that they consider inadequate."\textsuperscript{94}
\end{quote}

Although material revenue allocation is yet to be seen, little will be achieved by disregarding the evolution of the commercial and global conditions under which tax treaties will operate in the future. The revenue allocation - the basic bargain on which treaties have been created and have operated - is not a mere political issue, but rather, a treaty policy issue. A reform process that disregards revenue reallocation is likely to be inherently inadequate. If, as a result, tax treaties do not deal effectively with e-commerce, the growth of e-commerce will increase the occurrence of unilateral measures and correspondently decrease the relevance of tax treaties to international trade.

Application of Existing Rules - Evaluation of Policy Objectives

The OECD Final Report sets out a number of evaluation criteria that it applies in examining alternatives to the existing rules. However, the OECD Final Report does not apply those criteria to the default option, that is, maintaining the existing rules in respect of royalties and business

\begin{flushleft}
\textsuperscript{91} Note 30.
\end{flushleft}
profits. Therefore, it is useful to evaluate this default option on the basis of the relevant evaluation criteria in the OECD Final Report as well as other considerations. This evaluation is provided below.

- **Certainty and simplicity** - Tax rules should be clear and simple to understand. However, existing rules have not been designed to deal with e-commerce and thus their application can result in inconsistency and uncertainty:

  “The substitution of digital products for the more traditional physical products has led to new markets and new ways of providing access to those products…Payments for these digital products are likely to differ both as to amount and as to character for tax purposes. In particular, the line traditionally drawn between royalties and payments for goods and/or services is likely to become increasingly blurred.”

These concerns have not been eliminated by the OECD’s proposed interpretation of existing rules. The identification of the essence of a payment is not always a straightforward task, and tests that are based on the balancing of a complicated set of factors, contractual and legal concepts and judgment calls can result in incoherence, uncertainty and inconsistency. Indeed, although the OECD Final Report observes that the OECD Categorisation Report presents "reasonable results", it is conceded that:

  “Income characterization has long been a complicated issue, and tax authorities have struggled for decades to distinguish sales from royalties, sales from services and services from royalties. Similar questions have arisen recently in the context of software and e-commerce transactions.”

Moreover, the uncertainty surrounding the OECD's interpretation of existing rules is fuelled by the simple fact that tax authorities, taxpayers and tax advisers may attach different weight to various criteria and considerations, and that intellectual property laws differ among states. For example, an Indian committee on e-commerce took a view different to that of the OECD Characterisation Report in relation to 13 of the 28 relatively simple categorization examples discussed in the OECD Characterisation Report. A number of states do not adhere to the OECD Commentary on software, on which the OECD's position on characterisation is based, and argue that any software

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94 Paras. 107-108.
98 Indian Ministry of Finance, High Powered Committee on E-Commerce and Taxation, *Report to the Indian Government on E-Commerce and Taxation* (July 2001), pp. 96-145. However, a recent Indian decision seems to support one of the OECD's conclusions - see Sanjay S, *Indian Tribunal Holds Subscription Fees Paid to Nonresident not Taxable*, 37 *Tax Notes Int'l* 449 (Feb. 2005).
purchase produces royalty income or that royalty income arises when less than all of the rights to software are transferred.  

- **Efficiency** - The flip-side of certainty and simplicity is efficiency. High degrees of uncertainty and complexity will result in high compliance and administrative costs, and increase the risk of disagreements and disputes.

- **Flexibility** - Tax rules should be flexible and dynamic to ensure that they keep pace with technological and commercial developments. However, technologies, business models, transactional structures and market behaviour will continue to evolve. The OECD’s position on income categorisation thus has a limited life-span because it is based upon the business models and technologies which may be outdated in the near to medium term. The preservation of existing rules will require ongoing adjustments, which may result in inconsistency, uncertainty and unfairness.

- **Neutrality** - The distinction between private and business consumers, and exclusion of the mass private consumer market from source taxation, are likely to undermine neutrality. Tax treatment of intellectual supplies may be determined by reference to an industry (e.g. business consultancy or entertainment) or a product (e.g. accounting software or gaming software). Interestingly, in its criticism of one of the reform proposals (the base-erosion approach), the OECD Final Report expressed similar concerns in relation to the consumer market:

  "This would mean that business-to-consumers e-commerce would not be affected by the proposed rule, which would constitute a serious disadvantage."

- **Effectiveness and enforcement** - Tax rules should minimise tax avoidance and tax evasion. Indeed, the prevention of tax evasion is a core treaty objective. However, as the application of existing rules can result in uncertainty and complexity, there is a risk that the scope of tax planning opportunities will be broadened. Moreover, e-commerce creates a whole new spectrum of opportunities to structure the flow of profits through low-tax jurisdictions. An obvious scenario is the relocation of operations to low-tax jurisdictions. A pro-residence state system can backfire on some of the OECD's core policy objectives. For example, residence taxation may be effectively deferred permanently where the attribution rules of the "ultimate" residence state do not apply to active e-commerce income or where the "ultimate" residence state has no attributions rules at all. Alternatively, residency taxation may be simply avoided.

- **International acceptance** - In addition to the uncertain element of the existing rules which may lead different observers to reach different conclusions, and the unacceptance of the OECD's interpretation solutions by some states, a major barrier to the retention of a broadly accepted international norm is that the interpretation and application of existing rules are likely to benefit residence states. This may induce states to adopt unilateral measures, which will further undermine the objective of achieving

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99 OECD Commentary on Article 12, paras. 27-31; Sheppard L, Revenge of the Source Countries, Part 2, Royalties, 40 Tax Notes Int’l 7, p. 10. 
100 Para. 263.
broad international acceptance. Although the current approach of the OECD to income characterisation favours residence taxation, market forces will eventually dictate what is acceptable and what is tolerable. The OECD Model's zero royalty withholding tax rate is an example in point. The next significant failure of the OECD to set or reflect international norms and market forces may well be the OECD's approach to income characterisation.

Towards a Coherent Framework for the Taxation of Intellectual Supplies in Tax Treaties

The above discussion indicates that the preservation of existing rules - the distinction between royalties and business profits - in the e-commerce context is far from optimal. The appropriateness of existing rules will continue to be eroded. E-commerce is developing rapidly. Only 15 years ago, e-commerce was just a novel and limited phenomenon. In a few years time, today's e-commerce and technological abilities may be viewed as embryonic and primitive versions of whatever will have been created and developed by then.

The OECD Final Report evaluates a number of reform alternatives with respect to business profits, some of which would be a fundamental modification of the existing rules and some that would not. The essential conclusion is that, whilst one or two non-fundamental alternatives that may render the interpretation of existing rules clearer should be further considered, e-commerce has not evolved to a stage justifying “a dramatic departure from the current rules.” It would appear that this conclusion is correct at the present time. Moreover, ill-considered and ill-informed reform processes are likely to cause more damage than benefit. However, given the time it takes to implement international tax reforms and the processes involved, it is certainly important to consider now the way ahead. And the way ahead is likely to have at least one large milestone that will affect international taxation. It will appear once e-commerce evolves to a stage where it brings about the loss of a "critical mass" of source state revenue. Thus, there is a need and a case for starting to outline a framework for reform, and in particular, a framework for the reform of the taxation of intellectual supplies under tax treaties.

Framework Outlined

The new framework for the taxation of intellectual supplies may be based on an addition to the royalty definition that will capture digital intellectual supplies and subject them to source

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102 Chapter 4.
103 Para. 350.
104 See Final Report, para. 125.
taxation, imposed by way of low-rate withholding tax. The tax withheld will not be final. The non-resident will be entitled to lodge tax returns and be taxed on a net basis. The non-resident will be entitled to relief from double taxation, to be granted by the residence state. The new framework will supplement the PE concept.

Conceptual and Theoretical Perspective

The OECD Final Report examines some of the conceptual bases for sharing the tax base, in particular the economic allegiance and the benefit doctrines. As to the former, the majority of the Technical Advisory Group ("TAG") rejected the argument that economic allegiance warrants source taxation solely on the basis of the provision of market demand:

"the mere fact that the realization of business transactions requires an interaction between the supply of goods or services by an enterprise and the demand in a market state has not historically been considered by countries to provide a sufficient link for considering that the profits of the enterprise arising from these transactions should, for purposes of income taxation, be sourced in the market state."107

This argument appears correct. Although mere demand is, in principle, a legitimate fiscal nexus under the economic allegiance doctrine, it may be too weak to apply in practice.

However, the TAG could not agree on stronger fiscal links. Some members considered that the use of source state infrastructure would only sanction taxing rights if the enterprise carries on activities therein. Other members took a contrary view, based on the benefit doctrine:

"For some members, source taxation is justified in such a case because the business profits of the foreign enterprise derive partly from the enterprise’s use of important locational advantages provided by that country’s infrastructure which make the business operations profitable. These may include, but are not limited to means of transportation (such as roads), public safety, a legal system that ensure the protection of property rights and a financial infrastructure."108

As a result, the OECD Final Report draws no conclusions on conceptual bases and source taxation:

"That disagreement prevented the TAG from articulating a single comprehensive conceptual base for evaluating the current rules for taxing business profits and the alternatives to these rules."109

105 Such a framework may partly be based on two alternatives considered in the OECD Final Report (Alternatives 4.B.a) and 4.B.b), which will require adaptation, modification and consolidation into a single framework (mainly because the OECD Final Report concerns business profits (rather than royalties) and because the description of the alternatives is fairly brief and rigid in terms of developing possible variations of the alternatives considered). Alternative 4.B.b) is based on the 'base-erosion' approach associated with the work of Professor Doernberg (see Doernberg Richard L, “Electronic Commerce and International Tax Sharing”; 98 TNI 6-43; Doernberg and Hinnekens, pp. 315-323; Doernberg Richard L, Hinnekens Luc, Hellerstein Walter and Li Jynian, Electronic Commerce and Multijurisdictional Taxation (The Hague, Kluwer Law International, 2001), pp. 354-365). See also a review of alternatives in Pinto, D, E-Commerce and Source Based Income Taxation, IBFD, 2002, Chapters 68.

106 Net basis taxation should be an option also under the present treatment of royalties, irrespective of a PE.

107 Para 41.

108 Para. 44.

109 Para. 46.
It is unfortunate that the OECD Final Report has missed such a rare opportunity to re-examine core theories and form a position about nexus, source and taxing rights. However, it appears that the answer is not as debatable as presented in the OECD Final Report, and that in the e-commerce context, even the theories that purport to justify the distinction between royalties and business profits lose much force. First, there are two conceptual bases that support the distinction in general: the benefit and economic allegiance doctrines. This support is based on the notion that the mere sale of goods without a PE would not create sufficient fiscal nexus with the source state; the fiscal claims of the residence state would typically be much stronger than those of the source state. On the other hand, royalties justify source taxation principally because the source state provides the legal framework and enforcement to protect the value of the intellectual supply concerned. In the e-commerce context, by contrast, business profits are very much like royalties in terms of the contribution made by the source state to the production of income. The value of intellectual rights and intellectual content depends on the source state's laws and law enforcement. Moreover, given that reproduction is so easy and cheap, there is even a greater dependence on source state protection. As a result, the source state has a strong claim over e-commerce business profits, as it has with respect to royalties which have been historically and broadly accepted as an income category that should be subject to source taxation.

Second, e-commerce adds another set of challenges to the debate on CEN and CIN. In general, it may be assumed that electronic commerce is conducted by corporations. The difference is that there is no investment by the non-resident corporation in the source state from which income is derived. The investment is in infrastructure, hardware, administration and the like, and can be made anywhere. Residence-based taxation of corporations may therefore be warranted under CEN on the basis that source taxation is, as a matter of fact, irrelevant to the location of the investment. Yet CIN would validly suggest that electronic commerce increases the importance of source taxation on electronic commerce profits. Although the online vendor makes no investment in the source state, it still needs to compete with other online vendors in the same market. Different rates of residency taxation would affect the competition among different vendors in the destination markets. More importantly, residence-based taxation of electronic commerce would simply direct investment to, and the establishment of corporate residency in, low-tax jurisdictions. Low or non-taxation may be better rectified through source taxation.

Scope of Framework

The royalty definition is principally designed to capture an income category based upon the realization of value embodied in intangible property, that is, “income from intangibles with a
Source taxation of royalties is perhaps best understood in that context. However, in the e-commerce context, the definition may not achieve that objective. Prior to the advent of e-commerce, it might have made sense to impose tax chiefly on the basis of “a letting”; i.e., the use or right to use intellectual property rights, rather than the right to use the product itself. This is ultimately because reproduction was not easy and cheap. For example, it made sense to tax the right of a local music distributor to reproduce a rock album, and not to tax the occasional use by a person who listened to the album, even if she purchased the album directly from abroad. The number of direct purchases was too small to warrant a broader royalty definition. The source state taxed the vast majority of copyright use through the imposition of withholding tax on the payment made by the local distributor to the foreign rock band.

In the digital age, however, the local distributor is sidelined. The main use of copyright is copying digital goods, containing images and sounds, and this use is as easy and common as a mouse click. This may be an incidental use of copyright, but this is not the point. The point is that use of copyright as a threshold warranting source taxation has little material meaning in the age of digitisation. Intellectual content is purchased in an environment that increasingly requires source state protection of the value of that content. If the purpose of royalty taxation at source is to tax income from intangibles with a substantial intellectual content then it may be an odd outcome if the rock band sells the same music (say from the 1970s), derives the same amount of source profit, enjoys the same or more source legal protection, but pays a much lower amount of source tax. The definition of royalties should thus be broadened to apply to intellectual supplies digitally made over the internet or similar media. This will be a natural extension of the concept of royalties and its adaptation to the realities of the digital age.

110 OECD Equipment Report, para. 18(i) (emphasis added).
111 OECD Commentary on Article 12, para. 1.
112 A definition that does not rely on the use of or right to use intellectual property is not novel. For example, although it may not have been originally intended to capture digital intellectual supplies, the Australian domestic definition of ‘royalties’ (and in some new Australian treaties) also applies to payments for:

"the reception of, or the right to receive, visual images or sounds, or both, transmitted to the public by:
(i) satellite; or
(ii) cable, optic fibre or similar technology."

Paragraph (da) of the definition of ‘royalties’, s. 6(1), Income Tax Assessment Act 1936. The extended definition of ‘royalties’ is also included in the Australia’s tax treaties with Canada (Article 12(8)(a)), New Zealand (Article 12(3)(f)), Czech Republic (Article 12(3)(e)), Taipei (Article 12(3)(e)), South Africa (Article 12(3)(f)), Slovak Republic (Article 12(3)(f)), Argentina (Article 12(3)(f)), Romania (Article 12(3)(e)), Russia (Article 12(3)(f)), and Mexico (Item 9 of the Protocol). See discussion in Tadmore N, Aspects of Electronic Commerce Taxation in Australia, (2003) 57 Bulletin for International Fiscal Documentation, 422.

113 The proposed framework does not change the PE concept. E-commerce will not do away with factories, equipment, construction projects and the like. The PE concept will continue to fulfil an important role in tax treaties. In addition, the PE concept may not be the suitable regime for reform that concerns intangibles because it is overwhelmingly a physical concept. Additionally, a framework that focuses on the taxation of digital intellectual supplies would better accord, and operate within, the rules that are inherently designed to deal with intangibles, that is, the rules dealing with royalty taxation.
This approach has two implications. First, there should be no taxation at source of intellectual content that is delivered in a form that does not enable easy and cheap reproduction. For example, the delivery of books will continue to warrant source taxation only on the basis of copyright, whereas the delivery of DVDs will warrant source taxation on the basis of the additional royalty definition. The difference goes to the very reason behind the proposal, namely ease and cost of reproduction, and source state protections. Second, the scope suggested will not capture e-commerce transactions that are not digital intellectual supplies. For example, the source state may not be justified in imposing tax on a residence car rental company that merely sells a four-wheel drive package there to a source state customer. The source state would merely provide the demand, which is too slight a nexus.

**Balanced Approach to Revenue Reallocation - A Low Tax rate**

One-sided solutions favouring the claims of only one of the two states concerned may not be realistically achievable. At the practical level, it must be appreciated that the consent of both states is required to bring about changes. True, the source state has the ability to implement unilateral measures, but the residence state does not have to cooperate, and it can refuse, for example, to grant relief from source taxation. Source and residence states may need to acknowledge that the revenue division issue may only be resolved by the core principle of tax treaties, namely compromise.

Since it is difficult, if not practically impossible, to determine whose claim is stronger in any given set of circumstances, equal sharing arrangements of electronic commerce tax revenue may make sense.\(^{114}\) Essentially, the compromise suggested is an application of the "division of the tax", method considered by the four economists. The inaccurate nature of such a solution may be compensated for by greater simplicity. At the end of the day, since one-sided solutions will be fraught with difficulties, the likelihood of reaching an international agreement on electronic commerce may significantly increase if it is agreed that an arbitrary but equal division of tax should apply. Such a division is also sanctioned on conceptual grounds. Although the source state has a strong fiscal nexus with the income, it should not be forgotten that the residence state also has strong claims in relation to that income. The residence state should not be entitled to have all the revenue shifted its way as a result of electronic commerce, however, the source state cannot rightfully suggest that the pre-electronic commerce tax base should be fully preserved. For this reason, the withholding tax rate should be relatively low (say, 3%-6%).

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\(^{114}\) See general comment in the Final Report, para. 59.
Evaluation of Policy Objectives

The discussion below evaluates this new framework on the basis of the relevant evaluation criteria in the OECD Final Report as well as other considerations.

- **Certainty** - The new framework will do away with the difficulties surrounding the use or right to use intellectual property and the sale or letting of digital products, and thus will reduce uncertainty. However, uncertainty will not be eliminated. The main challenge will be the distinction between intellectual supplies and services, and incidental intellectual supplies or mixed payments.

- **Efficiency** - Reduced degrees of uncertainty and complexity will result in reduced compliance and administrative costs, and decrease the risk of disagreements and disputes. Compliance costs may, however, increase where the non-resident elects to be taxed on a net basis.\(^{115}\) Yet this cost may be part of doing business in the digital age, as compliance costs are likely to be incurred mainly where taxation on a net-basis will result in a lower tax burden at source.

- **Flexibility** - A framework based on digital intellectual supplies will be inherently more flexible than existing rules as it will be designed to apply to e-commerce transactions.

- **Relationship with Free-Trade Agreements and similarity to consumption taxes** - The OECD Final Report raised the valid concern that a final withholding tax system may be inconsistent with principles of income tax and WTO rules, but conceded that the ability to be taxed on a net basis and obtain a tax credit would assist in mitigating against these difficulties.\(^{116}\)

  Another concern correctly raised in the OECD Final Report is that ultimately the withholding tax will be passed on to source state consumers. This would arise where the non-resident supplier refuses to sell unless it gets its asking price, which means that the consumer would have to gross-up the payment. However, this possibility is likely to be diminished significantly in a treaty context, or where foreign tax credits are unilaterally available.\(^{117}\)

- **International acceptance** - The OECD Final Report notes that the clear advantage of the existing rules is that they are the current international norm.\(^{118}\) However, as discussed above, the continuing operation of existing rules may undermine the broad acceptance of the current international norms. An important feature of the proposed framework is that its conceptual basis is already widely accepted (although not under the OECD Model), namely source taxation of royalties, of the use and right to use intellectual property rights. An extension of this concept and its adaptation to new and prevalent business models will be conceptually consistent with this approach and thus be a sound springboard for a new international norm.

\(^{115}\) Final Report, para. 263.
\(^{117}\) Final Report, para. 278.
\(^{118}\) Para. 123.
• **Enforcement** - Enforcement of a withholding tax may be divided into deductible payments (business-to-business supplies) and non-deductible payments (business-to-consumer payments). Enforcement of deductible payments can be readily achievable because if the tax is not withheld the payment will not be deductible.\(^{119}\) In the business-to-consumer market, however, consumers have little interest, incentive or ability to comply with any such obligation.\(^{120}\) This can significantly weaken the proposed framework with respect to private consumers. Whatever benefit or economic allegiance rights the source state has, however fair its claim about its diminishing tax base may be, as the realistic doctrine suggests, there is no point in imposing taxes which cannot be collected. In the e-commerce context, theory, policy and collection are intertwined, and collection will dictate and shape any change to the current rules. As Adams once said, “tax should not be assigned to a jurisdiction which cannot effectively administer and collect the tax.”\(^{121}\)

The advance of technology and international cooperation, and the creation of stronger compliance cultures, may ultimately address this issue by rendering feasible the collection of tax concerning business-to-consumer transactions. At present, however, there appears to be no satisfactory solutions. For example, inconvenience can be addressed by relatively simple technological advancements. The consumer, for example, would be able to call on an automated user-friendly virtual tax agent "working" for the local tax authority that will calculate and collect the tax when the transaction is made. However, short of draconian enforcement measures, this will not address the second barrier to direct collection, namely lack of incentive. Another possibility is collection by residence state. This, however, will require an unprecedented degree of cooperation. Indeed, assistance in the collection of taxes is not a new concept. Such a regime was suggested in 1928 by the League of Nations, when it published its first model treaty.\(^{122}\) Not much progress has taken place in this area since then.\(^{123}\) Perhaps close cooperation will be more feasible where states are closely associated in blocks, such as the European Union.\(^{124}\) A more viable alternative, which requires careful consideration and planning, may be collection by intermediaries, such as source state financial institutions.\(^{125}\) A consumer buys a product online, the financial institution is instructed by the consumer to transfer funds to a foreign bank account, the financial institution withholds a portion of the payment, and the financial institution remits that portion to the tax authority. The main advantage of this method is that it radically reduces the number of tax collectors and the compliance burden at the consumer level. Its main disadvantage is that it is somewhat draconian and would

\(^{119}\) This is the essence of the "base erosion approach" associated with Professor Doernberg (see note 105).
\(^{120}\) Final Report, para. 262.
\(^{122}\) League of Nations 1928 Report, Part IV (Bilateral Convention on Assistance in the Collection of Taxes).
\(^{123}\) The recently-added Article 27 of the OECD Model, dealing with assistance in the collection of taxes, can enhance cooperation. However, Article 27 seems to be designed to deal with specific instances where assistance in collection is required, rather than creating an ongoing mutual collection and remittance mechanism. See discussion in van der Bruggen (2002).
\(^{124}\) VAT within the European Union is an example in point - see Jensen P, VAT Levied on Digital Sales within EU, The International Tax Lawyer, 30.1 (2004).
\(^{125}\) See in general Report by OECD’s Technology Technical Advisory Group (December 2000), paras. 22-32 (in relation to indirect taxes).
involve, considerable practical difficulties with respect to its actual operation as well as avoidance opportunities.

- **Revenue reallocation** - In the absence of viable collection solutions with respect to private consumers, the framework will essentially be modelled on the base-erosion approach suggested Professor Doernberg and others (but only to the extent that that approach applies to digital intellectual supplies). The approach goes a long way to address revenue allocation by "permitting increased source state withholding on payments that erode the tax base of the source state." However, it will obviously not address revenue reallocation in the rapidly growing business-to-consumer marker. If one considers the iPod, for example, one may conclude that it is plausible that this market will be very significant.

- **Neutrality** - In the absence of viable collection solutions with respect to private consumers, the framework would only be applicable to deductible payments. Accordingly, neutrality will be compromised. The impact on neutrality will not only be constant, it will also accelerate. The growth of the business-to-consumer market would create an ongoing pressure to increase the low withholding tax rate imposed on deductible payments to avoid further erosion of the source state’s revenue base. This may require setting an even lower withholding tax rate on deductible payments.

**Conclusion**

The source state is entitled to tax intellectual supplies. Source taxation of royalties reflects that entitlement. In practice, source taxation of royalties is a product of the historical hangover underpinning income categorisation and bargaining processes between source and residence states. The advent of e-commerce, in particular digitization, is creating new commercial realities that warrant source taxation at two levels. First, the dependency of the resulting profits heavily relies on source state benefits. Second, reliance on traditional rules will exclude source taxation of intellectual supplies in the digital age and are likely to result in revenue reallocation. At some point, this is likely to undermine the core bargain between the states as well as the current international norms.

A coherent framework for the taxation of intellectual supplies should be based on the adaptation of the royalty definition to include digital intellectual supplies. It would impose a low rate of source taxation on such supplies, taking into account the need to balance the fiscal assertions of both the source and the residence states. Ideally, the tax will apply to all digital intellectual supplies. However, the main challenge of this framework will be enforcement in the mass consumer market. Viable solutions may be adopted as technology evolves, but in the absence of

such solutions, the framework will have to be confined to deductible payments, which will compromise neutrality.

Nonetheless, the default option - to continue to use existing rules - would compromise neutrality to at least the same extent. Moreover, it would also come with all the additional costs and consequences associated with its diminishing relevance and competence. The application of existing rules that emanated from the realities of the 1920s-1930s can only go so far in the digital age.

The proposals made above would make tax treaties more responsive to technological changes, and thus enable tax treaties to remain effective and meaningful fiscal arrangements as the economic changes brought about by new technologies continue to emerge. Treaty history shows that treaty policy and development are followers of international commercial trends. The digital age may well reverse that position by forcing treaty policy and development into a leadership position.

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