

# eJournal of Tax Research

Volume 5, Number 2 (Michigan Issue)

December 2007

## CONTENTS

- 168 Introduction  
**Reuven Avi-Yonah, Binh Tran-Nam and Michael Walpole**
- 169 Tax Treaty Treatment of Royalty Payments from Low-Income Countries: A Comparison of Canada and Australia's Policies  
**Kim Brooks**
- 199 Purism and Contextualism within International Tax Law Analysis: How Traditional Analysis Fails Developing Countries  
**Arthur Cockfield**
- 225 Tax Enforcement for SMEs: Lessons from the Italian Experience?  
**Giampaolo Arachi and Alessandro Santoro**
- 244 Tax Policy for Investment  
**W. Steven Clark**

# Tax Treaty Treatment of Royalty Payments from Low-Income Countries: A Comparison of Canada and Australia's Policies

**Kim Brooks\***

## **Abstract**

The proposal made in this paper is a modest one: that high-income countries should further the cause of reducing global inequality by ensuring that in their tax treaties with low-income countries they do not usurp needed revenues by reducing low-income countries' ability to collect tax on income with a source in the low-income country. This argument is made in the specific context of the taxation of royalty payments, which present one of the most extreme examples of high-income countries unfairly confiscating revenues that appropriately belong to their low-income treaty partners. The Organisation for Economic Co-operation and Development (OECD) model tax treaty, which most high-income countries in the world closely follow in negotiating their own tax treaties, provides that to avoid double taxation, source countries (invariably low-income countries) should reduce their rate of withholding tax on royalty payments to zero. Thus low-income countries that enter into tax treaties modelled on the OECD model convention are unable to levy a tax on royalty payments that have a source in their jurisdiction. In many cases, this simply results in a net transfer of revenue from the low-income country's treasury to the treasury of the high-income country. In making the general case for source taxation of royalty payments, the paper examines and compares Canadian and Australian tax treaty policies to see to what extent those countries have followed the OECD model convention in negotiating with low-income countries.

## **I. TAX TREATIES AS A POLICY INSTRUMENT FOR THE PROMOTION OF TRADE AND INVESTMENT, AND FOR REVENUE ALLOCATION**

### **A. Giving with One Hand, Taking with the Other**

One of the most urgent problems facing the world is the huge divide in material living standards, and in every other indicia of human development, between high-income and low-income countries. Of the 177 countries tracked in the United Nations Development Programme's *Human Development Report 2005*, only 57 were categorized as high human development and they had average GDP per capita in

---

\* Associate professor, H. Heward Stikeman Chair in the Law of Taxation at McGill University and senior research fellow in the Taxation Law and Policy Research Institute at Monash University. Email: [kimberley.brooks@mcgill.ca](mailto:kimberley.brooks@mcgill.ca).

The author is particularly grateful to the faculty and staff at Atax, the taxation school of the Faculty of Law at the University of New South Wales, for the opportunity to spend a month in Australia as the Abe Greenbaum visiting research fellow. This paper was written in part while the author was in residence at Atax on that fellowship. The research for this article was made possible in part by a Hampton Research Grant provided by the University of British Columbia and also by a standard research grant from the Social Science and Humanities Research Council of Canada. The author is indebted to Amy Chapman, Matthew Swanson, and Morgan Troke for their excellent research assistance, and to a range of people who made helpful comments throughout the writing of this paper, including participants in the 2006 Critical Tax Theory workshop at Mercer University School of Law, faculty members at the Saint Louis University School of Law, an anonymous Australian reviewer, and Arthur Cockfield. This paper is dedicated to the memory of Abe Greenbaum, a consummate tax teacher, whose patience, clarity and insight, attention to detail, and obvious grasp of both the detail and underlying policy of tax law are missed.

(PPP) US dollars of \$25,665; the 88 countries the program labelled as medium human development countries had an average GDP per capita of \$4,474; and 32 low human development countries had an average GDP per capita of only \$1,046.<sup>1</sup> These disparities in living conditions are intolerable.

At one point, orthodox economic theory was interpreted as suggesting that the level of incomes in rich and poor countries would converge. Investment would flow from rich countries, where capital is in abundant supply and thus returns are low, to poor countries, where capital is in short supply and thus returns are much higher. The brutal facts behind the on-going economic crises in Africa and the continued stagnation in much of Latin America and parts of Asia have rendered this theory unsustainable.<sup>2</sup>

A number of well-known development economists have recently called for urgent and drastic action to deal with the crises in world poverty and inequality. Jeffrey Sachs, known for his work as economic advisor to governments around the world and director of Columbia University's Earth Institute, has published a plan calling for roughly \$150 billion in additional foreign aid a year. He contends that properly disbursed this amount could bring an end to mass destitution (such as the 1.1 billion extremely poor living on less than \$1 a day) within 20 years.<sup>3</sup> Branko Milanovic, an economist with the Carnegie Endowment for International Peace and the World Bank, in a book in which he scrupulously documents the increasing income inequalities between countries, calls for global redistribution through taxes that would be levied on the world's rich by an international, authorized body.<sup>4</sup> As an indication of the immediacy with which people now view the problem of global inequality, both of these somewhat technical books have become best sellers over the past year.

By comparison to these bold schemes for reducing global inequality, the proposal made in this paper is modest, but not necessarily insignificant in the long-run. High-income countries should further the cause of reducing global inequality by ensuring that in their tax treaties with low-income countries they do not usurp needed revenues by reducing low-income countries' ability to collect tax on income with a source in the low-income country. In this paper, this argument is made in the specific context of the taxation of royalty payments, which present one of the most extreme examples of high-income countries unfairly confiscating revenues that appropriately belong to their low-income treaty partners. The Organisation for Economic Co-operation and Development (OECD) model tax treaty, which most high-income countries in the world closely follow in negotiating their own tax treaties, provides that to avoid double taxation, source countries (invariably low-income countries) should reduce

---

<sup>1</sup> United Nations, *Human Development Report* (2005) table 14.

<sup>2</sup> For a collection of papers on globalization, law and development representing a range of views on the best approach to ensure globalization promotes the development of all countries see the symposium in (2004) 26 *Michigan Journal of International Law*. See also Nancy Birdsall, Dani Rodrik and Arvind Subramanian, 'How to Help Poor Countries' (2005) 84 *Foreign Affairs* 136 (arguing that wealthy countries should provide developing countries with the ability to design their own economic policies, and that developed countries can support developing countries achieve that end by offering increased aid with fewer onerous reporting restrictions, reducing trade inequities, financing new development-friendly technologies, and opening up labour markets).

<sup>3</sup> Jeffrey Sachs, *The End of Poverty: Economic Possibilities for Our Time* (2005).

<sup>4</sup> Branko Milanovic, *Worlds Apart: Measuring International and Global Inequalities* (2005).

their rate of withholding tax on royalties payments to zero.<sup>5</sup> Thus low-income countries that enter into tax treaties modelled on the OECD model convention are unable to levy a tax on royalty payments that have a source in their jurisdiction. In many cases, as is argued in more detail below, this simply results in a net transfer of revenue from the low-income country's treasury to the treasury of the high-income country.

Low-income countries are, of course, desperate for revenues to provide basic health care and education for their populations and to construct modern transportation and communication systems to increase the productivity of their workers. It seems incongruous, some might even say immoral, for high-income countries to, on the one hand, admit the moral case and the pragmatic need for providing aid to low-income countries, but, on the other hand, to enter into tax treaties with them that deny them the ability to collect revenue from income earned in their jurisdictions that normative principles of international tax suggest they have a right to tax. In making the general case for source taxation of royalty payments, I examine and compare the Canadian and Australian tax treaty policies to see to what extent those countries have followed the OECD model convention in negotiating with low-income countries.

The suggestion that high-income countries should use their tax systems and, in particular, tax treaties, to assist low-income countries, is not novel.<sup>6</sup> Almost from the emergence of tax treaty negotiations in the 1920s and 1930s, low-income countries have recognized the importance of appropriately drafted tax treaties in preserving their revenue raising capacities. The United Nations has had the problem under on-going review since the late 1960s. A number of articles have been written over the years making the case for strong source taxation generally and arguing that this jurisdiction to tax should be preserved in treaties.<sup>7</sup> Recently, Karen Brown, a tax professor at George Washington University Law School, has written a series of articles arguing that the United States should modify its tax treaty stance and its domestic tax rules to encourage US companies to invest in low-income countries, particularly African nations.<sup>8</sup> Reuven Avi-Yonah, a tax professor at The University of Michigan Law School, has written extensively on the need to curb international tax competition to

---

<sup>5</sup> Organization for Economic Co-operation and Development, *Model Tax Convention on Income and on Capital: Condensed Version* (2005) [OECD model convention] art 14.

<sup>6</sup> Most fundamentally, determining whether a particular stream of income should be taxed at its source or in the country of the taxpayer's residence is simply a question about tax fairness – how should the tax revenues be fairly shared? As noted by Richard Bird and Scott Wilkie, “the source-residence question is, essentially, ‘who gets how much tax?’” See Richard Bird and Scott Wilkie, ‘Source- vs. Residence-based Taxation in the European Union: The Wrong Question?’ in Sijbren Cnossen (ed), *Taxing Capital Income in the European Union: Issues and Options for Reform* (2000) 78, 96. On the general question of fairness and the taxation of international income, see Nancy Kaufman, ‘Fairness and the Taxation of International Income’ (1998) 29 *Law & Policy in International Business* 145.

<sup>7</sup> See below n 29.

<sup>8</sup> Karen B. Brown, ‘Transforming the Unilateralist into the Internationalist: New Tax Treaty Policy Toward Developing Countries’ in Karen B Brown and Mary Louise Fellows (eds), *Taxing America* (1996) 214; Karen B Brown, ‘Missing Africa: Should U.S. International Tax Rules Accommodate Investment in Developing Countries?’ (2002) 23 *University of Pennsylvania Journal of International Economics and Law* 45; Karen B Brown, ‘Harmful Tax Competition: The OECD View’ (1999) 32 *George Washington Journal of International Law and Economics* 311. For a reply to Brown's argument see Paul B McDaniel, ‘The U.S. Tax Treatment of Foreign Source Income Earned in Developing Countries: A Policy Analysis’ (2003) 35 *George Washington International Law Review* 265.

protect the tax bases of low-income countries.<sup>9</sup> Naturally, there are other commentators who take the view that tax system changes and tax treaties, in particular, have more than functioned ineffectively, and have failed to function at all as a means for assisting low-income countries.<sup>10</sup>

### **B. The Evolution of Double Tax Treaties**

Tax treaties are generally regarded as important instruments for the promotion of trade and investment because they remove the potential for double taxation.<sup>11</sup> Obviously, a multinational enterprise or investor in one country is more likely to be willing to do business or invest in another country if it can be confident that it will not be subject to double tax on the income it earns in that country. The potential for double tax arises since many countries assert jurisdiction to tax on the basis of both residence and source. They tax persons who are resident in their jurisdiction (or who have similar strong economic connections) on their world-wide income and they tax non-residents on income that they earn that has a source in their jurisdiction. Consequently, whenever a person resident in one country earns income with a source in another country both countries are likely to assert their right to tax the income. Traditionally, this potential for double tax has been alleviated somewhat because most countries provide that their residents can claim a foreign tax credit for any taxes they might have had to pay on income with a source in another country. However, tax treaties – agreements between the two countries about how they will structure their taxes on flows of incomes between them – are potentially a more comprehensive, certain, and fair way of removing the potential for double taxation.

The most obvious way to remove the potential for double taxation is for the source country to agree with its treaty partner not to tax the income earned in its jurisdiction. This approach would promote foreign economic activities since corporations and investors will not have to be concerned about the details of the tax laws in the foreign countries in which they operate. If the income flows between the two countries are about equal there would be no revenue loss to either government. Each country would forgo taxes on the income earned in its country by residents of its treaty partner, but would increase the revenues collected on the income earned by its residents in treaty partner countries since the treaty partner would not impose any source tax. However, if the income flows between the countries are not reciprocal, then limiting taxation in the source country as a mechanism for removing double taxation will have a significant effect on the fair allocation of tax revenue between the two jurisdictions. Hence the conflicting positions taken by high-income countries (generally capital exporting countries) and low-income countries (generally capital importing countries) in treaty negotiations. High-income countries would prefer to negotiate tax treaties in which the residence jurisdiction is given primacy to tax; low-income countries would prefer to negotiate tax treaties in which the source jurisdiction is given primacy to tax. Although countries' positions as net capital importers or exporters may change over

---

<sup>9</sup> Reuven Avi-Yonah, 'Globalization, Tax Competition and the Fiscal Crisis of the Welfare State' (2000) 113 *Harvard Law Review* 1573; Reuven Avi-Yonah, 'Bridging the North/South Divide: International Redistribution and Tax Competition' (2004) 26 *Michigan Journal of International Law* 371.

<sup>10</sup> See, eg, Allison Christians, 'Tax Treaties for Investment and Aid to Sub-Saharan Africa: A Case Study' (Research Paper No 05-15, *Northwestern Law & Economics*, 2005).

<sup>11</sup> Tax treaties facilitate trade and investment in a number of ways in addition to removing the potential for double taxation. For a succinct statement of the purpose of tax treaties see US, American Law Institute, *Federal Income Tax Project: Tentative Draft No. 16, United States Income Tax Treaties* (1991) 1, 1–14.

time and by type of income, at a general level this conflict is evident throughout the evolution of double tax treaties.

The story of the development of modern double tax treaties has been often and well told and only the highlights will be noted here to provide some context for the proposals suggested in this paper. By the 1920s, rates of income taxation in industrialized countries and the volume of international business had increased to the point where double taxation had become a matter of worldwide significance. In 1920, the League of Nations directed its Financial Committee to examine the issue. The Committee, in turn, commissioned a report from a group of four prominent economists, one each from the United States, the United Kingdom, the Netherlands, and Italy. Their 1923 report was comprehensive and anticipated most of the debates and issues relating to international double taxation.<sup>12</sup> On the question of the right to tax, they concluded that countries should have the jurisdiction to tax those persons who owed them economic allegiance.<sup>13</sup> They reviewed the implications of this principle for various categories of wealth and income and concluded that for land and business property, the country in which the taxpayer had a fixed location had the strongest claim to the taxpayer's economic allegiance;<sup>14</sup> in contrast, for both tangible and intangible personal property, the predominant claim of economic allegiance was held to rest with the country in which the owner resided.<sup>15</sup> Thus they thought that for royalty payments, for example, the source country should cede the right to tax. They recognized that this would create an imbalance between "creditor" and "debtor" countries, but thought this might be resolved by some form of revenue sharing between countries.<sup>16</sup>

Following the four economists' report, the League continued working on the problems of double taxation. In 1925, it published a report of a Committee of Technical Experts<sup>17</sup> and in the late 1920s it drafted a series of model treaties. Although the legacy of the League's preliminary work on double taxation treaties can be seen in many aspects of modern tax treaty making, perhaps most significantly, its interpretation of the economic allegiance principle - that the right to tax income connected with a fixed business location should be accorded to the country in which it is located, but that various forms of investment income should be taxed in the country in which the owner is resident - continues to dominate international tax practice and policy.

In the late 1920s the League appointed a permanent Fiscal Committee to monitor the development of tax treaties.<sup>18</sup> As part of its on-going work, in 1943, a regional

---

<sup>12</sup> League of Nations, Economics and Financial Commission, *Report on Double Taxation Submitted to the Financial Committee by Professors Bruins, Einaudi, Seligman and Sir Josiah Stamp*, League of Nations document no E.F.S.73.F.19 (1923).

<sup>13</sup> Concepts of economic allegiance as a basis of taxation preceded the four economists' report. See Georg von Schanz' argument in 1892 that economic allegiance should act as the only principle to ensure the fair and equitable distribution of tax revenues between countries. "Zur Frage der Steuerpflicht" (1982) 9 II Finanzarchiv 1.

<sup>14</sup> Ibid 24.

<sup>15</sup> League of Nations, above n 12, 34.

<sup>16</sup> Ibid 48.

<sup>17</sup> *Report and Resolutions submitted by the Technical Experts on Double Taxation and Tax Evasion to the Financial Committee of the League of Nations*, League of Nations Doc C.115. M.55. 1925 II (1925).

<sup>18</sup> One of the most significant products of this Committee's early work was the approval in 1934 of a model treaty that adopted the "arm's length" standard for allocating profits among related corporations

conference was held in Mexico. The conference was attended by the United States, Canada, Mexico, Argentina, Chile and a number of other Latin American countries. The immediate objective of the conference was to settle tax problems between countries in the Western Hemisphere; however, an important issue for discussion was the continuing conflict over residence versus source principles. A majority of the participants, who represented low-income countries, approved a draft model treaty that gave taxation rights almost exclusively to source countries, with the burden of tax relief, in order to prevent double taxation, assigned to the residence country. Not surprisingly, the draft provided that royalties should be taxable only in the country where the patent or similar right is exploited, but provided an exception for payments for the right to use a musical, artistic, literary, scientific or other cultural work or publication, which were to be taxed only by the residence state.<sup>19</sup> This Mexico model has been viewed as “the first attempt by the developing countries to write a model treaty reflecting their particular problems.”<sup>20</sup> High-income countries naturally regarded the Mexico model as too biased towards the source-country principle and hence another series of meetings was held in London under the Fiscal Committee's auspices in 1946. The London model that emerged from this conference was considerably more biased in favour of residence countries. For example, with respect to royalties, it called for the exclusive taxation by the country in which the grantor of the patent resided.<sup>21</sup> However, the source state was provided with some scope for taxing royalties where the royalties were paid by an enterprise to another enterprise that had a dominant participation in its management or capital, although the source state was required to permit a deduction for all expenses, including depreciation.<sup>22</sup> Negotiations between high-income and low-income countries continued, but eventually stalled in the early 1950s.

In the late 1950s, concerned about the effect of tax uncertainty on the increasing amount of international trade and investment, the international business community persuaded the Organization for European Economic Co-operation (OEEC) to form a Fiscal Committee and charged it with the task of exploring the possibility of achieving a uniform multi-lateral treaty for the avoidance of double taxation. In 1961, the OEEC was re-constituted as the OECD, with the addition of the United States and Canada as members. In 1963, the work of the Fiscal Committee culminated in the publication of the OECD model bilateral income tax treaty. Although the committee had reviewed both the Mexico and London models, its model treaty was closer to the London model and reflected a strong residence bias. The 1963 OECD model convention has been revised a number of times since and has become, without question, the most important influence on tax treaty policy. Almost all tax treaties are based not only upon its structure and outline but closely reflect its substantive policy judgements about the most appropriate means of avoiding the potential of double taxation.

---

carrying on businesses in different countries. League of Nations Fiscal Committee, *Report of the Fourth Session of the Committee*, League of Nations Doc No C.339 M.204.1933.IIA (26 June 1933).

<sup>19</sup> League of Nations, *Fiscal Committee Model Tax Conventions: Commentary and Text* (1946) 64. See in particular Article X of the Mexico Model, paragraphs 2 and 3.

<sup>20</sup> *Manual for the Negotiation of Bilateral Tax Treaties Between Developed and Developing Countries*, UN Doc ST/ESA/94 (1979) 16. See also K C Wang, 'International Double Taxation of Income: Relief Through International Agreement' (1945) 59 *Harvard Law Review* 73, 95.

<sup>21</sup> League of Nations, *Fiscal Committee Model Tax Conventions: Commentary and Text* (1946) 65. See, in particular, Article X, paragraph 2 of the London Model.

<sup>22</sup> See Article X, paragraph 3 of the London Model.

Not surprisingly, low-income countries felt that the OECD model convention was inappropriate as a model agreement for concluding tax treaties between low-income and high-income countries and recognized it would deprive them of badly needed revenue from income flowing from their territories. Therefore, shortly after the completion of the 1963 OECD model convention, the Economic and Social Council of the United Nations began a study of the principles that should underlie tax treaties between high-income and low-income countries. In 1967 it established the Ad Hoc Group of Experts on Tax Treaties Between Developed and Developing Countries. The group consisted of representatives from ten high-income and ten low-income countries.<sup>23</sup> Over the course of the next decade, the group issued eight reports on its work,<sup>24</sup> which provide a comprehensive discussion of many of the problems raised by developed-developing country treaties; guidelines,<sup>25</sup> and later a manual,<sup>26</sup> for the negotiation of such treaties; and finally, in 1980, a model treaty.<sup>27</sup>

Although the UN model convention was drafted with representatives from low-income countries, it has been widely noted that it did not depart radically from the OECD model convention, and indeed it amounts, by and large, to a commentary on the OECD model.<sup>28</sup> Nevertheless, the UN model convention reflects a much stronger source-country bias than the OECD model. For example, for royalty payments, in contrast to the OECD model convention, which extends the exclusive right to tax royalties to the country in which the owner resides, the UN model convention does not allocate the exclusive right to tax royalties to the country of residence of the recipient of the royalty payment and instead stipulates that the country of source may levy a

<sup>23</sup> Argentina, Brazil, Chile, France, Federal Republic of Germany, Ghana, India, Israel, Japan, the Netherlands, Norway, Pakistan, the Philippines, Sri Lanka, the Sudan, Switzerland, Tunisia, Turkey, the United Kingdom of Great Britain and Northern Ireland, and the United States of America comprised the group of twenty countries. There were also several observing countries including Austria, Belgium, Finland, the Republic of Korea, Mexico, Nigeria, Spain, Swaziland and Venezuela and several observing organizations including the International Monetary Fund, the International Fiscal Association, the Organisation for Economic Cooperation and Development, the Organization of American States, and the International Chamber of Commerce.

<sup>24</sup> UN Department of Economic and Social Affairs, *Tax Treaties between Developed and Developing Countries, First Report*, UN Doc E/4614 ST/ECA/110 (1969); *Second Report*, UN Doc E/4939 ST/ECA/137 (1970); *Third Report*, UN Doc ST/ECA/166 (1972); *Fourth Report*, UN Doc ST/ECA/188 (1973); *Fifth Report*, UN Doc ST/ESA/18 (1975); *Sixth Report*, UN Doc ST/ESA/42 (1976); *Seventh Report*, UN Doc ST/ESA/79 (1978); *Eighth Report*, UN Doc ST/ESA/101 (1980).

<sup>25</sup> *Guidelines for Tax Treaties Between Developed and Developing Countries*, UN Doc ST/ESA/14 (1974). See also Stanley S Surrey, 'United Nations Group of Experts and the Guidelines for Tax Treaties Between Developed and Developing Countries' (1978) 19 *Harvard International Law Journal* 1.

<sup>26</sup> *Manual for the Negotiation of Bilateral Tax Treaties Between Developed and Developing Countries*, above n 19.

<sup>27</sup> *Model Double Taxation Convention Between Developed and Developing Countries*, UN Doc ST/ESA/102 (1980). See S Surrey, 'United Nations Model Convention for Tax Treaties Between Developed and Developing Countries: A Description and Analysis' in *International Bureau of Fiscal Documentation, Selected Monographs on Taxation* (1980) vol 5. The UN model convention was updated most recently in 2001, see *Model Double Taxation Convention Between Developed and Developing Countries*, UN publication no ST/ESA/PAD/SER.E21 (2001) [UN model convention].

<sup>28</sup> See, eg, Sol Picciotto, *International Business Taxation: A Study in the Internationalization of Business Regulation* (1992) 56. ("The UN Guidelines did not make any new departures in the approach to tax treaties. They took as their starting point the 1963 OECD draft, and merely noted the differing views expressed by experts....Neither the Guidelines, the Manual nor the Model Treaty could be said to challenge the basic principles of the OECD model. Although the report of the UN experts stressed the primacy of taxation at source, this was not expressed in any general principle.")



withholding tax on royalties. The UN model leaves the rate of withholding tax at source on royalties to bilateral negotiations.

The fact that the OECD model convention reflects a strong residence country bias, and hence can have adverse effects on the revenue of low-income countries, has been noted by countless commentators.<sup>29</sup> Given wide recognition of this obvious flaw, the somewhat puzzling question is why it has remained the model for so many high-income countries even when negotiating with low-income countries. The presence of the bias might be the product of some historically contingent set of facts; or, reflect a careful and prudent weighing of all the tax, economic, and social factors relevant in attempting to achieve a compromise beneficial to all affected parties; or, it might conceivably simply reflect the self-interest of the most powerful participant in tax treaty negotiations, the United States. This last possible explanation, that the United States' position in its treaty negotiations influences other countries' negotiations (even in the absence of the United States as a party to the particular treaty), was suggested by Charles Irish in a leading article on the problems of tax treaties:

There appear to be several reasons for the emphasis on residence in tax agreements between developed countries. Probably the fundamental reason is that the emphasis on residence represents the more favorable alternative for the country with the stronger bargaining position. Frequently countries have an interest in capital, technology and services possessed by the taxpayers of other countries. In such instances, the 'interested' country is the potential source country and the other is the potential residence country. As between the two countries, the potential residence country thus has the stronger economic position and the evidence indicates that it has used its superior position to 'persuade' the source country to forgo tax revenues so as to insure availability of the desired capital, technology and services. This apparently is what happened immediately after World War II between the countries of Western Europe and the United States. At that time, the Western European countries were very interested in attracting United States capital and technology to rebuild and modernise their war-ravaged economies. In order to ensure the unfettered flow of such capital and

---

<sup>29</sup> Recently, this point has been made perhaps most strongly by Lee Sheppard who comments that: "the international system has been set up to preserve residence-based taxation by rich capital-exporting countries at the expense of everyone else. Under the OECD model treaty, which rich countries impose on others, whenever there is a conflict or a possibility of double taxation, the source country is required to cede its primary right to tax. Originally intended to relieve double taxation, these treaties have become instruments of double nontaxation all over the world, and everyone knows it." 'Revenge of the Source Countries, Part IV: Who Gets the Bill?' (2005) 40 *Tax Notes International* 411, 416. See also Hope Ashiabor, 'The Taxation of Foreign Investments in Developing Countries Under the Treaty Regime: The African Experience' (1996) 22(4) *International Tax Journal* 69; Avi-Yonah, "Bridging the North/South Divide", above n 9; Brown and Fellows, above n 8; Brown, above n 8; Tsilly Dagan, 'The Tax Treaties Myth' (2000) 32 *International Law and Politics* 939; H L Goldberg, 'Conventions for the Elimination of International Double Taxation: Toward a Developing Country Model' (1983) 15 *Law & Policy in International Business* 833; Charles Irish, 'International Double Taxation Agreements and Income Taxation at Source' (1974) 23(2) *International and Comparative Law Quarterly* 292; Chang Hee Lee, 'Impact of E-Commerce on Allocation of Tax Revenue Between Developed and Developing Countries' (1999) 18 *Tax Notes International* 2569; Lee Sheppard, 'Revenge of the Source Countries, Part 2: Royalties' (2005) 40 *Tax Notes International* 7; Stanley S Surrey, 'United Nations Group of Experts and the Guidelines for Tax Treaties Between Developed and Developing Countries' (1978) 19 *Harvard International Law Journal* 1.

technology into their economies, these countries accepted tax agreements with the United States with a heavy emphasis on the residence principle.<sup>30</sup>

Once low-income countries have conceded to the United States' demands for a primarily residence basis of taxation in their tax treaties with the United States, it then becomes difficult not to provide those same terms in their negotiations with other high-income countries. However, now that low-income countries are so desperate for new technology from high-income countries, and for an increased revenue base for social and economic development, in negotiating treaties with them high-income countries should ensure that the agreement they reach on the withholding on royalty payments is in fact in the best interest of the low-income country.

### C. The Significance of Royalty Payments

When one country transfers technology to another, the payments that are made in return for the transfer to the exporting country might be characterized in a variety of ways – as business profits, fees for services, rents, salaries, dividends, capital returns, or royalties. Domestic tax rules and tax treaties treat each of these types of payments differently. When a creator or inventor of property (normally intangible property) transfers that property to a third party for use or reproduction of that property in some fashion, the third party payment is generally characterized as a royalty. Royalty payments might helpfully be classified into four broad types. First, there are payments for the use of cultural property, including royalties for the use of a copyright of literary or artistic work. Second, there are payments for the use of intangible industrial property; for example, payments for the use or reproduction of industrial, commercial, or scientific experience (“know how”), or patents, designs, secret processes and formulas, trademarks, and similar property. Third, there are payments for the use of tangible property; for example, payments for the use of natural resource properties or for industrial, commercial, or scientific equipment. Finally, in at least some circumstances, royalties include payments for technical assistance associated with any of the above types of royalties (“show how”).<sup>31</sup>

Residents of high-income countries naturally are much more likely to produce property giving rise to royalty income than residents of low-income countries.<sup>32</sup> The Human Development Report supplies statistics on the number of patents granted to residents and of the receipts of royalties and license fees for the 177 countries it tracks. In 2002, residents of countries with high human development were granted an average of 250 patents per million people, in contrast with the average of seven patents per million people granted in medium human development countries, and no patents in low human development countries. Naturally, similar disparities are observed in the receipt of royalties and license fees. In 2003, in high human development countries on

---

<sup>30</sup> Irish, *ibid* 294.

<sup>31</sup> The OECD model convention defines royalties as “...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.” OECD model convention, above n 5, art 12.2. For a detailed history of the evolution of the definition of “royalty” in the Canadian tax context see Duncan Osborne, ‘Revisiting Royalties in the Age of Electronic Commerce’ (1999) 47(2) *Canadian Tax Journal* 410, 410–455.

<sup>32</sup> The five leading research economies are the United States, Japan, Germany, France, and the United Kingdom. Jonathan Eaton and Samuel Kortum, ‘Trade in Ideas: Patenting and Productivity in the OECD’ (1996) 40 *Journal of International Economics* 251, 252.

average approximately \$80 per person was received from royalties and license fees, while in medium human development countries only 30 cents was received per person, and no royalties were received by persons in low human development countries.<sup>33</sup>

Although the privileging of residence-based taxation of royalty payments has always been unfair to source countries, that unfairness has been exacerbated by two trends over the last forty years. First, due to a number of factors the value of royalty payments has grown significantly: the upsurge in reliance on outsourcing (and the related transfer of technical knowledge); the dramatic increase in the use of computers, computer processes and software, which are transferred to almost every jurisdiction where an enterprise carries on operations; and, the increased ease with which intangible property giving rise to royalty payments may be relocated anywhere in the world. Second, the increasing ease of characterizing the consideration for the transfer of property and services as a royalty payment exacerbates the ability of source countries to collect their fair share of tax revenue. The income from sales of books, to take an obvious example, has traditionally been characterized as income from business; however, if the book is transferred digitally, the income could conceivably be characterized as a royalty. The characterization of income payments has plagued the drafters of the OECD model treaty and commentators who have struggled with drawing clear lines between business income and royalty payments, but there is little doubt that an increasing number of payments take, or can be modified to take, the form of royalties in order to gain a tax advantage.

Despite both an increasing number of cross-border royalty payments from low-income countries and a growing consensus in development economics that low-income countries urgently require mechanisms for self-directed development, and an increased number of cross-border royalty payments, the OECD has not amended its tax treaty position against the imposition of a royalty withholding tax. Although in 1963 the failure to grant source jurisdictions the right to tax royalty payments may not have resulted in a large loss of revenue to low-income countries, and may thus have been a sensible concession to administrative considerations, given the changing nature of world trade and investment the attachment of the OECD to the residence-only taxation of royalty payments has become increasingly unacceptable.

## II. ALLOCATING REVENUES THROUGH THE ROYALTY ARTICLE IN TAX TREATIES

Both Canada and Australia have entered into a substantial number of treaties with low-income countries, as shown in Appendix A. Canada has entered into 88 tax treaties and Australia has entered into 42. Of Canada's 88 tax treaties, 53 (or just over 60%) have been negotiated with low-income countries (countries where the GDP per capita is below \$12,500 (US) per person).<sup>34</sup> Australia has negotiated fewer tax treaties

---

<sup>33</sup> UNDR, above n 1, table 13.

<sup>34</sup> Although a number of organizations, including the United Nations, the World Bank, and the International Monetary Fund, have classified countries as developing or developed using a variety of criteria, for the purposes of this paper, I used a relatively simple approach. If the country had GDP per capita in excess of \$12,500 per year (US, PPP), it was classified as high-income; if the GDP per capita was below \$12,500 it was classified as low-income. This is an admittedly rough method of classifying jurisdictions; however, gross domestic product per capita seemed like a sensible measure of economic impoverishment since my argument is that Canada (and other high-income countries) should provide for a more just allocation of tax revenues by permitting low-income countries to take a larger portion of those revenues.

with low income countries – only 17 of its tax treaties (or just over 40%) have been negotiated with low-income countries.

This part reviews the role and effect of the royalties article in tax treaties, and compares Canada and Australia's tax treaties. Four aspects of the royalties article are examined in particular. Section A discusses the importance of taxing royalties at source. Contrary to the OECD model convention, both Canada and Australia allow for the imposition of a withholding tax on royalties at source in their tax treaties. This section argues they should continue to do so. Section B argues that a higher rate of withholding is appropriate where a party to the tax treaty is a low-income country. Both Canada and Australia have granted higher withholding tax rates to some of their low-income treaty partners. In a few instances Canada has granted non-reciprocal treatment to low-income countries and allowed them to impose a higher withholding tax rate than Canada agrees to impose. Section C reviews the characterization difficulties that arise when royalty payments are taxed differently from business profits and services. Despite the difficulties inherent in distinguishing income from business and services income from income from property (here, royalties), that distinction should be maintained, and, indeed, the scope of the royalties provision broadened. Section D examines the exclusion of, or reduction in, the withholding tax rate for particular types of royalty payments. This section argues that there should be no exemptions from, or reduced rates for, royalty taxation at source. Canada has negotiated a large number of exemptions or reductions for royalty payments in its tax treaties with low-income countries. In stark contrast, Australia has not negotiated any exemptions from withholding for royalty payments from low-income countries, and has negotiated only a small number of reductions in the standard withholding rate.

#### **A. Low-Income Countries Should be Permitted by Treaty to Tax Royalty Payments at Source**

One of the most significant differences between the OECD and UN model conventions is the position each convention takes on the right of source jurisdictions to tax royalties. As noted above, although the OECD model convention provides for both residence and source taxation when property income in the form of interest or dividends is paid, for royalty payments only the residence country is granted jurisdiction to tax royalties.<sup>35</sup> The UN model convention, in contrast, permits both residence and source-based taxation of royalty payments.<sup>36</sup> The OECD and those who support its position have marshalled four arguments in favour of exclusive residence-based taxation of royalty payments, which mirror the arguments in favour of exclusive residence-based taxation more generally. However, they are insufficient to justify depriving low-income countries of a share of the tax revenues associated with the use of property giving rise to royalty income in the low-income country.

First, it is argued that the residence country has a principled claim to tax income from royalties because of the economic nexus between the owners of the property giving rise to the royalties and their country of residence and other the normative values underlying an income tax. This argument is based largely on three considerations: first, since the owners of the property giving rise to the royalty have invested the time and expense of developing the intangibles in the residence state, that state has an economic connection to the income; second, because the residence state can require

---

<sup>35</sup> OECD model convention, above n 5, art 12.1.

<sup>36</sup> UN model convention, above n 27, art 12.1.

individuals (this argument does not apply equally to corporations) to total their income from all sources, the residence state alone can impose tax based on taxpayer's ability to pay; and finally, the taxation of worldwide income in the state of residence preserves capital export neutrality, which means that taxpayers will be tax-indifferent between exploiting their property for the purpose of earning royalty income in their home jurisdiction or in another jurisdiction.<sup>37</sup> However, at best these are arguments for preserving some ability of the residence country to tax royalties, and not a justification for exclusive jurisdiction.<sup>38</sup> Indeed, based on economic nexus, the source country has an arguably stronger claim to tax the revenues produced by the use of the royalty-producing property. The income arose from the property's use in that jurisdiction, so there is an obvious economic connection to the source state. The benefits provided by the source state are significant. On a general level, the source country provides the benefit of infrastructure, including communications (e-commerce) infrastructure, and the right to incorporate separate legal entities.<sup>39</sup> In addition, the source state may provide a well-educated, highly-skilled workforce that can be employed in the technology sector. It will, as well, provide an orderly market place for the taxpayer to exploit.<sup>40</sup> More specifically in the context of royalty payments, where the property that gives rise to the income is an intangible, the intellectual property protections provided by the source country dwarf in significance those provided by the residence state.<sup>41</sup> Moreover, where the source state is a low-income country, the ability to tax the royalty income at source might be seen as one way of compensating low-income countries for complying with the intellectual

---

<sup>37</sup> The argument that residence-based taxation is necessary to support capital export neutrality is less strong in the context of non-rivalrous intangible property in particular since its owner does not need to make a choice between using the technology at home or abroad as the same technology can be used in both places. See Eric Laity, 'The Competence of Nations and International Tax Law' (draft on file with the author) 28.

<sup>38</sup> Some commentators, eg, Klaus Vogel, have argued that ideally royalties should be taxed in both the source and residence state as a way of preserving neutrality and equity. Vogel argues that to be perfectly neutral the "interest" component of a royalty payment should be taxed at the place of residence of the lessee/user, while the "sales price" (the amortization of the underlying right) and the risk (services) portions of the royalty payment should be taxable in the state of residence. Accepting the practical limits of unbundling a royalty payment into its three component parts, Vogel proposes that a fixed share of the payment should be taxable by both the residence and source states ( $\frac{1}{4}$  to the state of residence, and  $\frac{3}{4}$  to the state of source); a solution that is similar to that proposed in this paper. Vogel, 'Worldwide vs. source taxation of income – A review and re-evaluation of arguments' (Pt 2) (1988) 10 *Intertax* 310, 317–318; and 'Worldwide vs. source taxation of income – A review and re-evaluation of arguments' (Pt 3) (1988) 11 *Intertax* 393, 402.

<sup>39</sup> One of the fundamental justifications for the formation of multinational enterprises is the benefit of sharing intangibles. Businesses may have concerns that they are unable to secure adequate protections for their intangible property through the use of contracts between unrelated parties, and therefore, they choose instead to establish a foreign enterprise over which they exercise a significant degree of control. Therefore, the source state's protection of that separate entity has significant value to the intangible's owner. See generally Oliver E Williamson and Sidney G Winter (eds), *The Nature of the Firm: Origins, Evolution, and Development* (1991), and Bengt Holstrom and Jean Tirole, 'Transfer Pricing and Organizational Form' (1991) *Journal of Law, Economics and Organization* 201.

<sup>40</sup> See, Stephen Shay, J Clifton Fleming Jr and Robert Peroni, "'What's Source Got to Do With It?'" Source Rules and U.S. International Taxation' (2002) 56 *Tax Law Review* 81, 93–95.

<sup>41</sup> Lawrence Lokken, 'The Sources of Income from International Uses and Dispositions of Intellectual Property' (1981) 36 *Tax Law Review* 235, 240–241. ("The laws and legal system at the place of use constitute, in sum, the governmental services and protections of greatest consequence for royalty income.")

property regimes imposed by high-income countries.<sup>42</sup> Finally, since many intangibles are unique, it might also be assumed that their owners are earning economic rents in source jurisdictions and that as a consequence the source country has a legitimate claim to recoup at least part of these economic rents.<sup>43</sup>

Second, it is argued by those who support the OECD position that the country of residence is better able to design a tax regime that accurately reflects the expenses associated with the production of intangibles and other property that gives rise to royalties and therefore is better able to tax the real income associated with the use of those intangibles. Since royalty payments are necessarily taxed at source through the imposition of a withholding tax on the gross payment, no account is taken of the expenses associated with the production of the royalty property. However, this argument is insufficient to justify failing to impose a withholding tax at source. In many cases where royalty property is transferred to a low-income country there will be few expenses associated with its use. Often, intangible property like patents and processes are licensed in low-income countries only after their value has been fully recouped in high-income countries.<sup>44</sup> If their costs are not yet fully recouped in the residence country, because intangibles are generally non-rivalrous, it is likely that few, if any, additional costs are incurred when they are transferred for use in another jurisdiction. Finally, even if there are expenses associated with the production of property giving rise to royalty income in low-income jurisdictions, the need to recognize those expenses is not sufficient to justify non-taxation of royalty income at source. The rate of withholding will be set lower than otherwise would be the case since it is being levied on a gross payment and not net revenue. Interest and dividend payments are subject to withholding tax under the OECD model convention, generally at rates of 10 percent and 15 percent respectively. It is not clear why the need to recognize expenses would support a position of no source-based taxation of royalty payments, and yet the difficulty of setting a withholding tax rate that recognizes expenses associated with the production of interest and dividend payments would not be seen to be similarly intractable.

As an alternative to setting a low withholding tax rate on gross royalty income that would act as a proxy for a higher rate on net royalty income, source countries could permit investors to make a net basis election that would allow them to pay tax in the source country on the basis of their net royalty profits.<sup>45</sup> As another admittedly unlikely alternative, if high-income countries were committed to supporting the

---

<sup>42</sup> See Frederick Abbott, 'Toward a New Era of Objective Assessment in the Field of Trips and Variable Geometry for the Preservation of Multilateralism' (2005) 8 *Journal of International Economic Law* 77; Ruth Mayne, 'Regionalism, Bilateralism, and "TRIP Plus" Agreements: The Treat to Developing Countries' (2005) UNDP Occasional Paper. I am indebted to Donatella Alessandrini at Kent University Law School for this point.

<sup>43</sup> These arguments in their generic form are frequently discussed as arguments based on economic allegiance, benefit, and entitlement. See Charles E McLure Jr, 'Source-Based Taxation and Alternatives to the Concept of Permanent Establishment' in *Report of Proceedings of the First World Tax Conference: Taxes Without Borders* (2000).

<sup>44</sup> See paragraph 6 of the commentary to the UN model convention. In paragraph 7 of the UN model convention, developed countries reply that it is not true that valuable intangibles are transferred to developing countries only after they have been fully exploited by developed ones. See UN model convention, above n 27, commentary paragraphs 6 and 7.

<sup>45</sup> Some countries permit a net basis election for rent payments made to non-residents; see, eg, s 216 of the Canadian *Income Tax Act*, RSC 1985 (5<sup>th</sup> Supp), c 1, s 216. See also Richard Doernberg, 'Electronic Commerce and International Tax Sharing' (1998) 16 *Tax Notes International* 1013.

revenue-raising goals of low-income countries, and were also committed to ensuring the correct taxation of income, high-income countries could undertake to refund any overpayment of tax in the source country to residence taxpayers. This refund would amount to a tax expenditure by high-income countries, designed to support investment in low-income countries.

Third, exclusive residence-based taxation is sometimes justified on the ground of administrative ease. Administrative justifications for residence-only taxation fall into four categories: first, the difficulty of determining the geographical location of the property that gives rise to the royalty; second, the risk of tax avoidance that arises because of the ease with which intangibles are (re)located; third, the inability of source countries to administer a withholding tax on royalty payments; and fourth, the additional tax compliance costs that withholding taxes impose on inventors and creators of royalty property.

An obvious administrative difficulty of imposing a withholding tax on royalties is determining their geographical source.<sup>46</sup> Historically, the geographic source of a royalty payment has been the location where the royalty is used.<sup>47</sup> This test makes sense because presumably the role of a test for determining the geographic location of a royalty is to operationalize the purpose of permitting the source country to tax the income – namely, to reflect the economic connection of the source state to the income, to compensate the source state for the benefits it provides that relate to the income produced, and to allow the source state to capture some of the economic rent.<sup>48</sup> Given that intellectual property can be used at the place where, for example, the goods that rely on the patent are manufactured, where those goods are sold, or where those goods are consumed, the subsidiary question is always where is the place of use of intangible property? The place of use should be the place where the protections offered by the government are the most important to the income-earning process, generally the place of sale.<sup>49</sup>

Despite the alignment of a place of use rule with the objectives of allocating at least some tax revenue to the state that provides the protections critical to the income production, the explosion of e-commerce, and other forms of electronic communications, have made it much easier to move intangible assets and much more difficult to pinpoint the geographical use.<sup>50</sup> Therefore, while the place of use rule

---

<sup>46</sup> For a review of the Canadian judicial decisions on the geographic source of royalty payments see Neal Armstrong, 'Exploiting the Unique Features of Intellectual Property' in *R&D Credits Today, Innovation Tomorrow*, 1999 Corporate Management Tax Conference (1999) 9:1.

<sup>47</sup> For a comparison of the domestic and treaty geographic source rules for royalties (and other types of payments) in Canada, the United States, and Mexico see Michael Schadeewald and Tracy Kaye, 'A Look at the Source of Income Rules and Treaty Relief from Double Taxation with the NAFTA Trading Bloc' (2000) 21 *Tax Notes International* 1063.

<sup>48</sup> See Shay et al, above n 42, 139. Although Shay et al justify source taxation on the basis that it provides a means of imposing a market access charge, they make the important point that there is no normative content to a geographic source rule – instead, the rule should simply support the purpose of imposing the source rule in the first place ("...we submit that U.S. source taxation should be justified under the market access charge rationale explained [above], that its scope should be determined under the principles articulated [above], and that the income source rules should be articulated for the limited purpose of implementing those principles.").

<sup>49</sup> See Lokken, above n 39, 277–282.

<sup>50</sup> There is a large literature on the difficulty of determining the geographic source of a payment for the use of intangible property. For a recent contribution to this literature, see Erin Guruli, 'International

seems sensibly aligned with the purpose of permitting the source jurisdiction to tax the royalty income (because presumably the place where the royalty is used is the place where the intellectual property protections matter and so on), enforceability concerns suggest that a secondary test may also be necessary. For example, the UN model convention provides that the geographic source of a royalty is the residence of its payer, unless the person paying the royalties has a fixed base or permanent establishment that bears the cost of the royalties, in which case the royalties are deemed to arise in the state where the fixed base or permanent establishment is located.<sup>51</sup> While the place of the payer does not line up with the purpose of imposing the source tax as closely as the place of use test does, as a secondary test it supports the enforceability of a withholding tax.

A workable test for the source of a royalty payment would appear to require tax treaties to include a three-prong geographic source rule. First, royalties should have their geographic source in the place of use of the underlying property. Second, in the event that the place of use cannot be determined, the residence of the payer should determine the geographic source of the royalty. Finally, where neither the place of use nor residence of the payer can be determined, competent authorities should provide a decision on the royalty's geographic source. This default to competent authority is increasingly necessary given that residency, as the alternative to source rules, does not provide a simple manipulation-free means of determining geographic source – the residence of corporations, for example, is in many cases easier to manipulate than the source of income.<sup>52</sup> However, in the context of low-income countries, the place of use should generally be sufficient because the problem of determining the geographic source of royalties is likely not as difficult as locating the place of use in high-income countries given that intangible property transferred to low-income countries is much more likely to be manufacturing and other intangibles that are related to use in specific physical places than intangibles that are completely disconnected from any physical source. Neither Canada nor Australia have included a “place of use” test for geographic source in their tax treaties, relying instead on a residence of the payer test. The only exception to this practice for both countries is in their tax treaties with the United States, which includes a residence of the payer test as a primary test, but with a place of use test as a secondary test.<sup>53</sup>

A second administrative difficulty with the imposition of a withholding tax on royalty payments is the creation of avoidance and evasion opportunities. The location of intangible property in many cases is easily manipulated; however, as argued above, an enforceable source rule for royalties is possible. Moreover, source-based taxation may

---

Taxation: Application of Source Rules to Income from Intangible Property' (2005) 5 *Houston Business and Tax Law Journal* 204.

<sup>51</sup> UN model convention, above n 27, 12.5.

<sup>52</sup> See the discussion in Reuven Avi-Yonah, 'International Taxation of Electronic Commerce' (1997) 52 *Tax Law Review* 507, 520, 527; McLure, above n 42, 6:7–6:8; Angel Schindel and Adolfo Atchabahian, 'General Report' in *Source and Residence: New Configuration of Their Principles* (2005) vol. 90a, 30–31; John Sweet, 'Formulating International Tax Laws in the Age of Electronic Commerce: The Possible Ascendancy of Residence-Based Taxation in an Era of Eroding Traditional Income Tax Principles' (1998) 146 *University of Pennsylvania Law Review* 1949, 1993.

<sup>53</sup> The 1995 protocol to the Canada-United States Tax Convention altered the geographic source of a royalty payment from its place of use to the location of the payer. For a discussion of the 1995 protocol amendments to the royalty article of the Canada-United States Tax Convention see Catherine Brown, 'The 1995 Canada-US Protocol: The Scope of the New Royalty Provisions' (1995) 43(3) *Canadian Tax Journal* 592.



assist in combating abusive schemes. The non-taxation of royalty payments at source creates additional incentives for taxpayers to avoid taxation by inflating the royalty payments received from a particular jurisdiction. Where royalty payments are not subject to tax, but payments characterized as from another source (for example, business profits) are subject to tax, taxpayers will seek either to recharacterize their cross-border payments as royalty payments to access the tax exemption or increase the value assigned to the royalty property so that larger royalty payments can be made tax-free.<sup>54</sup> Unduly large royalty payments may particularly be a problem for low-income countries that lack transfer pricing rules, or the ability to enforce those rules.<sup>55</sup> Unjustifiably increasing royalty payments may be particularly appealing if the royalty payment were not subject to tax in the residence country either, say, because the residence-country parent company was non-taxable or had losses.<sup>56</sup> In addition, source-based taxation combined with residence-based taxation means that two jurisdictions' taxing authorities have an incentive to attempt to track and tax the transfer of property giving rise to royalty payments. Permitting the taxation of royalties at source also increases the value to low-income (or source countries) of entering into robust exchange of information agreements with high-income countries.

Third, the non-taxation of royalty payments at source has been justified on the administrative ground that low-income countries do not have sufficiently sophisticated tax administration to appropriately enforce and collect the withholding tax. The short answer to this objection is, of course, that high-income countries should assist low-income countries in enforcing their tax rules. But at the very least, one incidental benefit of joint taxation by source and residence countries might be increased communication between taxing authorities, which may assist with the transfer of tax administration knowledge and experience from high-income to low-income countries and facilitate stronger tax administrations in low-income countries.<sup>57</sup>

The last administrative argument sometimes used to justify the non-taxation of royalty payments at source is that withholding taxes increase the compliance costs of making transnational investments and therefore discourage international trade and investment. But, this argument applies to all taxes levied by source countries; if source countries levy taxes, in addition to complying with the tax rules in its residence country an

---

<sup>54</sup> One could reply that the transfer pricing rules would operate to reduce the payment to one that arm's length parties would agree to; however, the transfer pricing rules are notoriously hard to apply to intangible transfers. See the discussion of this issue in United Nations, *Taxation of Technology Transfer: Key Issues* (2005) 23.

<sup>55</sup> Jeff Ngoy, 'International Taxation in Sub-Saharan Africa' (2001) 24 *Tax Notes International* 275.

<sup>56</sup> This reason for imposing a withholding tax on royalties is commonly acknowledged by commentators. In her report on the September 2005 International Fiscal Association meetings in Buenos Aires, Lee Sheppard, in noting that the OECD model convention imposes no withholding tax on royalties, quips, "With the prevalence of intangibles exported from developed countries, royalties are becoming a sore point for market countries. Eight percent of royalty payments worldwide are made between related companies, according to the United Nations Conference on Trade and Development. Income stripping, anyone? That is the chief concern of host countries, for obvious reasons." Sheppard (Pt 2), above n 29, 8.

<sup>57</sup> Tax administrators and tax reformers have been critiqued for failing to take the differences in social and economic context between developed and developing countries seriously when tax administration strategies that work well in developed countries are exported. These critiques suggest that location-specific tax administration approaches ought to be developed. See Miranda Stewart, 'Global Trajectories of Tax Reform: Mapping Tax Reform in Developing and Transition Countries' (2003) 44 *Harvard International Law Journal* 140.

investor making a transnational investment must also comply with the tax rules of the source country. In most cases the costs of complying with source country taxes will be a small percentage of the additional costs of exporting or doing business abroad. In any event, flat-rate withholding taxes on gross receipts that are withheld by the payer in the source country are the simplest taxes to calculate and pay.

The final argument raised by high-income countries in support of residence-only taxation of royalty payments is that it is important to exempt royalty payments from source taxation to facilitate the transfer of technology from suppliers in high-tax countries to users in low-tax countries. The argument rests upon a premise that is similar to the premise of the argument frequently made for the non-taxation of interest payments that flow from persons in source countries to investors resident in another country, namely, that if withholding taxes are imposed on royalties, the licensor will demand that they be paid by the licensee in the source country. Either the licensor will insist that the royalty be paid net of the taxes or the royalty payment will simply be required to be grossed-up to account for the withholding taxes. In either case, the withholding tax will be effectively paid by the licensee in the source country. Hence, the effect of the withholding tax will be to act as a duty on imported technology, raising the price of technology to source country licensees.

However, for two reasons the incidence of the withholding tax is unlikely to fall on the licensee. First, in most cases the licensor will be able to completely offset the withholding tax against its income tax liability in its residence jurisdiction through the use of the foreign tax credit.<sup>58</sup> Indeed, where this is the case, if the source country does not impose a withholding tax on the royalty payment it will simply amount to a transfer from the low-income country's treasury to the high-income country's treasury.

Second, there might be some cases where the licensor will not be able to offset the withholding tax against its residence jurisdiction's income tax, either because it is diverting the royalty payment to a tax haven jurisdiction where it will not bear tax liability (or it is evading paying tax on this income) or the withholding tax exceeds the tax credit available in the resident country. However, even in these cases the licensee might not bear the withholding tax. Rates of interest are generally set in international markets and because so many countries do not impose withholding taxes on them, and because international flows of interest are often not subject to income tax in the hands of the investor, it is generally accepted to be the case that a withholding tax on interest must be born by the borrower.<sup>59</sup> However, much of the property that gives rise to royalty payments is unique, and it must be transferred to specific markets to be exploited. Therefore, for the transfer of the types of property on which royalties are generally paid, one might reasonably assume that the payer of the royalty has

---

<sup>58</sup> Of course, even if the withholding tax is creditable in the resident country there may be a cost to the imposition of a withholding tax because the withholding tax is likely to be due at the time payment is made and the income tax payable in the resident country might not be due until some later date. Therefore, given the time value of money, withholding taxes may impose some small additional cost on non-resident investors. See Irish, above n 29, 304.

<sup>59</sup> It might be noted, however, that within the EU member states, EU Council Directive 2003/49/EC as modified by 2004/76/EC requires that interest and royalty payments between European Union members not be subject to withholding tax at source. This may put increased pressure on non-EU member states to follow suit and to reduce or remove withholding taxes on royalty payments. The latest states to join the EU have been granted a transition period in which to remove their current withholding taxes.

increased bargaining power, and, where the foreign tax credit is incomplete, may be able to negotiate to pay less or none of the withholding tax.

Indeed, the effect of the position of high-income countries that low-income countries should sacrifice source taxation in the name of greater ease of trade has perhaps ironically led to the reverse result. High-income countries ostensibly seek to enter into tax treaty negotiations to facilitate international trade and investment. Yet, if high-income countries insist on terms, including that royalty payments be exempt from source taxation, that are unacceptable to many low-income countries the number of treaties entered into between high- and low-income countries will remain low and hence international trade and investment diminished.

### **B. Withholding Tax Rates Should be Sufficiently High that Low-Income Countries Receive their Fair Share of Tax Revenue**

If it is accepted that source countries should be able to retain the right to impose a withholding tax on royalty income, the appropriate rate of withholding must be determined.<sup>60</sup> In setting that rate a number of factors must be considered. First, the rate is being applied to the gross royalty payment; therefore, since the withholding tax is meant to be a tax on the taxpayer's net income, the rate should be lower than the rate that the source country would apply directly to the taxpayer's net income. But, as suggested above, in fact in many cases there are likely to be few expenses associated with earning the royalty payment in the source country thus the rate might not have to be reduced too greatly on this account. Second, the rate should not be set so high that it will discourage technology transfers into the source country. Third, the rate should be set at a percentage that ensures there is little incentive for taxpayers to attempt to characterize other sources of income as royalty payments in order to avoid taxes. Finally, the source country should consider the strength of its normative claim for imposing taxes on royalty payments earned within its jurisdiction. These criteria might suggest different rates for different types of royalty payments. For example, they might suggest that withholding tax rates should be the highest for royalty payments derived from the use of natural resources located in a source jurisdiction. In fact, both the OECD and UN model conventions treat income from immovable property in a separate Article (Article 6) and both conventions permit taxation of that property at source.

The UN model convention does not prescribe an appropriate withholding tax rate for royalty payments (nor for other types of income from property such as interest and dividend income). Instead the Group of Experts suggested that the applicable rate of withholding should be left to the negotiators of particular tax treaties and that considerations such as those mentioned above should be taken into account, in addition to the source country's need for revenue and the fiscal inequity of the two negotiating parties.<sup>61</sup>

The withholding tax rates on royalties permitted by each of Canada and Australia's tax treaties are set out in Appendix A. In Canada's tax treaties, the usual rate of

---

<sup>60</sup> For a discussion of a range of considerations that might be taken into account in setting a withholding tax rate in the e-commerce context, including some illustrations of the effects of particular rates on profits see Richard Doernberg et al, *Electronic Commerce and Multijurisdictional Taxation* (2001) 359, 359–363.

<sup>61</sup> See paragraphs 8 and 9 of the commentary to the UN model convention.

withholding on royalty payments is 10 percent, occasionally it is 15 percent, and in a small number of cases it is greater than 15 percent. It is slightly more likely that a rate higher than 10 percent will be negotiated with a low-income country than with a high-income country. In Canada's 35 treaties with high-income countries the rate is 10 percent in 31 treaties, in the remaining four treaties (Israel, Korea, New Zealand, and Singapore) it is 15 percent. In Canada's 53 treaties with low-income countries, the rate is 10 percent in 32 treaties, 12.5 percent in one (Nigeria), 15 percent in 15, 18 percent in one (Dominican Republic), 20 percent in one (Tanzania), and non-reciprocal in three (Cameroon, Pakistan, and Philippines). Thus in approximately 11 percent of its tax treaties with high-income countries Canada negotiated a rate higher than 10 percent while in almost 40 percent of its treaties with low-income countries it negotiated a rate higher than 10 percent.

In Australia's tax treaties, as well, the usual rate of withholding on royalty payments is 10 percent. In 21 of its 25 treaties with high-income countries the rate of withholding is 10. In two of its treaties with high-income countries the rate is only 5 percent (the United Kingdom and the United States), and in one it is 12.5 percent (Taiwan). In its 17 treaties with low-income countries, the rate is 10 percent in nine treaties, 15 percent in seven treaties, and 25 percent in one treaty (Philippines). Thus Australia has negotiated a rate in excess of 10 percent in eight percent of its treaties with high-income countries, while in approximately 47 percent of its treaties with low-income countries the rate is above 10 percent. By this measure, it would appear that Australia and Canada have been roughly equally likely to enter into treaties with low-income countries that have withholding tax rates in excess of 10 percent.

On its face, one of the most progressive steps a country can take in allocating tax revenues to low-income countries is to allow the low-income country to impose a higher withholding tax on payments with a source in its jurisdiction than the high-income country imposes on payments with a source in its jurisdiction. Australia has not negotiated any non-reciprocal withholding tax rates for royalty income. Canada, however, has entered into three tax treaties with low-income countries that permit those countries to impose a higher withholding tax on royalties than Canada does. Cameroon (15 percent Canada / 20 percent Cameroon), Pakistan (15 percent Canada / 20 percent Pakistan), and the Philippines (15 percent Canada / 25 percent Philippines). It is not entirely clear why Canada agreed to these non-reciprocal rates and it is interesting that they have not done so in any recent treaties with low-income countries.<sup>62</sup> These three treaties were signed in 1982 (Cameroon), and 1976 (Pakistan and Philippines). Although agreeing to non-reciprocal rates might appear to be generous on the part of the high-income country, since there are likely to be so few, if any, flows of royalty payments from high-income countries to low-income countries, the rate imposed by the high-income country is likely in most cases to be irrelevant. Certainly the revenue implications of the high-income country reducing the rate would be utterly trivial to it and would not likely result in much, if any, additional revenue to the low-income country.

### **C. Tax Treaties Should Give Broad Scope to the Meaning of Royalty**

When a business simply sells ordinary goods in a source country, goods that have been perhaps ordered through the mail, traditionally it has been held that the source

---

<sup>62</sup> Although in its treaty with Senegal, signed in 2001, Canada agreed to non-reciprocal rates of withholding for dividend and interest payments.

country does not have a sufficient basis for taxing the business on the profits that it might earn in the source country. All tax treaties provide that businesses are exempt from tax in the source country unless they have a permanent establishment in the country. Permanent establishment is defined differently in treaties, but basically it includes any fixed (and physical) presence in a country; for example, an enterprise is generally held to have a permanent establishment in a jurisdiction where it has a place of management, branch, office, factory, or workshop, or a place of extraction of natural resources, or a construction or installation project that lasts for an extended period of time. Most treaties remove from the definition of permanent establishment casual or temporary business activities.

If the taxpayer is earning a royalty in the source country, as argued above, the source country should be entitled to impose a withholding tax on the gross royalty payment (in lieu of imposing an income tax on the net royalty profits earned in the source country). But, if the income earned in the source country can be characterized as income from a business (and not a royalty) then it will not be subject to source taxation unless the taxpayer has a permanent establishment in the source country. Accepting, in principle, (as all tax treaties do) that the source country does not have a legitimate claim for taxing businesses that are simply selling ordinary products in the country (unless the business has a permanent establishment in the country), but does have a legitimate claim for taxing royalty payments received by a non-resident taxpayer that has a source in the country (whether or not the taxpayer has a permanent establishment in the country), the question remains as to whether it is possible to conceptually and practically distinguish between royalties and business income.

Some commentators have argued that one justification for not allowing source countries to impose a withholding tax on royalty payments is that the distinction between royalties and business income is simply too tenuous in principle and impossible to make in practice. Above I have argued that the owner of royalty payments derives a sufficient benefit from or owes a sufficient economic allegiance to the source country that it can justifiably tax the payment. Here I will briefly deal with the question of whether it is practicable to distinguish between royalty payments, business profits, and services income.

There is no question that with the advent of electronic commerce the distinction between royalties, business profits, and payments for related services has become more difficult to make.<sup>63</sup> Various roundtable discussions where commentators have discussed how they would characterize payments reveals that tax experts are

---

<sup>63</sup> For a discussion of the issues that arise in characterizing income in the e-commerce context as business income or royalty income, see Catherine Brown, 'The Canadian Income Tax Treatment of Computer Software Payments' (1994) 42 *Canadian Tax Journal* 593; Arthur Cockfield, 'Balancing National Interests in the Taxation of Electronic Commerce' (1999) 74 *Tulane Law Review* 133; Richard Doernberg, 'Electronic Commerce: Changing Income Tax Treaty Principles A Bit?' (2000) 21 *Tax Notes International* 2417; Aldo Forgiione, 'Clicks and Mortar: Taxing Multinational Business Profits in the Digital Age' (2003) 26 *Seattle University Law Review* 719; Jinyan Li, *International Taxation in the Age of Electronic Commerce: A Comparative Study* (2003) 420, 420–444; Niv Tadmor, 'Further Discussion on Income Characterization' (2004) 52(1) *Canadian Tax Journal* 124, 124–140. For a discussion of the difficulties of line drawing between business and investment income more generally see, eg, John F Avery Jones et al, 'Treaty Conflicts in Categorizing Income as Business Profits: Differences in Approach Between Common Law and Civil Law Countries' in Brian Arnold et al (eds), *The Taxation of Business Profits Under Tax Treaties* (2003).

frequently split on the appropriate approach to characterization issues.<sup>64</sup> This has been widely recognized and several studies have been undertaken in an attempt to develop guidelines to assist in distinguishing between the two types of payments. Indeed, where there is any uncertainty in the appropriate characterization of payments, perhaps not surprisingly, high-income countries tend to be biased in favour of characterizing the payments as business profits. For example, in a recent examination of the characterization of 28 e-commerce transactions, an OECD working group determined that only three of the transactions were royalties, while the rest of the transactions gave rise to business profits.<sup>65</sup> In contrast, an Indian Ministry of Finance report concluded that in 14 of the 28 transaction examples provided, the transaction described gave rise to a royalty.<sup>66</sup>

Several commentators have proposed solutions to the difficulty of distinguishing between types of income, particularly focused on the e-commerce context. For example, Reuven Avi-Yonah proposes eradicating the differential treatment of services, royalties, rents, and business profits, and considering all electronic commerce payments as active business income subject to a withholding tax regime based on gross sales into a jurisdiction.<sup>67</sup> Arthur Cockfield similarly proposes that servers and other minor physical e-commerce related hardware not be considered a permanent establishment in the source state, but that all cross-border transfers of e-commerce goods, services, and capital that pass a threshold value of, for example, \$1 million, be subject to a low withholding tax rate of, say, 5 percent, thereby leaving at least some revenue in the hands of source countries.<sup>68</sup>

A solution in the tax treaty context might simply be to draft a decision-rule that provides a preference for royalty treatment where a withholding tax on royalty

---

<sup>64</sup> For example, at the 2005 International Fiscal Association Congress in Buenos Aires several panel members discussed whether particular payments in four different cases would appropriately be considered to be “royalties” given the definition of royalties in the OECD model convention. In each of those cases the panel members differed about whether particular payments were properly royalties, business profits, capital gains, or payments for services. See Catherine Bobbett and John Avery Jones, ‘The Treaty Definition of Royalties’ 60(1) *Bulletin for International Taxation* 23. See also Sheppard, (Pt 2), above n 29, 8–11; and Brian Arnold, Jacques Sasseville and Eric Zolt, ‘Summary of the Proceedings of an Invitational Seminar on Tax Treaties in the 21<sup>st</sup> Century’ (2002) 50(1) *Canadian Tax Journal* 65, 81. (“One real-life example...was the use of a non-resident-owned satellite by the domestic television network of a developing country. Because the non-resident did not have a PE in the developing country, that country could not tax the non-resident’s business profits. However, by characterizing the payment for the use of the satellite as rent or royalty, the developing country levied a gross basis withholding tax, which was excessive having regard to the amount of net income derived by the non-resident.”).

<sup>65</sup> OECD, *Tax Treaty Characterisation Issues Arising from E-Commerce: Report to Working Party No. 1 of the OECD Committee on Fiscal Affairs* (1 February 2001), Annex II. For a discussion of the report, see Wright Schickli, ‘Characterization of E-Commerce Revenue – The Final OECD Report Revealed’ (2001) 22 *Tax Notes International* 1671.

<sup>66</sup> India, *Report of the High Powered Committee on Electronic Commerce and Taxation* (2001), Annex 2.

<sup>67</sup> Avi Yonah, “Electronic Commerce”, above n 54, 541–545.

<sup>68</sup> See Arthur Cockfield, ‘Balancing National Interests in the Taxation of Electronic Commerce Business Profits’ (1999) 74 *Tulane Law Review* 133. For a similar proposal, see Richard Doernberg, above n 45 (suggesting that a permanent establishment concept be maintained, but that e-commerce importing countries be permitted to levy a 10 percent withholding tax in the absence of a permanent establishment). See also Chang Lee, above n 29, 2569 (“The right solution, from the perspective a developing country, will be to impose taxes even without a permanent establishment and adopt formulary apportionment.”). But see Brian Arnold, ‘Threshold Requirements for Taxing Business Profits under Tax Treaties’ (2003) *Bulletin for International Fiscal Documentation* 476, 492.

payments is imposed. This rule in tax treaties would characterize any payment based on production or use as a royalty; any payment arising from activities that are highly substitutable with those kinds of payments as royalties; and any payments that are difficult to unbundle, but that include a royalty payment, to be royalties for the purpose of treaty withholding. In other words, any payment for the production from or use of property – whether in the form of the transfer of a tangible asset, an intangible asset, or specialised knowledge or skills – should be characterized as a royalty payment under tax treaties between high and low-income countries, and should be subject to withholding tax.

As a step in this direction, in a number of treaties, countries have defined both “know how” and “show how” or other fees associated with services provided with the transfer of an intangible to be royalty payments, and have included payments for the use of scientific equipment in the royalties article.<sup>69</sup> Although these kinds of payments might arguably be considered to be business profits, or profits from the provision of services, they are payments that are difficult to unbundle, and defining those payments as royalties ensures that investors from high-income countries are not able to strip tax revenues from low-income countries simply by attempting to characterize income at the margins of the business income/services income/royalties income distinctions as non-source-taxed income. Canada has only rarely included fees for included services within the scope of the royalties provision,<sup>70</sup> while all of Australia's tax treaties (except Singapore) have some version of the fees for included services provision. Both Canada and Australia generally include payments for scientific equipment within the definition of royalties in their tax treaties.<sup>71</sup>

Once the business activities of an investor become significant in a low-tax jurisdiction, the provisions of most tax treaties would ensure that the royalty payments are taxed as business profits (because of the provision that characterizes royalties attributable to or effectively connected with permanent establishments to be business profits), so at that point, the decision-rule would no longer apply.

The primary drawback to this decision-rule is its possible effects on those who use or reproduce property in small amounts. For example, a student who downloads a videogame may be subject under this definition to withholding obligations. For administrative reasons, then, it may make sense to provide a *de minimis* threshold like those often provided in the dependent and independent personal services articles, where users of property giving rise to royalties are only required to withhold and remit tax once a low (cumulative by the user) threshold of value is passed, for example, \$5,000 per year. This would remove from the scope of taxation relatively low-value transactions to low-use taxpayers in the source country, while still ensuring that the purposes of imposing a withholding tax on royalty payments are met.

---

<sup>69</sup> See Richard Doernberg's discussion of the U.S. – India tax treaty and its inclusion of “included services” in the royalties article ‘The U.S.-India Income Tax Treaty: Breaking New Group in Taxing Services Income from Licensing Technology’ (1991) 44 *Tax Lawyer* 735.

<sup>70</sup> See, eg, Canada's treaties with Argentina, Australia, Cameroon, India, Kazakhstan, Kyrgyzstan, New Zealand, and Papua New Guinea.

<sup>71</sup> But see Canada's tax treaties with Jamaica, Norway, and the United States, and Australia's tax treaties with the United Kingdom and the United States. It might also be noted that Canada imposes a withholding tax of 15 percent on every person paying to a non-resident person a fee, commission or other amount in respect of services rendered in Canada under Regulation 105.

#### **D. No Exemptions from or Reductions to the Withholding Tax Rate Should be Granted for Particular Types of Royalty Payments**

As explained above, royalties might be divided broadly into cultural royalties, such as royalties in respect of copyrights, rights to produce artistic works, motion picture films, and tapes or films used for radio or television broadcast, and industrial royalties, such as royalties for the use of patents, trademarks, designs, secret formula, knowhow, and software. In some tax treaties, an exemption or lower rate of withholding is granted to cultural or industrial royalties. These exemptions erode the revenue raising capacity of the source country and are unjustified.

The exemption or lower rate of tax for cultural property commonly includes royalties for the production or reproduction of literary, dramatic, musical or artistic work but in every case excludes royalties for motion picture films and broadcasting films and tapes including those to be used for television broadcasting. One reason that royalties derived from the use of films are commonly excluded from the exemption (and thus subject to the full withholding rate for royalties) is that the withholding tax is considered a proxy for taxing the salaries of the actors and other participants in the film, which otherwise would only be taxed in the country of residence.<sup>72</sup> The exemption is generally justified on the grounds that cultural property developed in a residence country has a much stronger economic nexus to that country than other types of property that yield royalties in the source country.<sup>73</sup> It is frankly difficult to see why cultural property should be regarded as having a closer economic nexus to the residence country than any other form of property that yields royalty income in the source country. Like all forms of royalty-yielding property, it is the source country that provides the market for the property and the rules of contract and property law that protect its value.

Canada, in particular, has frequently also negotiated exemptions and lower rates of withholding tax for three types of industrial royalties: payments for the use of, or the right to use, (1) patents, (2) information concerning industrial, commercial or scientific experience, and (3) computer software. The justification for these exemptions is that a zero or reduced withholding tax will encourage the investment of these properties in the source country. Slightly more than a decade ago, Canada announced its intention to attempt to negotiate these exemptions in all of its treaties (to exempt from the withholding tax royalties on computer software, patents, and information concerning industrial, commercial, and scientific experience) in order to “reduce the cost to Canadian firms of accessing technology developed by foreign firms” and to “make it more attractive for Canadian firms to export technology they have developed.”<sup>74</sup> Of course, to the extent that Canada taxes these royalty payments, all these exemptions do is transfer tax revenue from low-income countries to the Canadian government. Assuming the tax credit mechanism operates effectively, the only real costs to Canadian investors are the transaction costs associated with paying taxes in two jurisdictions. However, as argued above, these costs seem reasonable in

---

<sup>72</sup> UN model convention, above n 24, commentary para 10.

<sup>73</sup> Although occasionally this exemption is justified on the grounds that the dissemination of cultural materials should be encouraged, and that the underpayment of authors should be recognized by alleviating the potential for over-taxation of royalties on cultural material at source. See Alejandro Heredia, ‘Copyright and Software and Spanish Tax Treaties: An Issue of Balance between Technology-Importing and Technology-Exporting Countries’ (2006) 45(1) *European Taxation* 36, 42.

<sup>74</sup> Canada, Department of Finance, *Special Report: The Federal Budget* (1993) 20.



light of the benefits of source taxation, which include increased opportunities to detect evasion, and in light of the benefits provided to investors in the form of government services and protections for intellectual property in the source country.

Even if there were a principled case for providing an exemption for certain types of royalty payments, inevitably the conceptual and administrative costs of doing so outweigh the gains. For example, exempting payments for the use of, or the right to use, information concerning industrial, commercial or scientific experience requires unbundling mixed contracts that contain those payments as well as otherwise taxable payments into their component parts.<sup>75</sup> Similarly, in treaties that exempt cultural royalties for the use of, or right to use, any copyright of a literary work, but that do not explicitly exempt software, determining whether payments for the use of software are a literary copyright and therefore exempt have swamped tax administrators.<sup>76</sup> In addition, where one country exempts particular types of royalty payments from withholding but another country does not, or where a country exempts some kinds of royalty payments from withholding tax but does not exempt those payments in all of its tax treaties, treaty shopping is encouraged.

Canada has negotiated exemptions from the royalties withholding tax in 26 of its 35 tax treaties with high-income countries (approximately 75 percent of such treaties) and in 13 of its 53 tax treaties with low-income countries (approximately 25 percent of such treaties), as shown in Appendix A. Thus although Canada is less likely to negotiate exemptions with low-income countries, still in about one-quarter of those treaties there are unjustified exemptions. In the great majority of the treaties with low-income countries in which there are exemptions from the royalty withholding tax it is an exemption for cultural property. In only four treaties is there exemptions for industrial property (Algeria, Kyrgyzstan, Russia, and Ukraine). Canada has negotiated reduced rates of withholding in 14 of its 53 tax treaties with low-income countries (approximately 26 percent). In most of these cases, Canada has granted a reduced rate of withholding for both cultural and industrial royalties.

In stark contrast to Canada's policy of negotiating exemptions and reduced rates for royalty payments, Australia has negotiated an exemption from withholding tax in only two cases (both with high-income countries – Canada and Singapore) and in only three treaties (with low-income countries) has it negotiated a reduced rate of withholding (Argentina, India, and Indonesia). In the case of Argentina the reduced rates of withholding apply to both cultural and industrial royalties, while in the case of India and Indonesia the reduced rates apply largely to industrial royalties.

---

<sup>75</sup> The concern about the difficulty of unbundling was raised by the U.S. Senate Foreign Relations Committee when Canada and the United States negotiated the 1995 Canada – United States Tax Convention protocol. United States, *Report of the Senate Foreign Relations Committee on the Revised Protocol Amending the Tax Convention with Canada*, Executive Report 104-9, 104th Cong, 1st Sess, (10 August 1995) 23–25.

<sup>76</sup> In many, but certainly not all, of Canada's tax treaties an exemption is set out for both cultural royalties and payments for the use of software. For a discussion of the difficulties jurisdictions have in distinguishing between those payments, see Heredia, 'Copyright and Software and Spanish Tax Treaties', above n 72.

#### **IV. THE IMPORTANCE OF ALLOCATING TAXING RIGHTS OVER ROYALTY PAYMENTS TO LOW-INCOME COUNTRIES**

Low-income countries ought not negotiate away their right to impose a withholding tax on royalty payments earned in their jurisdiction. Source states have a strong economic connection with royalty payments derived from property used in their jurisdictions; source states provide benefits of significant value to investors who earn royalties in their jurisdictions; a withholding tax is relatively easy to administer and comply with; source taxation provides the potential for residence and source countries to work together to combat tax avoidance and evasion; and, taxation at source diminishes the incentives for taxpayers to attempt to convert non-royalty income into royalty income to avoid source-based taxation. None of the arguments in favour of the non-taxation of royalties at source justify depriving low-income countries of the revenue associated with the taxation of royalty income. While the property that yields royalties has an economic nexus to the residence state where it was developed this connection is no stronger than the connection of the royalty payment to the source state; when a tax credit mechanism is used the taxpayer can still be taxed based on ability to pay in the resident state; a withholding tax can be set that adequately reflects the expenses (if there are any) associated with the production of royalty income in the source country; workable rules for geographic source can be designed; and, the evidence that a withholding tax on royalty payments increases the cost of the technology transfer to licensees is weak. Thus, high-income countries ought to permit tax withholding at source for royalty payments; they should ensure that withholding tax rates negotiated with low-income countries are appropriate; they ought to resist calls to tax income like royalties only when a sufficient threshold connection (like a permanent establishment) has been reached; and, they ought to reduce or eliminate the number of exemptions from and reductions to the withholding tax rate for royalty payments.

The OECD model convention provides that source countries should not provide a withholding tax on royalty payments. This aspect of the model treaty has been followed in many of the US treaties with low-income countries and has been implemented among states of the European Union. However, both Canada and Australia have allowed source countries to collect withholding taxes in their treaties with low-tax countries. Although each of these countries has made some effort to provide low-income countries with a greater share of the tax revenue from the taxation of royalties, each has room to better assist low-income countries. Canada has entered into over twice the number of tax treaties as Australia, and has entered into over three times the number of treaties with low-income countries as Australia. These treaties facilitate trade and (at least in principle) can ensure that low-income countries receive their fair share of tax revenue. Australia might consider expanding its tax treaty network with low-income countries with which it has significant trade relations. Canada and Australia have been roughly equally likely (controlling for the number of treaties) to grant withholding tax rates on royalties in excess of 10 percent, but both countries have granted only the standard 10 percent rate in over 50 percent of their treaties with low-income countries. Tax administrators in both countries might be urged to consider raising withholding tax rates when negotiating future tax treaties with low-income countries, and might revisit the rationale for keeping withholding tax rates on royalties low in the over 50 percent of the treaties with low-income countries that maintain the 10 percent rate. Australia has been more generous than Canada both in ensuring that included services are part of the royalties definition (therefore

exacting some of the tax revenue associated with the provision of included services) and in avoiding unjustified exemptions from the scope of the royalty provision. Canada should follow Australia's lead on these issues.

Low-income countries' need for increased revenue to assist in the development of transportation and communication infrastructure, for the alleviation of extraordinary depths of poverty, and for the improvement of education and health cannot be questioned. Tax treaties provide at least one instrument that can assist low-income countries in developing their own revenue sources to improve the living conditions of their citizens without needing to rely on transfers of conditional aid from high-income countries and without exposing low-income countries to the uncompensated exploitation of their markets from enterprises resident in high-income countries.

If the argument in this paper - namely, that low-income countries should be able to impose a withholding tax of significance on royalty payments at source - is not accepted, but the general proposition that source countries have a greater claim to the tax revenues derived from the use of intangible properties in their countries than currently reflected in tax treaties, is accepted, then a range of alternatives might be considered. For example, high-income countries could collect the share of the source tax on behalf of the low-income country. This may be done by exempting royalties from withholding tax at source, but by setting a revenue-split percentage rate on the profits collected by high-income countries on royalty income earned by their residents in another jurisdiction.<sup>77</sup> If the concern were that withholding taxes exacted excessive taxes from businesses engaged in the source country, as a more generous solution, the residence country could consider designing a tax expenditure to support the source-taxation of the royalty payment. This expenditure would permit a refund of tax in the residence state where the source-country tax exceeded the residence taxation of the particular income stream. Lastly, to the extent that it is difficult to draw a bright line between business income and royalty income, all non-resident enterprises that transfer property into a source jurisdiction for use, whether the income from the property is characterized as business or property income, could be subject to withholding tax on the payments derived from the use of that property.

Tax treaties can be used to improve the living conditions of citizens of low-income countries to the extent that they are fashioned to allocate revenues to source countries, and to facilitate trade between low-income and high-income countries – two of the means frequently identified as critical pillars in the international struggle to reduce economic inequality. The revenue-raising aims of low-income countries ought to be taken seriously in designing an international tax system for the taxation of royalty payments, thereby ensuring a fairer allocation of tax revenues on income associated with the use in low-income countries of property owned by residents of high-income countries.

---

<sup>77</sup> As a model, this might be designed in the same way that the federal government in Canada collects the provincial tax of some provinces. The downside is that the source country would not get to define what constitutes taxable income from property giving rise to a royalty payment and would simply need to accept the domestic rules that applied in the residence country. However, this approach to revenue sharing would alleviate the administrative burden on underdeveloped tax administrations, while still ensuring an equitable share of the tax revenue from royalties was allocated to developing countries. But see the suggestions of Reuven Avi-Yonah to impose a source withholding tax as a backstop to residence

**APPENDIX A A COMPARISON OF CANADA AND AUSTRALIA'S TAX TREATY POSITIONS  
ON WITHHOLDING TAX RATES AND EXEMPTIONS/REDUCTIONS FROM WITHHOLDING**

---

taxation in 'The Structure of International Taxation: A Proposal for Simplification' (1996) 74 *Texas Law Review* 1301, 1337.



COUNTRY	GDP (PPP)	TREATY PARTNER		RATE WITHHELD		EXEMPTION FROM WITHHOLDING										REDUCTION FROM WITHHOLDING RATE											
		Can	Aus	Can	Aus	Canada					Australia					Canada					Australia						
						Cultural	Patent	Software	Scientific	Other	Cultural	Patent	Software	Scientific	Other	Cultural	Patent	Software	Scientific	Other	Cultural	Patent	Software	Scientific	Other		
Kuwait	18,047	•		10																							
Kyrgyzstan	1,751	•		10		•	•	•	•																		
Latvia	10,270	•		10																							
Lebanon	5,074	•		10												•	•	•	•								
Lithuania	11,702	•		10																							
Luxembourg	62,298	•		10		•	•	•	•																		
Malaysia	9,512	•	•	15	15	•				•																	
Malta	17,633	•	•	10	10	•																					
Mexico	9,168	•	•	15	10	•																					
Moldova	1,510	•		10																							
Mongolia	1,850	•		10												•	•	•	•								
Morocco	4,004	•		10												•											
Netherlands	29,371	•	•	10	10	•	•	•	•																		
New Zealand	22,582	•	•	15	10																						
Nigeria	1,050	•		12.5																							
Norway	37,670	•	•	10	10	•	•	•	•																		
Oman	13,584	•		10		•	•	•	•																		
Pakistan	2,097	•		15/20*		•										•											
Papua New Guinea	2,619	•	•	10	10																						
Peru	5,260	•		15																							
Philippines	4,321	•	•	10/25*	25																						•
Poland	11,379	•	•	10	10	•																					
Portugal	18,126	•		10																							
Republic of Korea	17,971	•	•	15	15																						
Romania	7,277	•	•	10	10											•	•	•	•								
Russia	9,230	•	•	10	10	•	•	•	•																		
Senegal	1,648	•		15																							
Singapore	24,481	•	•	15	10											•											
Slovak Republic	13,494	•	•	10	10	•																					
Slovenia	19,150	•		10																							
South Africa	10,346	•	•	10	10											•	•	•	•								
Spain	22,391	•	•	10	10	•																					
Sri Lanka	3,778	•	•	10	10	•																					
Sweden	26,750	•	•	10	10	•	•	•	•																		
Switzerland	30,552	•	•	10	10	•	•	•	•																		
Tanzania	621	•		20																							
Taiwan	27,600		•		12.5																						
Thailand	7,595	•	•	15	15											•											
Trinidad and Tobago	10,766	•		10		•																					
Tunisia	7,161	•		15		•																					
UAE	22,420	•		10		•	•	•	•																		

COUNTRY	GDP (PPP)	TREATY PARTNER		RATE WITHHELD		EXEMPTION FROM WITHHOLDING										REDUCTION FROM WITHHOLDING RATE																						
		Can	Aus	Can	Aus	Canada					Australia					Canada					Australia																	
						Cultural	Patent	Software	Scientific	Other	Cultural	Patent	Software	Scientific	Other	Cultural	Patent	Software	Scientific	Other	Cultural	Patent	Software	Scientific	Other													
UK	27,147	•	•	10	5	•	•	•	•																													
Ukraine	5,491	•		10				•																														
US	37,562	•	•	10	5	•	•	•	•	•																												
Uzbekistan	1,744	•		10																						•	•	•	•									
Venezuela	4,919	•		10																						•	•	•	•									
Vietnam	2,490	•	•	10	10																																	
Zambia	877	•		15																																		
Zimbabwe	2,443	•		10																																		

\* Canada's withholding rate / other party's withholding rate