INCOME CHARACTERIZATION AND THE SHARING OF GLOBAL TAX REVENUES IN THE CONTEXT OF ELECTRONIC COMMERCE

by

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ABSTRACT

The question of characterizing income by its source in the context of electronic commerce has brought forward problematic issues in the international taxation regime. It has presented prominent scholars, administrators and judges with what have sometimes seemed intractable difficulties. Characterization and geographic source difficulties are linked to the lack of international uniformity in the characterization of income from computer software transactions, which expose taxpayers to potentially arbitrary characterization outcomes. Characterization outcomes also affect the global sharing of tax revenues collected from international transactions as the taxation in a particular country is linked to the character of the income. The current international tax system furthermore brings forward problems of equity and the inequalities between developed and developing countries in sharing international tax revenues arising from electronic commerce transactions.

In this thesis I analyze the international tax rules currently applied to electronic commerce transactions. I explore the underlying rationale for characterizing income by its source and the international uniformity in the area. I review the international guidance for the application of traditional rules to electronic commerce transactions and examine the international uniformity for the characterization. Moreover, I review the theoretical foundation for the taxation of international income and analyze the imbalance in sharing the global tax base under the current rules. This reveals, that the underlying rationale for income characterization has no convincing support for the continued distinction. The application of traditional rules and concepts reveals uncertainties and complications and there is no absolute international uniformity. Ultimately, the theoretical basis for taxing international income appears to suffer a disconnect and today’s system furthermore fails to ensure a fair sharing of the global tax base.
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CHAPTER ONE - INTRODUCTION

I. ELECTRONIC COMMERCE, INCOME CHARACTERIZATION AND THE TAXATION OF COMPUTER SOFTWARE PAYMENTS

Electronic commerce\(^1\), the sale of goods, services and technology over the internet by non-physical means, presents both threats and challenges to taxation and has received attention from both governments and private organizations throughout the world. The Organisation for Economic Co-operation and Development\(^2\) has played a vital role in the development of taxation principles for e-commerce and has recognized the importance of e-commerce tax related issues since 1996. Most importantly in 2001 the Technical Advisory Group on Treaty Characterisation on Electronic Commerce Payments (mandated by the OECD) issued a report\(^3\) on the characterization of electronic commerce transactions clarifying characterization issues in the taxation of electronic transactions.

\(^1\) Electronic commerce [e-commerce] is the internet-marketplace where buying, selling, distributing, marketing and servicing of products and services is done through electronic digital systems. Canada Revenue Agency, “About e-commerce, What is e-business?”, online: Canada Revenue Agency <http://www.cra-arc.gc.ca/tax/business/topics/ecomm/faq-e.html#ebusiness>. According to the Canada Revenue Agency (CRA) e-commerce or e-business is defined as follows: E-business is any commercial activity conducted over networks linking electronic devices (mainly computers). It includes commercial transactions conducted by Internet, telephone and fax, electronic banking and payment systems, trade in digitized goods and services, and electronic purchasing and restocking systems.

\(^2\) The Organisation for Economic Co-operation and Development [OECD], is an international economic organization, formed by 30 member countries, with the object of helping governments tackle the economic, social and governance challenges of a globalized economy. The organization produces internationally agreed instruments, decisions and recommendations to promote rules of the game in areas where multilateral agreement is necessary for individual countries to make progress in a globalized economy. Further information available online: <http://www.oecd.org/about/0,2337,en_2649_201185_1_1_1_1_1_1,00.html>.

The report provides recommendations on how "common" electronic transactions should be characterized for tax purposes. However, numerous problems still exist in the digital world when it comes to taxation and income characterization. For example, because e-commerce transactions are digital they present challenges for administrators who are charged with determining whether a product has been transferred, an intangible product has been licensed, or a service has been performed - the line between income categories is blurred. These characterization problems are increasingly important because, by all accounts, electronic commerce is exploding. In Canada, e-commerce and technology grew significantly from 2005 to 2006 with private and public sector online sales combined increasing 40% to $49.9 billion. Online sales by private firms rose 42% to $46.5 billion, while sales by the public sector increased 17% to $3.4 billion, and retailers traded goods and services online worth $4.7 billion. This growth in electronically performed sales recorded a double-digit growth for the fifth consecutive year in 2006. With the dramatic rise in e-commerce transactions, the tax treatment of these transactions inevitably grows in significance and the complications become more visible. It is therefore timely to consider the almost intractable characterization issues computer software payments present tax scholars, administrators, judges, and practitioners. In addition, the question of the geographic source of revenue is of great importance and is influenced by the characterization of the income.

Characterization and geographic source difficulties are linked to the lack of international uniformity in the characterization of income from computer software transactions, which

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expose taxpayers to potentially arbitrary characterization outcomes. Characterization outcomes also affect the global sharing of tax revenues collected from international transactions as the taxation in a particular country is linked to the character of the income. The problem lies with the traditional income categories used in domestic law and treaty law and the distinction between business and property income, which is not valid for the taxation of computer software transactions. Several prominent scholars have argued that a different overall approach to the taxation of income from e-commerce should generally be engaged to account for the flaws of the traditional international tax system. For example, a different overall approach to the traditional international tax principles regarding income characterization, the permanent establishment threshold, and transfer pricing rules are suggested.\(^5\) In advocating a re-evaluation of the international tax system others argue that the present tax treatment of international capital flows is inefficient and inequitable and that the principles therefore require re-evaluation.\(^6\) Moreover, others argue that the need for re-evaluation arises from the existing problems of international taxation that are aggravated by the rise of e-commerce and that reconceptualization therefore is necessary.\(^7\) To justify the validity of this, the thesis focuses on the rationale behind income characterization in e-commerce and essentially asks: Why do we employ a distinction between business and property income? Is there an international consensus in characterizing income from e-commerce for income tax purposes? What approach has been adopted in the context of computer software payments? Is the traditional concept of income characterization still valid in the context of e-commerce and the taxation of

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\(^7\) Jinyan Li, International Taxation in the Age of Electronic Commerce: A Comparative Study, (Toronto: Canadian Tax Foundation, 2003), at 583-584 and 589.
computer software payments? Should the distinction between business and property income be preserved for e-commerce transaction?

II. The Logic Behind the Classification of Income

There are two common explanations for why tax administrators distinguish between business and property source. First, the international tax system, with its historic schedular approach to income calculation has influenced this area.\textsuperscript{8} The source doctrine was intended to protect the privacy of taxpayers and most international treaties are based on this historic system. Second, classifying some income as property income serves administrative goals.\textsuperscript{9} Typically, for international tax purposes, net-basis taxation is applied to active income, i.e. business and service income, while gross-basis taxation is applied to passive income, i.e. royalty income. Withholding taxes are administratively simple for two reasons (1) they are more easily collected when imposed on a gross-basis, and (2) residents of the taxing country are liable to withhold the tax and the tax is therefore easier to enforce. Because e-commerce makes drawing the distinction between passive and active income difficult, it may not make sense to place income from e-commerce transactions in traditional categories for taxation purposes. In other words, the question arises as to whether the traditional arguments provide a fair justification for the use of business and property income characterization for international taxation purposes in e-commerce. Could the same objectives be addressed by a different, less detailed, income allocation system? This idea is examined in more detail in chapter two of the

\textsuperscript{8}Ibid. at 514.

\textsuperscript{9}Ibid.
thesis, where I examine the underlying rationale for income characterization and evaluate the justification in e-commerce.

III. APPLYING ANALOG RULES IN A DIGITAL ENVIRONMENT

As mentioned in the previous section, income classification (as business or property) has two underlying justifications. First, it is historically influenced through the source doctrine. Second, a more simple administration is experienced through characterizing income. Drawing the conceptual distinctions between different concepts in tax law is a fundamental principle. Income characterization is one of these fundamental principles of income taxation. One of tax laws law’s most difficult distinctions is the distinction between income from business and income from property. Digital products in electronic commerce have caused these line drawing exercises to become even more complex. Nevertheless, the principle of characterizing income is applied both domestically and internationally, also in the context of e-commerce. In the course of evolution, the traditional principles have proven difficult to manage, because they were developed with a different type of commerce in mind. It is therefore interesting to examine the historic development to the application of these rules in dealing with e-commerce as a new phenomenon in income taxation. This is what chapter three of the thesis examines, in order to provide a greater understanding of the challenges met and the solutions chosen over the course of the revolution in e-commerce.
IV. EXPLORING INTERNATIONAL UNIFORMITY

Under the current regime of both domestic and international taxation, the character of income is the underlying basis for taxation. Thus, the income flowing from e-commerce must therefore be characterized for income tax purposes. Income arising from e-commerce transactions may be characterized as either active income or passive income, depending on the circumstances present. Because the distinction between the different types of income is artificial it creates a window for creative tax planners to move income into a certain category by manipulating its characterization, thereby possibly obtaining a more favorable tax result. The characterization issue is particularly relevant where there is little guidance and no clear answer. Where differing positions are taken by nations, this can result in double taxation or double-non-taxation.

Computer software transactions are particular complicated e-commerce transactions and cannot easily be categorized. The issue is complicated by disagreement amongst states, as to the allocation of the tax revenues arising from differences related to definitions of income categories. For example, where a non-resident makes the benefit of software,

10 Ibid, at 513.
11 Under Canadian Tax law this form of tax planning is lawful tax planning referred to as tax mitigation. This should be distinguished from tax evasion, which represents the commission of an act knowingly with the intent to deceive so that the tax reported by the taxpayer is less than the tax payable under the law. This form of tax planning constitutes unlawful tax planning. Tax avoidance is another type of tax planning, which is concerned with the minimization of tax. It can be lawful or unlawful either because of the manner or the motive with which it is executed. It is unlawful only where it offends established judicial doctrines or prescriptive legislation such as the General Anti Avoidance Rule (GAAR) in S. 245 of the Income Tax Act, R.S.C. 1985 (5th Supp.), c. 16.
12 Li, supra note 7, at 513-514.
which can be downloaded for a fee from the non-residents server located in the non-resident’s state, available to a customer in a foreign jurisdiction, differences in the definition of income category may appear. Some states may view this transaction as giving rise to a sale or a service, which is only taxable in the non-resident state, unless the threshold of permanent establishment is met in the foreign jurisdiction. Other states may view such a transaction as giving rise to a royalty, which is subject to withholding tax at source, meaning taxation in the foreign jurisdiction. Such disagreements in characterization may be indicative of the fact that there is no international consensus as to how e-commerce transactions should be characterized. Disagreements between nations might also be an indication that some countries are not sharing in economic returns generated by e-commerce, possibly because they are primarily importing states. To the extent that some countries feel that they are not sharing the rewards of e-commerce, they may attempt to tax the base-eroding payments by characterizing the income from an e-commerce transaction as royalties, even though this means “artificially” characterizing the income. This leads to complications and magnifies the dilemma of using rules that are not easily applicable in e-commerce transactions, because they were developed with non-virtual transactions in mind. In chapter four of the thesis, the approach to characterization taken by five sample jurisdictions is examined using specific examples, in order to establish whether or not there is international consensus in this area.

13 The United States, Canada, Australia, China, and Chile are the jurisdictions that have been chosen for the examination. Several factors have influenced the choice of jurisdictions. The U.S. 1996 discussion paper Selected Tax Policy Implications of Global Electronic Commerce, initiated the debate on e-commerce tax policy and essentially set the scene for the debate internationally, and the U.S. has played a leading role in developing principles for characterization issues in e-commerce.

Canada has a well-developed international taxation system, however, this system finds its roots in source-based taxation differentiating it from the system seen in the United States. Moreover, Canada has contributed to the development of international taxation principles significantly and also participated
V. IDENTIFYING IMBALANCE, THEORETICAL FOUNDATIONS, SOLUTIONS AND REFORM

Electronic commerce mostly originates in the more developed nations. With the current international rules on income characterization it is most likely that the transactions will give rise to business income. This type of income is most likely to be taxed by only the developed country under the current rules. Since the developing countries are delivering consumers of e-commerce, but not very many producers, they are missing the opportunity to collect their fair share of the global tax base arising from e-commerce through the current system. The theoretical foundation for the taxation of international income is also violated under the current rules. The theoretical justifications for taxation support greater source based taxation than employed today. Indeed, one idea of international taxation is that it should be designed to deal with the fundamental question of sharing the tax revenue from international transactions between countries – where this sharing is an aim of international taxation, due regard must be paid to the effect of particular tax rules on

actively in the preparation of OECD reports. Canadian jurisprudence has influenced the international scene and brought about changes to the model tax convention and the commentary and has been a leading country in this respect.

Australia is similarly situated to Canada and both nations are capital importing nations and might take a more open approach to developing countries then the United States in their tax policy and thus in their tax treaties. Although the two nations are similar, interesting differences might be seen as Australia for example has a broader definition of royalty than the definition employed in Canada.

In addition to the above-mentioned countries two developing countries have been chosen as sample jurisdictions. China stands as a contrast to these systems in term of complexity and sophistication as the taxation system as understood in the West was not introduced until 1980. This system generally follows the international norm and is largely based on the OECD model tax treaty. China also focuses on source-taxation in the choice tax policy, which is a natural reflection of the country’s position as one of the world’s largest capital importing countries. Chile was chosen as a representative of the South American region. Chile represents a different level of development in their tax systems and is a relatively new actor on the tax treaty scene. Chile has for example recently negotiated one of its first treaties with Canada as a developed country. Bringing developing countries into the research provides the opportunity to examine the position taken on e-commerce issues by countries not suffering from old rules and principles in their tax policy. The wide range of countries from around the world, offers a good opportunity to examine the international uniformity or the lack of it.
developing countries. Chapter five examines the problem of sharing international income taxation under the current rules and examines the theoretical basis for taxing income. Ultimately, the chapter explores what a reformed system that ensures a fairer sharing of the global tax base between developed and developing countries could look like.
CHAPTER TWO - THE PROBLEM OF DISTINGUISHING BUSINESS INCOME FROM PROPERTY INCOME

Every area of law turns on drawing conceptual distinctions. These line drawing exercises should reflect the underlying purpose of drawing the distinction in the first place. One of tax law’s most difficult distinctions is the distinction between income from business and income from property. One might expect that the distinction between these sources of income could be easily made: the concepts of “property” and “business” seem distinct. Business might import a sense of activity in the income earning process, while property might suggest less activity. Nevertheless, drawing the lines between the sources at the margins has proved to be difficult for tax administrators. For example, where a taxpayer has a number of “passive” assets such as buildings or stock certificates, but these assets are used in the course of the taxpayer’s business, administrators struggle with whether the income from those assets should be characterized as income from property or income from business. Digital products in electronic commerce have caused these line drawing exercises to become even more complex. Should income from a transfer of digital products give rise to sale of goods or services generating business profits, or a licensing of copyright generating property income in the form of royalties? To answer these questions, the evaluative criteria for good tax policy and the rationale for the distinction between business and property must be analyzed.
I. EVALUATIVE CRITERIA FOR GOOD TAX POLICY

The fundamental evaluative criteria for all tax rules – international and domestic – are equity, neutrality, and administrative ease.\textsuperscript{14} A good tax system must promote these different aspects through the tax rules.

The concept of equity is divided into horizontal equity and vertical equity. Horizontal equity requires similarly situated taxpayers, as measured by income, to be treated similarly. Vertical equity requires differently situated taxpayers, as measured by income, to be treated differently. Vertical equity is predicated on the ability-to-pay principle. The ability-to-pay principle requires that the higher a taxpayer’s income, the greater his or her proportionate share of the taxes owed. The objective of taxpayer equity is accomplished through the taxation of income on a worldwide basis. Non-taxation of foreign sourced income violates horizontal equity, since otherwise similarly situated taxpayers, as measured by income, are not treated equally. Moreover, vertical equity is also violated, because a taxpayer’s ability to pay is increased where he or she earns foreign income, and by not taxing the foreign income, differently situated taxpayers, as measured by income, are not treated differently.

In the international context, the concept of equity also includes the difficult issue of how tax revenues should be shared between states, often referred to as inter-nation equity. For this system of sharing to work, there has to be a common notion of equity and fairness between states. Equity is accepted as a fundamental feature of international tax policy,

but what constitutes equity internationally is hotly contested. Scholars and administrators disagree about which policy achieves inter-nation equity, with some suggesting mainly residence taxation and others suggesting mainly or exclusively source taxation.\textsuperscript{15}

Neutrality is another objective of international tax policy. Neutrality requires that, to the extent possible, a taxpayer's choices are not altered by the imposition of the tax regime.\textsuperscript{16} In the international arena, neutrality is often evaluated by one of two possible methods: capital export neutrality ("CEN") and capital import neutrality ("CIN").\textsuperscript{17} Under the CEN concept, the tax system should not distort the choice between domestic and foreign investment, since capital should be taxed the same, whether exported or not. Under the CIN concept, the importing country should tax the capital in the same way as domestic capital is taxed, which would mean that a non-resident earning income from property or business in Canada should be taxed as a Canadian resident earning that same income. Under Canadian tax law a compromise between the two concepts of neutrality is employed, since deferral of Canadian tax is prevented for passive income (CEN), but for active business income, deferral is permissible (CIN).\textsuperscript{18} Particularly important for the taxation of e-commerce is the concept of transactional neutrality, which translates into similar treatment of economic transactions, regardless of form or means of


\textsuperscript{16}Li et al., supra note 14, at 13.

\textsuperscript{17}Ibid.

\textsuperscript{18}Ibid. at 14.
The principle of neutrality is possibly the hardest to accomplish internationally, because varying rates and bases for tax are chosen by different countries depending on the particular circumstances of the individual country.

Administrative effectiveness is a third objective of tax policy. A tax system is administrable if it minimizes compliance costs and administrative costs for taxpayers and tax administrations respectively; it is easy to enforce, and difficult to evade. If a tax is difficult to administer, it will fail to serve as a reliable source of revenue. The international tax rules under the *Income Tax Act*\(^{21}\) (ITA) are known to be more complicated than domestic rules, in part because these rules need to address both jurisdictional issues, different legal systems interacting, and the complexity of international business.

The idea of taxing international income through source and residence taxation finds justification under the theory in the economic allegiance theory, benefit theory, entitlement theory and the ability-to-pay principle. The economic allegiance theory ensures a fair and equitable distribution of the tax burden between nations with the determinative factor for a taxpayer's economic allegiance to a country being consumption or business activities. The benefit theory represents the principle that those who benefit from public services of a particular country should be charged for the use of these services. Benefits might be provided by both the residence and source country and

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taxation by both is therefore equally supported by the theory. The theory of entitlement asserts that a country can levy tax as a national rental charge for the use of the country’s investment environment and natural resources. This theory mainly supports source taxation but residence taxation is equally possible under this theory. As we will see later, the theory underlying international taxation at times almost seems disconnected from the doctrinal material, as the League of Nations' specialists did not apply the theories at the same level of detail as they were developed and did not see the benefit and entitlement theories as sufficient in accounting for certain issues and therefore did not adopt them. 

II. HISTORICAL RATIONALE UNDERLYING THE CHARACTERIZATION OF INCOME BY ITS SOURCE

To answer the question of why we characterize income by its source, one must look to historical resources for the domestic rules. The concept of segregation was first conceived in the U.K. in the Addingtons Act in 1803. The rationale behind the segregation of types of income was that no single government official should know the total income of a person. The source doctrine was therefore intended to protect the privacy of taxpayers. The Canadian tax system is based on this scheme of income segregation, but has a different focus than the system it was built on. Where the U.K. system only taxes income if it falls within one of the schedules, which are mutually

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22 The League of Nations was an international organization founded as a result of the Paris Peace Conference, 1919. The goals of the League of Nations included disarmament, preventing war through collective security, settling disputes between countries through negotiation diplomacy and improving global welfare.
23 See chapter five of the thesis for a more detailed discussion of the theoretical foundation for international taxation and the specific theories.
exclusive, under the Canadian system, the named sources\textsuperscript{25} are not mutually exhaustive, and income can arise from any other source.\textsuperscript{26} However, the scope of the source doctrine in Canada is not settled.\textsuperscript{27}

There are several reasons for the characterization of income for international tax purposes however, the distinction might be based on largely historical reasons. Most international treaties are based on the drafting of the model tax convention by the League of Nations in the early 1920s, when very few countries had a comprehensive tax system. However, many European countries employed a schedular system of taxation where different categories of income received a different treatment.\textsuperscript{28} The tax treaties adopted this system and the model tax conventions we have today still mirror this blueprint.\textsuperscript{29}

Administrative ease is another reason for characterizing income by its source. Withholding taxes are easier to collect when imposed on a gross basis and collected through the resident payor as an agent for the authorities. The continued use of a system that is already in place is also easier than developing new systems. The globalization of

\textsuperscript{25} The sources are found under section 3 of the ITA and are: income from an office, employment, business, property or capital gains, subsection 3(a).

\textsuperscript{26} Vern Krishna, \textit{supra} note 23, at 138.

\textsuperscript{27} In \textit{Canada v. Fries} [1990] 2 S.C.R. 1322, the court held that strike pay was not income, but the court did not address the underlying fundamental question: was the strike pay not taxable because it was not income or because it did not flow from a named source in section 3 of the ITA. The question of whether the section should be read on a global expansive basis or on a narrower schedular basis was not addressed. In another case, \textit{Schwartz v. Canada}, [1996] 1 CTC 303, DTC 6103 (SSC), the court again did not explore the scope of section 3, and held that damages were not taxable as retirement allowances. It is however worth noting that four judges observed that paragraph 3(a) should be read on an expansive basis: "The phrasing adopted by Parliament, in s. 3(a) and in the introductory part of s. 56(1) is probably the strongest that could have been used to express the idea that income from all sources, enumerated or not, expressly provided for in Subdivision d or not, was taxable under the Act." (At paragraph 50). This reflects the underlying policy of paragraph 3(a) and the principle of equity that connects the burden of tax with the ability to pay.

\textsuperscript{28} Li, \textit{supra} note 7, at 514.

\textsuperscript{29} \textit{Ibid.}
the world economy, largely facilitated through e-commerce, exposes the difficulties of
 taxing certain types of cross-border income under national rules. Given the difficulties,
 prominent tax scholars argue that income characterization is more of an anachronism than
 a well-considered policy decision.  

III. RATIONALE FOR DISTINGUISHING BETWEEN INCOME FROM BUSINESS AND
 INCOME FROM PROPERTY

Business and property income are treated differently by both domestic taxation rules as
 well as international taxation rules. Although the two sources of income are potentially
 distinguishable, for example income from property is generally understood to concern
 yields on assets and income from business is generally understood to require an active
 earning process, it is difficult to imagine why both types of returns are not taxed in the
 same way, since both clearly give rise to “income” for tax purposes. However, there are
 a number of places in the ITA where there is a different treatment of income from
 business and income from property. In these cases, the characterization of a particular
 stream of income matters, since the taxation of the income is dependent on the
 characterization outcome. In this part of the thesis, I examine six different sections under
 the ITA that distinguish between business and property income, and I attempt to
determine the rationale for distinguishing between them.

 Cdn. Tax J. 124 at 132.
The collection of taxes under the Canadian comprehensive income tax system finds validation in the theory of the ability-to-pay principle. The ability to pay is measured by net income, and the formulation by Haig-Simons is recognized as the most enduring definition of the income tax base. This definition is the foundation of the comprehensive income tax base, which was recommended by the Carter report and has become accepted as a model tax base in many countries, although no country approximates the tax base suggested by the Haig-Simons definition of income.

A. Administrative reasons

Several rules under the ITA have ease of administration as the underlying policy. The justification for these rules is the more effective collection of tax and a reduction in compliance costs.

i. Withholding on Passive Income of Non-Residents (Part XIII)

The tax liability for non-residents is connected to the source of income. In Canada, income from business carried on in Canada is subject to tax on a net basis under Part I of the ITA, whereas income from property is subject to a withholding tax on a gross basis at source under Part XIII. Where a non-resident is earning income from property, the


\[33\] See chapter five for a more detailed discussion of the theory.

\[34\] ITA, *supra* note 21, Part I and Part XIII.
income is subject to a withholding tax at source, generally reduced under the treaty provisions to between 5% and 15%. The underlying rationale for imposing a withholding tax is simply administrative ease, both under domestic law and under the treaty network. The theory underlying the collection of the tax is the economic allegiance theory since the threshold for claiming tax jurisdiction is the economic connection of the activity. As mentioned earlier, the ability-to-pay principle supports the collection of taxes. The theory of entitlement asserts that a country can levy tax as a national rental charge for the use of the country’s investment environment and natural resources. Imposing a withholding tax on property income earned by non-residents represents the view that there is an entitlement to tax on the basis of the use of the investment environment. The rule represents a tax claim based on source taxation, which finds support in the theory of entitlement. Because the income is earned by a non-resident, who may have no other business assets in the source country, the tax authorities may have difficulties enforcing the payment of the tax. A withholding tax ensures that the tax is collected and that the non-resident meets the tax obligations in Canada. This means that once the resident pays the appropriate amount of withholding tax on behalf of the non-resident, the non-resident may have no further tax obligations in the source country. The resident taxpayer becomes the agent for the tax authorities in collecting the tax from the non-resident. Under Canadian tax law, the ITA levies the withholding tax at a flat rate on the gross amount of passive income earned by the non-resident from Canadian sources. The underlying rationale for imposing a flat rate withholding tax is that the resident, acting as the agent for the authorities, cannot reasonably be expected to deduct

35 See for example the Income Tax Treaty between Canada and China, infra note 341, article 12(2).
allocable expenses and determine the appropriate tax bracket of the non-resident. The tax is based on a flat rate as a practical, administrable solution.\(^{36}\)

Where income from business is earned by a non-resident, the income is subject to tax on a net basis under Part I of the ITA under the individual rates.\(^{37}\) The tax liability is determined similar to that of a resident and the taxpayer is subject to the self-assessment system and must file returns. The policy underlying this treatment is that a non-resident who is significantly engaged in the economic life of Canada knows his or her tax liability, tax bracket, expenses and so on, and should be taxed in the same way as a Canadian. The theory underlying this position is equity, more specifically vertical equity since similarly situated persons, regardless of nationality, are treated similarly.

In order for Canada to be accorded jurisdiction to tax business income under the treaty network, the threshold test of permanent establishment must be met. Where the threshold cannot be met, the income from business is subject to residence-based taxation only. The rationale underlying the permanent establishment threshold is grounded in a concern that foreign governments may assert taxing claims too aggressively.\(^ {38}\) The permanent establishment was adopted as a safeguard to ensure that only the state in which the permanent establishment was located could levy source-based taxes on the income of an


\(^{37}\) ITA, *supra* note 21, s. 117 (individuals) and s. 123 (corporations).

\(^ {38}\) When the League of Nations model income tax treaty was drafted in the 1920’s they were concerned about “*aggressive assertion of source-based taxing claims by foreign governments*”. Walter Hellerstein, “Jurisdiction to Tax Income and Consumption in the New Economy: A Theoretical and Comparative Perspective” (Working Paper, April 1, 2003) 29-31 in Michael J. Graetz, *Foundations of International Income Taxation* (New York, N.Y.: Foundation Press, 2003) at 296-297.
enterprise. This principle is found in the OECD Model Convention as well as in Canada’s bilateral tax treaties. The theory behind the taxation of business income in the treaty context is grounded in the economic allegiance theory, but as applied by the League of Nations. This means a lower level of detail and a differentiation of income by its source.

ii. The Attribution Rules

Where property is transferred or loaned to or for the benefit of the transferor’s spouse or a person who has since become a spouse, it results in attribution of income or loss from the property or substituted property. Thus, the transferor must recognize the income or losses while the transferee holds the property. When the recipient disposes of the property, capital gains or losses are also attributed to the transferor. This rule only applies under the requirement that the person must have transferred or loaned “property” according to case law, and the courts have held that

[T]he attribution rules only apply to property income, not income from employment or income from business, nor, presumably, to income from property used in the course of carrying on business or employment.

In Nathan Robins v. MNR the court said that the requirements of the provisions:

[A]re designed to prevent avoidance of tax by transfer of income producing property to persons who are normally in close relationship with the transferor. But

39 Ibid. at 297.
41 ITA, supra note 21, Subsection 74.1(2) and section 74.3 to 74.5. The principles discussed apply equally to all of the attribution rules.
42 Ibid. Subsection 74.1(1).
43 Ibid. Section 74.2.
45 Robins v. MNR [1963] CTC 27 at 30, 63 DTC 1012.
what is deemed to be the income of the transferor, and this is clearly stated, is income from property only. Indeed there is no mention of income from a business such as we have here and, therefore, this section can be of no assistance in determining whether the business profit resulting from a real estate transaction is taxable as income of the appellant or of his wife.46

The attribution rules, therefore, only apply to income from property and not income from business, and the distinction between business and property income and the line determining where they depart is therefore crucial. The underlying rationale for the distinction under this provision is the avoidance of tax by transfer of income. Horizontal equity theory underlies this rule as it ensures similar treatment of similarly situated taxpayers. Because income from property is easier to manipulate, the section only applies to property income. Furthermore, income from business is difficult to trace back to the transferred or loaned property, which has precluded the attribution of income from this source.47 The policy accomplished through these rules is inter-taxpayer equity, since taxpayers in similarly situated circumstances are maintained in the similar situation by the attribution back to the transferor. Also, administrative ease is accomplished by not applying the rules to business income, due to tracing difficulties.

iii. The Foreign Tax Credit

A tax credit can be claimed for foreign taxes paid on both foreign business income and foreign non-business income.48 The credit is limited to the amount of Canadian tax otherwise payable. The difference between foreign business income and foreign non-

46 Ibid. at 1014.
48 ITA, supra note 21, s. 126.
business income is that foreign business income is income derived from the carrying on of a business in the foreign jurisdiction whereas foreign non-business income is income other than business income, such as investment income.\textsuperscript{49} The distinction between business and property income is rationalized by the different provincial tax treatment of foreign sourced income. Generally, Canadian corporations are not subject to provincial tax on their foreign sourced business income, and the foreign tax credit therefore applies without any reduction for provincial taxes payable. Foreign-sourced non-business income is subject to provincial taxes differently, and the foreign tax credit applies against Canadian tax payable after a discount for provincial tax payable.\textsuperscript{50} This different treatment makes the distinction between income from business and income from property necessary. Under income tax theory any measure in the tax system that departs from the normative tax system is considered as tax expenditures.\textsuperscript{51} The foreign tax credit is a tax expenditure since it departs from the normative tax system and because it is delivered through the tax system instead of through, for example, a direct grant by the government.\textsuperscript{52} The underlying rationale for the foreign tax credit rule is administrative efficiency because the rules are designed to mirror Canada’s provincial taxing rules. Such a measure violates neutrality, since government intervention influences economic market forces. The different treatment also encourages the carrying on of business rather than investment activities so the distinction in the tax credit rules might also be considered justifiable as an “incentive” as discussed below.

\textsuperscript{49} \textit{Ibid.} Subsection 126(7).

\textsuperscript{50} Li \textit{et al.}, supra note 14, at 173.

\textsuperscript{51} Tax Expenditure Analysis was introduced as a concept by Stanley Surrey in \textit{Pathways to Tax Reform} (Cambridge, Mass: Harvard University Press, 1973).

\textsuperscript{52} See Neil Bruce, ed., “Tax Expenditures and Government Policy” (Kingston, Ontario: John Deutsch Institute for the Study of Economic Policy, Queens University, 1988) at 21 for a detailed discussion of tax expenditure theory. The theory will not be pursued in further detail here.
B. Incentive Reasons

While some rules distinguish between business and property income for administrative reasons, other rules distinguish between the sources to provide an incentive to engage in business activities. The underlying policy behind these rules is to promote business activity and thereby support the economy. Following are some examples of those incentives.

i. The Small Business Deduction

The active business income of a Canadian controlled private corporation is subject to a special low tax rate as a result of the small business credit.\(^{53}\) This special rate is a tax expenditure under the expenditure analysis theory since the rule departs from the normative tax system. The low rate is only available for income from business. When this rule came into force with the revised ITA in 1972, it was clear that the intention was to make a distinction between income from business and income from property.\(^{54}\) The underlying rationale for making this low rate unavailable for income from property is grounded in incentive reasons. By giving Canadian-controlled private corporations an incentive to engage in active business income, the government tries to influence the behavior of businesses by encouraging active business in Canada. In *R. v. Rockmore Investments Ltd.*,\(^{55}\) the primary distinction between business and property income was described as "the mere investment in property (including mortgages) for the acquisition
of income from that property and an activity or activities that constitutes 'an adventure or concern in the nature of trade' or a 'trade' in the sense of those expressions in section 248.”

The scope of the small business deduction was furthermore limited to income from an active business. This scope was clarified by Parliament in 1979, since the distinction between business and property income in the small business deduction rules had become uncertain as a result of the “active” business income requirement. Experts have noted that “the definition of “specified investment business” seems directed at barring entitlement to the small business deduction for income from property, unless accompanied by very substantial business activity.”

The rationale underlying the distinction in this provision can therefore be attributed to the encouragement of business activity. This policy violates the principle of neutrality, because the tax system intentionally distorts the choice between foreign and domestic business activity, but is accepted as a policy choice.

ii. The FAPI Rules

Where a taxpayer is using a foreign corporation to carry on business or make investments outside Canada, the foreign income will generally not be subject to Canadian taxation until the income is distributed to the Canadian shareholder. This system enables tax deferral since the income is taxed later than if the income had been earned domestically. The foreign accrual property income (FAPI) rules eliminate this deferral, since income of

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56 Ibid. at 293.
57 SC 1979, c. 5, section 38(6).
a controlled foreign affiliate is to be currently included in income computation of a Canadian shareholder, notwithstanding that the income has not been distributed to the shareholder (as dividends) yet.\textsuperscript{59} The rule only applies to FAPI, but not to foreign active business income. As discussed under the domestic rules\textsuperscript{60}, income is characterized as property income if it is earned primarily from the mere ownership of property without any activity in the business earning process or business-like intervention of the owner.\textsuperscript{61} However, where income is earned by a corporation, there is a presumption that the income is business income.\textsuperscript{62} Only income from an active business is exempt from the FAPI rules, whereas income from an investment business is deemed to be income from property for FAPI purposes. The underlying rationale for this deeming rule is that earning FAPI does not serve Canadian interests.\textsuperscript{63} Carrying on an investment business internationally and earning FAPI through a foreign affiliate serves the interest of the foreign jurisdiction and not Canada. If the rules were to permit the deferral of Canadian tax (when the corporation earns passive investment income) it would violate the CEN principle because the rules would distort the choice between foreign and domestic investment. Furthermore, the entity used to earn FAPI through will be placed in a low tax jurisdictions in order to realize the highest benefit of the deferral, which would result in an overall erosion of the worldwide taxation principle.\textsuperscript{64} By only excluding active business income from the FAPI rules, the rules represent an incentive for taxpayers to engage in active business as as opposed to passive investment income. In correcting the tax

\textsuperscript{59} ITA, \textit{supra} note 21, Section 95.
\textsuperscript{60} See section V. A. 'The Domestic Differences Between Business and Property Definitions'.
\textsuperscript{62} \textit{Canadian Marconi Co. v. The Queen}, [1986] 2 CTC 465, 86 DTC 6526 (SCC).
\textsuperscript{63} Li \textit{et al.}, \textit{supra} note 14, at 201.
\textsuperscript{64} \textit{Ibid.}
violations the FAPI rules violate the CEN principle because the choice between foreign and domestic investment is influenced intentionally. But because neutrality can never be fully achieved, the highest degree of neutrality is desirable. Since the FAPI rules correct an imbalance in tax compliance they are accepted as the chosen policy.

iii. Deductions in Relation to Intangibles

When a taxpayer earns business or property income, most of the expenses incurred during the earning of that income are deductible. However, when dealing with intangible property, deductions are only allowed where the expenses are incurred as a result of carrying on a business.\(^{65}\) Only capital expenditures of an intangible nature that a taxpayer incurs to earn income from a business that are not deductible under any other provision of the ITA can be deducted. Once the requirements are met, 3/4 of the costs of certain capital expenditures are allowable for deduction at the rate of 7% on a declining basis. This amortization system for intangible property was introduced under the 1972 ITA, and creates a system similar to the capital cost allowance system and capital gains system.\(^{66}\) Because this rule allows for deductions it is a tax expenditure under the expenditure analysis theory as it is departing from the normative tax system. The underlying rationale of this system is the recognition of the costs, which prior to their introduction, were considered non-deductible capital outlays.\(^{67}\) This ensured that the expenses for the intangibles would be matched with the revenue they help produce.

\(^{65}\) ITA, _supra_ note 21, Paragraph 20(1)(b).
\(^{66}\) Tim Edgar _et al._, _supra_ note 44, at 554.
\(^{67}\) _Ibid._
Because the deduction rules are generally based on and recognized through the active earning of business income, income from property is not eligible for deductions.

C. Recognizing underlying Corporate Taxation

Some rules under the ITA are designed to offer credit for underlying corporate taxation. These rules distinguish between business and property income to balance corporate and shareholder taxation.

i. Refundable Dividend Tax on Hand

A portion of the dividend tax paid by a corporation is refundable when taxable dividends are paid to the shareholders. The refundable dividend tax on hand (RDTOH) is refundable on the basis of a $1 refund for each $3 of taxable dividends the corporation pays to its shareholders. The underlying rationale behind this refund is that the total tax paid on the income should roughly correspond with the tax the individual would have paid had the income been earned directly. Thereby integration of the corporate taxes and shareholder taxes on income is accomplished. This rule allows for a refundable dividend which means a refundable tax credit. This is again a divergence from the normative tax system and it is therefore a tax expenditure under the expenditure analysis theory. The aggregate investment income for the purposes of the RDTOH includes taxable income from capital gains in excess of allowable capital losses, income from

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68 ITA, supra note 21, Section 129.
69 Ibid. Subsection 129(1).
70 Tim Edgar et al., supra note 44, at 720.
71 Ibid.
property less losses from property, and income or losses from a specified investment business carried on in Canada. Income from business is not subject to the RDTOH mechanism, and the distinction between business and property income is therefore vital. The rationale for making the credit available only on property income is to encourage investment in Canadian corporations.

The examination of the different sections under the ITA uncovers several different reasons for distinguishing between the two different sources of income. First of all, administrative efficiency is an overarching rationale for employing the distinction between the two sources of income. This rationale is found both under the rules governing tax liability for non-residents, and under the attribution rules. This policy also advances equity. Where non-residents are significantly engaged in business and thus in economic life in Canada they are subject to the same tax as Canadian residents. Under the attribution rules similar situated taxpayers are treated similarly. Both approaches are advancing equity, which is an important feature of a good tax system. Second, incentive reasons for business activity are significant and designed to change behavior by giving preferential treatment to one source of income, as seen with both the small business deduction and the FAPI rules. The deduction for intangible property similarly encourages business activity. Under the dividend tax credit incentive reasons are also the guiding principle, but for investment income rather than business income.

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72 Ibid.
The rationale for distinguishing income from business and income from property seems well grounded in the taxation system. The different reasons laid out above all achieve policy goals set by the government, whether it is ease of administration or to promote incentives for particular activities. The theories underlying the rules are found in the traditional economic allegiance theory and the ability-to-pay principle within this theory. As such, the reason for distinguishing between the two sources makes sense, but the reason for the distinction in the first place remains an anachronism in today’s tax legislation.

IV. **Problems with the Historic Characterization**

Because the tax system favors some activities over others, for example, business activity over investment activity, and taxes these activities differently, complications are bound to arise. There are several problems with the historic characterization of income by its source. First, where there is more favorable taxation for one of the sources, the taxpayer will attempt to shift the character of the income. Second, the existing characterization rules do not easily accommodate e-commerce transactions, which make shifting the nature of the transaction easier. Third, the distinction between different types of income is inherently artificial, which provides opportunities for creative tax planning and cross-border tax arbitrage.\(^73\) Taxpayers inevitably attempt to categorize transactions in a way that will minimize the liability to tax.\(^74\) Finally, where different countries do not share the same view of the definition of income categories, the result can be double taxation or

\(^73\) Li, *supra* note 7, at 514.
even double non-taxation. In the former situation a state may be unwilling to relieve double taxation by granting a tax credit for any withholding tax imposed.  

V. E-COMMERCE AS AN ILLUSTRATION OF THE PRACTICAL PROBLEMS CREATED BY THE DISTINCTION BETWEEN BUSINESS AND PROPERTY

A. The Domestic Difference Between Business and Property Definitions

To determine if income will be characterized as having either a business or property source under the ITA, one might begin by examining the appropriate definition provisions. A business is defined as follows:

"Business" includes a profession, calling, trade, manufacture or undertaking of any kind whatever and, except for the purpose of paragraph 18(2)(c), section 54.2 and paragraph 110.6(14)(f), an adventure or concern in the nature of trade but does not include an office or employment.

Property is defined as:

"Property" means property of any kind whatever real or personal or corporeal or incorporeal and, without restricting the generality of the foregoing, includes (a) a right of any kind whatever, a share or a chose in action, (b) unless contrary intention is evident, money, (c) a timber resource property, and (d) the work in progress of a business that is a profession.

To provide further scope for the distinction between business and property income, the definitions, guidelines, and criteria employed in theory and in practice must be explored.

76 ITA, supra note 21, Subsection 248(1).
77 Ibid. Subsection 248(1).
As noted earlier, the rules governing the calculation of income differ according to the source of the income, as deemed by the ITA. There are five separate sources of income, and the ITA groups together the rules that apply to business income and property income. For most parts of the ITA, it is therefore not necessary to define the exact line between business and property income. However, as discussed above, identical rules do not apply in all circumstances as in some cases a different characterization leads to different tax treatment under the ITA and Canada’s bilateral tax treaties. This different treatment gives rise to the difficulties of distinguishing between income from business and income from property.

When operating in the area of international taxation, the distinction between business and property income becomes highly relevant because the taxation of non-residents requires the sources be taxed differently. Non-residents are taxed on a different basis for these two types of income, since (active) business income is taxed on a net basis, but under the higher threshold of a permanent establishment, whereas (passive) property income is taxed on a gross basis and subject to withholding tax. This represents only one of the circumstances under which the distinction becomes relevant. The distinction is also important because the classification of the income in the context of international taxation determines where the revenues are taxed - business income is taxed only at source under the higher threshold of a permanent establishment whereas royalties are taxed on a

78 Ibid. Paragraph 3(a) and 3(b).
80 Edwin C. Harris, Canadian Income Taxation (Butterworth & Co. (CANADA) Ltd., 1979) at 158.
81 Ibid. at 1134.
82 Ibid.
withholding basis at source. Thus, in the absence of a permanent establishment, the classification of the income as business income ultimately erodes the tax base in the source country. In some situations, deductions are allowed for the expenses related to the earning of business income but not property income. An example is the income from rental property, where deductions are allowed only if the property is used in the earning of business income, otherwise no deductions are allowed.  

According to case law, the distinction between business and property is based on the activity in connection with the income earned. In Hollinger v. The Queen, the court considered four criteria that may serve as indicia, namely:

(1) whether the income was the result of efforts made or time and labor devoted by the taxpayer; (2) whether there was a trading character to the income; (3) can the income be fairly described as income from a business within the meaning of that term as used in the Act; and, finally (4) the nature and extent of services rendered or activities performed.

But to these criteria the court noted that the “overriding consideration” is the “objective question of the source of the income.” The court moreover noted that:

If income from property has any meaning at all, it can only mean the production of revenue from the use of such property which produces income without the active and extensive business-like intervention of its owner or someone on his behalf.

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83 Harris, supra note 80, at 159.
84 Only a few of the leading cases are chosen to illustrate the distinction between the two sources of income, as a more detailed examination is beyond the scope of this paper. See for example Tim Edgar et al. supra note 44, chapter 5 for a detailed discussion.
85 Hollinger v. The Queen, supra note 61.
86 Ibid. at paragraph 39.
87 Ibid. at paragraph 40.
88 Ibid.
It can therefore be concluded that where the income is derived from the mere ownership of the property, the income is generally considered income from property. Conversely, if the earning of the income involves a significant amount of activity, the income is likely to be business income.\(^{89}\)

The distinction between income as either active business income or passive property income and the amount of activity required to establish active business income was also discussed in \textit{Canadian Marconi Co. v. The Queen}.\(^{90}\) Where the actor is a corporation, the court held there was a presumption that business was being carried on as expressed in \textit{Anderson Logging Co. v. The King}\(^{91}\) and cited in \textit{Canadian Marconi Co. v. The Queen}:

\begin{quote}
The sole raison d'etre of a public company is to have a business and to carry it on. If the transaction in question belongs to a class of profit-making operations contemplated by the memorandum of association, prima facie, at all events, the profit derived from it is a profit derived from the business of the company.\(^{92}\)
\end{quote}

The Court confirmed this presumption by noting "\textit{the case law thus provides ample support for the existence of the presumption.}"\(^{93}\) In \textit{Canadian Marconi Co. v. The Queen}, the level of activity coupled with the presumption that a corporation carries on business, was sufficient to determine the income as active business income and not (passive) property income.

\(^{89}\) \textit{Tim Edgar et al., supra note 44, at 353.}  
\(^{90}\) \textit{Canadian Marconi Co. v. The Queen, supra note 62.}  
\(^{92}\) \textit{Canadian Marconi Co. v. The Queen, supra note 62, at paragraph 9.}  
\(^{93}\) \textit{Ibid.}
To summarize how income from business is distinguished from income from property in the Canadian case law, the dividing line is drawn based on the level of activity. The more activity the more likely the income is to be characterized as business income. In addition, there is a presumption that corporations are earning income from business.

B. Application in the Canadian Context of E-commerce

i. OECD as the Leading International Source of Characterization Guidance

Given the relative absence of domestic authority on the characterization of e-commerce transactions,\(^{94}\) in this part of the thesis, I examine the characterization of e-commerce transactions by international bodies, and particularly by the Organization for Economic Co-operation and Development. The Canadian tax authorities, in general, apply the same principles as those of the OECD.\(^{95}\) The OECD has developed a Model Convention,\(^{96}\) analyzed e-commerce issues, and is regarded an authority around the world in developing the positions adopted by tax administrations.\(^{97}\)

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\(^{94}\) There are no publications from the CRA on E-commerce characterization as of yet. "The CRA is currently working on two publications that are undergoing an internal review process after which they will undergo a more formal external review process and will be made available to the public in due course." Canada Revenue Agency “Carrying on Business over the Internet and Income Characterization”, online: <http://www.cra-arc.gc.ca/tax/business/topics/ecomm/income/carryon-e.html>.


\(^{96}\) OECD Model Convention, supra note 40.

\(^{97}\) Ibid. at 2:
The OECD is a unique forum where the governments of 30 democracies work together to address the economic, social and environmental challenges of globalisation. The OECD is also at the forefront of efforts to understand and to help governments respond to new developments and concerns, such as corporate governance, the information economy and the challenges of an ageing population. The Organisation provides a setting where governments can compare policy experiences, seek answers to common problems, identify good practice and work to co-ordinate domestic and international policies.
characterization of e-commerce transactions is the report\textsuperscript{98} by the Technical Advisory Group on Treaty Characterisation on Electronic Commerce Payments.\textsuperscript{99} This report examines 28 different transactions of common e-commerce payments and recommends how these should be characterized. It is worth noting that only three of the 28 transactions are characterized as property income, whereas the rest are characterized as business income.

\textbf{ii. Looking at Developed and Developing Countries}

The International Monetary Fund (IMF), the United Nations (UN), the World Bank, and the World Trade Organisation (WTO) each employ their own definitions and distinctions between developed and developing countries. The terms “developed and developing country” are not a distinct category for one type of country. Different factors determine what category a country falls into depending on the organization using the definition. There is no absolute consensus on what a developing country is but the term is commonly used by many organizations and commentators.

The term “developing country” is used by the International Monetary Fund (IMF) for the bottom group in its hierarchy of advanced economies, countries in transition, and developing countries. The term “developed country” is used by the IMF for the top group in its hierarchy of advanced economies, countries in transition, and developing countries.

\textsuperscript{98} Characterization Report, supra note 3.
\textsuperscript{99} Technical Advisory Group on Treaty Characterisation on Electronic Commerce Payments [TAG]. This task force was established to advise the OECD Committee on Fiscal Affairs on e-commerce issues.
Chile and China are classified as developing countries by the IMF, whereas Australia, Canada and the United States are classified as developed countries.

The United Nations also use the terms “developing and developed countries”. According to the United Nations definition, there is no established convention for the designation of “developed” and “developing” countries or areas. In common practice, Japan in Asia, Canada and the United States in North America, Australia and New Zealand in Oceania, and Western Europe are considered ‘developed’ regions or areas. Despite this, the terms developed and developing economies are used by the United Nations.100 Chile and China are classified as developing economies by the UN while Australia, Canada and the United States are classified as developed economies. This classification for developing economies is based on the gross domestic product (GDP) of the country. Chile is classified as a developing economy with the income of 2000 per capita and a current GDP above US$ 4,500 and is therefore a high-income developing economy.101 China is also classified as a developing country with the income of 2000 per capita and a current GDP below US$ 1,000 and is therefore a low-income developing economy.102

The World Bank also uses the classification developing country and developed country or upper middle-income country/lower middle-income country as opposed to high-income country. The World Bank bases its consideration on income. The economies are divided according to 2006 Gross National Income (GNI) per capita, calculated by using the

101 Ibid. at xvii.
102 Ibid.
World Bank Atlas method. The groups are: low income, $905 or less; lower middle income, $906 - $3,595; upper middle income, $3,596 - $11,115; and high income, $11,116 or more. The World Bank has Chile and China classified as developing countries (Chile as a upper middle income country and China as a lower middle income country) and Australia, Canada and the United States classified as developed countries (as high income countries).

The WTO has no set definition of developed and developing countries. The members of the WTO announce whether they are developed or developing countries but other members can challenge the use of a provision available to developing countries. The developing country status brings certain rights under the WTO. Some provisions in WTO agreements provide developing countries with longer transition periods before they are required to fully implement the agreement. Developing countries can also receive technical assistance. It does not automatically mean that a country will benefit from the unilateral preference schemes of some of the developed country members, such as the Generalized System of Preferences (GSP), after announcing itself a developed country. In practice, the country giving preference decides the list of developing countries that will benefit from the preferences. Both Chile and China are categorized as developing

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104 Ibid.

105 WTO, Development, Definition, Who are the Developing Countries in the WTO, online: WTO <http://www.wto.org/english/tratop_e/devel_e/d1who_e.htm>.

countries under the WTO whereas Australia, Canada and the United States all are categorized as developed countries.

As is evident from the various definitions employed above and consequent different categorizations, difficulties have arisen in the attempt to reach an agreement on what constitutes a developing country.\textsuperscript{107} A developing country can generally be said to be a country that has a relatively low standard of living, an undeveloped industrial base, a low per capita income, widespread poverty and a moderate to low Human Development Index\textsuperscript{108} score.

For the purposes of the thesis the term developed and developing countries is understood as a general classification. Thus, Chile and China are both considered developing countries whereas Australia, Canada and the United States all are considered developed countries.

\textbf{iii. Base Erosion Problems for Developing Countries}

Characterizing e-commerce transactions mainly as business income presents problems for developing countries, since they may not have the same level of commerce activity as

\textsuperscript{107} A country may not only fall into one category only. For example, a high income country is defined as a country with a GNI per capita of $11,116 or more by the World Bank. But according to the UN definition a high income country might also be a developing country, as for example Chile as a high income developing economy. A high income country can therefore be classified as either a developed or a developing country. Another issue to consider when using GDP to define developed and developing countries is how some countries have achieved a high GDP through natural resource exploitation but lacking the diverse industrial and service-based economy necessary for 'developed' status. Some countries are, despite a high GDP, not considered developed countries, for example Trinidad and Tobago.

\textsuperscript{108} The UN has developed the Human Development Index measuring per capita GDP, life expectancy, the rate of literacy etc. as an indicator of statistics to measure the level of human development for countries where data is available.
their treaty partners. The imbalance in commerce means that business income, which is only taxable where there is a permanent establishment in the foreign jurisdiction, will not arise to the same extent as in developing countries as it will in developed countries. The developing country will not recoup the lost tax revenues through domestic income. The potential abuse of the permanent establishment threshold, for example by the manipulation of the location of a server by corporations from developed countries, magnifies the imbalance. The developing countries fail to gain both revenues from their own residents’ commerce in foreign jurisdictions as well as losing tax revenue from non-residents earning otherwise taxable business income in their jurisdiction. If the theories of benefit and entitlement were used as the underlying rationale of claiming jurisdiction to tax international income, the imbalance experienced could perhaps be prevented. The theory of entitlement allocate the jurisdiction to tax on the basis of what can be called a rental charge for the use of a country’s investment environment and natural resources. The benefit theory asserts that those who benefit from public services of a country should be charged for the use of the services and allocates the jurisdiction to tax on that basis. Both theories support source as well as residence taxation.

iv. Base Erosion Problems for Developed Countries

Developed countries also face base erosion challenges in the taxation of e-commerce. For example, the potential abuse of the permanent establishment threshold by the manipulation of the location of a server can also pose base erosion challenges for developed countries. When income is characterized as business income it cannot be subject to tax in the source country in the absence of a permanent establishment. The
developed countries therefore also suffer from the abuse of the permanent establishment threshold, because revenues are moved out of their taxing jurisdiction, typically into tax havens. As discussed under the developing countries, the use of the theories of benefit and entitlement as the underlying rationale of claiming jurisdiction to tax international income, might possibly prevented the imbalance experienced.

v. Avoiding the Base Erosion Problem

Both for developing and developed countries, the base erosion problem can be avoided through a different characterization of the income. Where the transactions can be characterized as giving rise to property income in the source country, the treatment is different. The income will then be subject to a withholding tax at source, without a threshold requirement. However, the rates of withholding are reduced under the treaty network, often to between 5% to 15%, and revenues will therefore still be lost in the source jurisdiction, due to the lower tax rates applicable. But because the tax is a gross tax on withholding, the problem might not be as severe.

The characterization of computer software payments is particularly complicated because the substance of payments is difficult to determine as a result of the virtual realm, in which e-commerce operates. As argued by Jinyan Li, the "form of delivery" and the "substance of what is delivered" are blurred.\(^{109}\) This opens the door to altering the characterization of the transactions to the more favorable source of income for taxation purposes. The nature of the traditional commerce, which often requires a physical

\(^{109}\) Li, supra note 7, at 513.
presence, or deems a physical presence in the source country, brought balance to the system. However, the nature of e-commerce, which requires no physical presence at all, presents a major challenge to this system. It is therefore important to examine the traditional concepts and the rationale and underlying policy behind them to evaluate their validity in the international tax regime and in the reality of a new era.

If the theories of benefit and entitlement were used as the underlying rationale of claiming jurisdiction to tax international income, I argue that the imbalance experienced could be prevented. In ensuring the redistribution of income internationally and maximizing global welfare, these theories ensure that the developing countries are not robbed from their fair share of the fruit of e-commerce. When recommending the differentiation of income by its source and residence and source-based taxation, the League of Nations was aware of the problematic issues arising from such a division. Despite this drawback income characterization by source was implemented because it was “the least of all evils”. In today’s commerce context this argument is not necessarily correct.

vi. Consequences of Different Characterization and E-commerce Transactions

Both domestic taxation and the application of treaty provisions will depend on how the income is characterized. Where income from an e-commerce transaction is characterized as business income (active income) it is only subject to source taxation

110 See chapter five.
where the threshold of permanent establishment is met. On the other hand, if the income from an e-commerce transaction is characterized as royalty income (passive income) it might be subject to withholding tax at source, often at a reduced rate under the bilateral tax treaty in force. Income arising from e-commerce transactions may be characterized as either active income or passive income, depending on the transaction issues at hand. Because the distinction between the different types of income is artificial it creates a window for creative tax planners to move income in to a certain category by characterizing it differently\(^{112}\) or avoiding the threshold requirements, thereby possibly receiving a more favorable tax result.\(^{113}\) The characterization issue is particularly relevant where there is little guidance and no clear answer as to how income should be characterized, as seen in this particular area. Where differing positions are seen among nations, this can result in double taxation or possibly even double-non-taxation because both states are taxing the income on a different basis and refuses to accept the other state's characterization.

In the international context the taxation of e-commerce is complicated by the above-mentioned factors and the issue of income characterization is highly relevant. It is necessary to determine whether the income is derived from sales, services, rents or

\(^{112}\) Under Canadian Tax law this form of tax planning is law full tax planning referred to as tax mitigation. This should be distinguished from tax evasion, which represents the commission of an act knowingly with the intent to deceive so that the tax reported by the taxpayer is less than the tax payable under the law. This form of tax planning constitutes unlawful tax planning. Tax avoidance is another type of tax planning, which is concerned with the minimization of tax. It can be lawful or unlawful either because of the manner or the motive with which it is executed. It is unlawful only where it offends established judicial doctrines or prescriptive legislation such as the General Anti Avoidance Rule (GAAR) in S. 245 of the ITA.

\(^{113}\) Li, supra note 7, at 513-514.
royalties as the characterization of the income determines the taxation base as described. Further complicating this characterization exercise is the conflict in the treaty context between states where they do not share the understanding of how the income should be categorized. As discussed earlier, the base erosion problem is also relevant in the e-commerce context and poses a challenge to the taxation of income in this area.

Income from e-commerce should be characterized as either business profits or royalties under the OECD's recommendations.\textsuperscript{114} The theory underlying this classification is originally the economic allegiance theory as applied by the League of Nations. As a practical solution, a more rough system of justice, where each interested country receives revenue on the basis of the quantification of its interest under a system of classification of income by different sources, was adopted. The League of Nation's group of experts noted that their recommendations were based purely on practical purposes. In an earlier report to the League of Nations the experts did not recommend the income characterization method as the basis of allocating tax jurisdiction. They rejected this method because it would be

\begin{quote}
Almost impossible in economic theory to get a direct assignment of a quantitative character of finally resultant income amongst all the national agents who may be said to have had a finger in the pie.\textsuperscript{115}
\end{quote}

As noted by Tadmore,

The view of the four economists, although expressed more than 80 years ago, echoes even louder in the modern context of electronic commerce and the distinction between

\begin{flushright}
\textsuperscript{114} Characterization Report, \textit{supra} note 3, Paragraph 9, at 4.
\end{flushright}
royalties and business profits. This is because, in this particular context, there is no sound justification for the distinction itself.\textsuperscript{116}

Where income is characterized as giving rise to business profits, the source country is only accorded jurisdiction to tax where the threshold of permanent establishment is met. This principle similarly applies in the area of e-commerce and computer software payments. The concept of a physical presence to justify source-based taxation is however challenged in the reality of e-commerce, where transactions are made through computer servers or websites, eliminating the need for a physical presence in a country. The strategy to resolve this challenge has been to maintain the status quo in the sense that the concept still applies, but it has been stretched to also include a computer server as physical presence, satisfying the threshold of permanent establishment.\textsuperscript{117} The problem with this position is obvious, since the server can be placed in any location the corporation desires, for example in a low or no tax jurisdiction, because the location may be irrelevant as a consequence of the e-commerce itself. It is therefore not difficult to organize the tax planning of a corporation around this rule and to thereby abuse the permanent establishment threshold. Where the threshold cannot be met, the income is removed from the source country's tax revenues and accorded to the residence country's tax revenues. The OECD approach further provides for exclusive residence taxation of royalties, which again prevents source country taxation. This illustrates the OECD Model Convention's bias towards residence country taxation, and shows that the OECD Model Convention generally prevents source-based taxation of e-commerce. In the situations where the threshold can be met or the tax treaty allows for source-based taxation of

\textsuperscript{116} Tadmore, \emph{supra} note 30, at 133.

\textsuperscript{117} OECD Model Convention, \emph{supra} note 40, Commentary on Article 5, paragraph 7, section 42.1-42.10.
royalties, the collection of source tax is more difficult because the audit trail in e-commerce is non-existent due to the very nature of the trade. If the agent who collects the withholding tax fails to withhold, this might be extremely complicated for the authorities to expose.

C. International Treatment of the Distinction Between Business and Property in the Context of E-commerce

i. The OECD Model Convention and the Approach to Characterizing Income from E-commerce

Over the past 10 years the OECD has had e-commerce taxation as a center of attention. The work with tax aspects of e-commerce was commenced in 1997 and a number of Technical Advisory Groups (TAG's) were established. These TAG's, comprised by both OECD and non-OECD member countries, and private sector representatives, were given a two year mandate to advise the Committee on Fiscal Affairs on e-commerce tax policy matters. The TAG on income characterization reported its recommendations in 2001 and these recommendations have now been adopted into the OECD Model Convention and commentary. The report recommended characterization of 28 common e-commerce transactions, and offered guidance for distinguishing between business profits and property income in the context of e-commerce. It is worth noting that only three out of the 28 transactions of payments are considered to give rise to income from property; the remaining 25 to income from business. The general bias towards residence country taxation in the OECD Model Convention becomes evident through this examination. This

being said, the Characterization Report applies a substance over form approach, which is highly recommendable, because it considers the actual nature of the transactions, thereby embracing the principle of transactional neutrality. The outcome of the characterization of the 28 categories is not questioned and, as such, I agree that the results are correct. But the traditional rules of characterizing income by its source coupled with a different tax treatment magnifies the problem of the majority of transactions resulting in business profits because the potential base erosion problem is at play.

ii. Policy Underlying Income Characterization

The general underlying policy of the OECD Model Convention is the elimination of double taxation and prevention of fiscal evasion. For transactions involving computer software payments, the commentary to the OECD Model Convention distinguishes between the underlying copyright in the program and software, which incorporates a copy of the copyrighted program. The commentary clarifies that e-commerce transfers of all digital products should attract the same treatment as software payments and that the form of the transfer is irrelevant. Where digital goods and services are transmitted in cross-border transactions, the income generated will be characterized as business income, because "the payment is essentially for the acquisition of data transmitted in the form of a digital signal and therefore does not constitute royalties." Where digital goods are

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119 See for example the OECD Model Convention, supra note 40, Introduction, paragraph 16, at 11; Commentary on article 10, paragraph 2, section 12, at 148; Commentary on article 11, paragraph 2, section 9, at 169; Commentary on article 12, paragraph 1, section 4, at 178.
120 Ibid. Commentary on Article 12, section 12.2.
121 Ibid. Commentary on Article 12, section 17.1 and Commentary on Article 12 section 14.1.
122 Ibid. Commentary on Article 12, section 17.3.
downloaded, royalties will only arise where the copyright is commercially exploited.\textsuperscript{123} The underlying rationale behind these characterization outcomes is to treat similar economic activity in the same way regardless of the choice of transfer, thereby achieving neutrality. Whether a computer software file is shipped to a foreign consumer or transmitted electronically to a foreign consumer for their own use the electronic nature of the product will not result in different tax treatment. Both transactions will be characterized as generating business income and not royalties under the OECD Model Convention and commentary. Canadian tax treaties are not OECD consistent on this point, since they allow for source taxation of royalties, which is prohibited under the OECD Model Convention. Canadian tax policy can therefore be said to be closer to that of developing countries than the OECD, but this policy is changing, since lower rates for dividends and an exemption from withholding taxes on certain royalties are seen in treaties today.\textsuperscript{124} Furthermore, the OECD favours the characterization of income as income from business over income from property for computer software payments.\textsuperscript{125} The characterization of income as business income brings the base erosion issue into play in the reality of virtual commerce. I agree with the argument, that in the context of e-commerce the justification for the distinction between income from business and income from property is hard to see.\textsuperscript{126}

\textsuperscript{123} *Ibid.* Commentary on Article 12, section 17.4.
\textsuperscript{124} Li \textit{et al.}, supra note 14, at 26.
\textsuperscript{125} Characterization Report, \textit{supra} note 3, 25 of 28 categories are characterized as business income and 3 of 28 as property income.
\textsuperscript{126} Tadmore, \textit{supra} note 30, at 133.
VI. Summary

There are several reasons for the distinction between income from business and income from property under Canada’s domestic and international taxation rules. For both the domestic and international rules, historical reasons and administrative ease are the main rationales for characterizing income and distinguishing between income from different sources. For the domestic rules, incentive reasons are also a significant justification. Also, the convenience of using categories that are similar to what has always been used and what is known is a way to ease the administration of the rules that influence the system. These reasons are both valid. Administrative efficiency is an internationally recognized criteria for evaluating tax policy. Whether this rationale is justifiable to characterize income in the e-commerce context is, on the other hand, questionable. It seems as though the income characterization in the international context is more of an anachronism and is creating more problems than solutions to taxation in this area. The administrative ease that is created for the authorities comes at a high price, base erosion, especially for developing countries, but also for developed countries. Not only do administrators suffer under their administrative inconvenience themselves but also taxpayers pay the price of being subject to possible double taxation where the authorities differ in their characterization of the income. The principle of equity is thereby violated and the characterization approach creates uncertainty for the taxpayers. Taxpayers should generally be able to rely on the rules for characterization, but since there do not seem to be international uniformity on the topic, this may not be the reality faced by taxpayers.
Another reason for characterizing income in particular ways is to limit tax abuse. This is an intended, important, and valid rationale, but the problem is that international characterization approaches cannot account for the problem in the same way the domestic rules can. The abuse of the permanent establishment concept in the international rules is not accounted for through the rules of income characterization because the physical presence can be anywhere due to the very nature of e-commerce. Characterizing income as business income under the current rules only opens the door to possible abuse of the permanent establishment threshold in the e-commerce context for servers. This leads to the possible erosion of the tax base, which still exists even if a withholding tax is applied because the rate of withholding is reduced under the bilateral treaties. So even though the underlying rationale is a valid one, the application in the context of e-commerce aggravates the traditional base erosion problems.

A third reason for characterizing income (as business rather than property income) is to motivate businesses by offering certain special rules for taxation and deductions that are unavailable to income from property. Such tax expenditures promote the business environment in the country “spending” revenues through the tax system. Through this practice, countries support the earning of income from an active business in the expectation that the behavior of the taxpayers will be changed by the preferential treatment. This rationale is a valid one to employ in the domestic system, but whether this also is the circumstance in the international context is questionable. However, this can be a valid policy, since the result of this may be more desirable than the non-violation of the neutrality principle. Nevertheless, the encouragement of business activity by some
countries may not be shared by others, and the use of the international tax system as a facilitator may not be the appropriate.

The theory behind claiming tax jurisdiction in the international context can almost be said to suffer a disconnection from the doctrinal material, as the theory of benefit and entitlement, underlying the economic allegiance theory, does not find application in today's international tax system as recommended by the League of Nations. The assumption of the flow of trade being equal between developed and developing countries underlies the use of the current rules. But the reality of the trade often being unequal presents a serious problem under the current system that might become more severe as e-commerce continues to grow. Tax jurisdiction can only be claimed to a limited extend by developing countries under the current rules, and they might therefore not benefit from the fruit of this the futures commerce.

In conclusion, the examination of the different provisions and the underlying rationale domestically as well as the underlying rationale internationally, suggests that the distinction between business and property income is not inevitably valid in the context of e-commerce. The overall rationale internationally is simply an anachronism and no convincing rationale support the continued distinction between these two types of income. In fact, the distinction seems to aggravate the difficulties experienced with income taxation in the e-commerce area. The distinction does, in other words, complicate things without offering solutions. Traditionally, some degree of physical presence was required of the non-resident in the source state in order to obtain the jurisdiction to tax,
but the theories of benefit and entitlement do not require this physical presence to accord the jurisdiction to tax.\textsuperscript{127} The OECD Model Convention reflects the view that property income (such as royalties) does not present a connection with the source states that justifies taxation. But many OECD countries impose a withholding tax on royalties, which may be a recognition of the benefit and entitlement theories.\textsuperscript{128}

It might therefore be worth considering whether the characterization concept could be replaced by a system that would consider the benefit and facilities that enable the non-resident to derive income from foreign sources and base the taxation on this and not the traditional concept employed in the area today. The revision of the system should create tax rules that still promote the features of a good tax system. Such a system could, for example, be a tax system where characterization is not necessary. This is explored in more detail in chapter five of the thesis where the original theories underlying international income taxation are examined.

\textsuperscript{127} Ibid. at 134.
\textsuperscript{128} Ibid, at 135.
CHAPTER THREE - TAXING DIGITAL TRANSACTIONS UNDER TRADITIONAL RULES

Over the course of the last two decades the tax treatment of computer software payments has been the subject of many reviews and changes by countries and supra-national governmental bodies internationally, and of criticism from both tax scholars and other tax experts. Historically developed rules govern the area of taxation, but these rules are constantly being modified to accommodate new taxation issues. The critique is aimed at exactly this, because as reviewed in the previous chapter, the traditional international tax rules cannot easily accommodate the taxation issues within e-commerce transactions. Digital products in electronic commerce have caused these line drawing exercises to become complex. Nevertheless, the source principle is applied both domestically and internationally in the context of e-commerce. This chapter examines the development in the international guidance found in the OECD Model Convention with its recommendations on the application of the traditional rules to e-commerce, since this guidance has been adopted into Canadian legislation. In addition, it reviews the Canadian approach to the application of the traditional rules in dealing with e-commerce.
I. INTERNATIONAL DEVELOPMENT UNDER THE OECD MODEL CONVENTION

A. The OECD Model Convention and the Recommendations for the Treatment of Computer Software Transactions

i. The Development of the OECD Model Convention

The first OECD Model Convention was published in a draft form in 1963 and revised in 1977, 1992, 2002, and most recently in 2005. But the work with international double taxation conventions dates back as far as the 1920s. In 1928, a bilateral tax convention was adopted by the general meeting of Government Experts on Double Taxation and Tax Evasion, and became the first published convention on which the OECD Model Convention builds. A later 1935 draft convention, although never formally adopted, has also influenced the development of the OECD Model Convention.

132 OECD Model Convention, supra note 40.
136 Li, supra note 7, at 41.
The approach to allocating tax jurisdiction between source and residence countries has changed over time. In the 1928 model there was no allocation of income between countries. But in the revised 1935 draft model\textsuperscript{137} the basic principle for business profits was restated to permit a contracting state to tax income of a foreign enterprise where the income was allocable to a permanent establishment within the territory. For the computation of income the same principle as found in the OECD Model Convention today was adopted. These early model conventions dealt with the distinction between business and property income, since income has been differentiated by its source throughout the history of taxation.\textsuperscript{138} The next formal model conventions were the Mexico Model Convention and the London Model Convention. These were negotiated in 1943\textsuperscript{139} (Mexico Model Convention) and 1946\textsuperscript{140} (London Model Convention) and replaced the 1928 convention. Different members were represented under the two models, with the London Model Convention better representing the capital-exporting countries, whereas the Mexico Model Convention better representing the capital-importing countries.

\textsuperscript{137} League of Nations, supra note 135.
\textsuperscript{138} See chapter two 'Historical Rationale Underlying the Characterization of Income by its Source' for the historical rationale.
The distinction between business and property income was present both in the Mexico Model (1943) and in the London Model (1946). The Mexico Model provides that business income is taxable in the source state only under the threshold of a permanent establishment and where this threshold cannot be met, taxation is exclusively accorded to the residence state.\footnote{Mexico Model, supra note 139, article IV.} For property income (royalties) the Mexico Model provides that such income is taxable under the geographical source rule for immovable property\footnote{Ibid. article X.1.}, but where the royalties are copyright royalties, they are taxable only in the state where the right is exploited.\footnote{Ibid, article X.2.} Where the royalties are in consideration of musical, artistic, literary, scientific or other artistic work, and such royalties are earned in the non-resident contracting state by a resident of the other contracting state, such royalties are not taxable in the non-resident state.\footnote{Ibid. article X.3} The London Model provides that business income is taxable where the taxpayer has a permanent establishment. Where the taxpayer has activities in a contracting state, such income shall only be taxable in the non-resident state if the higher threshold of a permanent establishment is met.\footnote{London Model, supra note 140, article IV.1 And IV.2.} Where there is a permanent establishment in each state, income attributable to the territory can only be taxed by that particular state.\footnote{Ibid. article IV.3.} For royalty income, the London Model provides that income from immovable property shall be taxed under the geographic source rule.\footnote{Ibid. article X.1.} Royalties in consideration for the right to use a patent, a secret process or formula, a trade-mark or other analogous right, arising in the non-resident state shall only be taxed in the resident

\footnote{Mexico Model, supra note 139, article IV.}
\footnote{Ibid. article X.1.}
\footnote{Ibid. article X.2.}
\footnote{Ibid. article X.3}
\footnote{London Model, supra note 140, article IV.1 And IV.2.}
\footnote{Ibid. article IV.3.}
\footnote{Ibid. article X.1.}
However, where royalties are paid on a non-arm’s length basis, the royalties shall be where the rights are exploited, and where that would be the non-resident state, taxation is thereby permitted by the non-resident state. Where royalties are paid as consideration for the right to use an artistic, scientific or other cultural work or publication, taxation is only permitted in the residence state. Neither of the Mexico and London models ever managed to be fully nor commonly accepted. Since the beginning of the international taxation empire, there has been disagreement between developed and developing countries about the taxation of investment income and the scope of source taxation. The disagreement has been reflected in the subsequent conventions for the prevention of double taxation, namely the OECD Model Convention and the UN Model Convention. 

In 1963 the first OECD model convention was adopted. The distinction between business and property income was present in this first model, since income from business and income from royalties was taxed under separate articles. In the 1977 revised model convention, business and property income continue to be separate sources. The model provided that business income earned in the other state is taxable in the residence state, unless the higher threshold of a permanent establishment is met, and the income that can be taxed is only the income attributable under the threshold. Deductions are allowed

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148 Ibid. article X.2.
149 Ibid. article X.3.
150 Ibid. article X.4.
152 Li, supra note 7, at 45.
153 1977 Model Convention, supra note 129, article 7(1).
for expenses related to the permanent establishment in computing income and profits and shall be attributed to the permanent establishment in each state on the basis of what it might have been expected to make as a distinct and separate entity.\footnote{154} Where customary determination of profits has been used, other provisions of the article does not preclude this\footnote{155}, and no profits shall be attributed by reason of mere purchase of goods and services.\footnote{156} The same method of attributing profits shall be used every year, unless there is a good reason for changing the method.\footnote{157} For royalties, the model provides taxation under the residence principle between two contracting states, unless business is being carried on through a permanent establishment.\footnote{158} The model also provides that royalties are defined as payments of any kind received as consideration for a specific list of rights.\footnote{159} Where royalty payments are not at arm’s length, only the payment in relation to the amount that would have been agreed upon between unrelated parties gains the benefit of being taxed under this provision.\footnote{160} The work of the OECD did not focus on the development and transfer of software in the 1963 Model Convention and 1977 Model Convention revision, since the phenomenon was still to develop. But in 1985 the trends in technology, industrial and government policies in the field of software became a center of attention for the OECD.

\footnote{154} \textit{Ibid.} article 7(2) and article 7(3).
\footnote{155} \textit{Ibid.} article 7(4).
\footnote{156} \textit{Ibid.} article 7(5).
\footnote{157} \textit{Ibid.} article 7(6).
\footnote{158} \textit{Ibid.} article 12(1) and article 12(3).
\footnote{159} \textit{Ibid.} article 12(3).
\footnote{160} \textit{Ibid.} article 12(4)
ii. OECD Recommendations for the Treatment of Computer Software Transactions

A report by the OECD released in 1985 marks the first formal international discussion on the development and transfer of software. The OECD’s Committee for Information, Computer, and Communications Policy found that a project in the field would be useful, since there was an incomplete perception of the complimentary relationship between hardware and software that was able to make both industry and policy makers overly optimistic and overly pessimistic at the same time. The application of intellectual property law, accountancy law, and tax law was uncertain. At the time it was not clear whether software would be protected by property law or whether software should be considered an asset, whether expenditures on software were current expenses or investment expenses, and whether software sales would be treated as sale of goods or services. The report is mostly concerned with the economic features of the industry related to software and how governments can promote the growth of the software industry. Only a limited portion of the report is devoted to the legal aspects of software and the tax treatment of this emerging information technology. On the topic of tax law, the report confirms that uncertainty prevails in the area, and provides examples of how software is regarded in some countries. For example, in Ireland software was generally viewed as a service, and in France there were no tax instruments that dealt with software. Although the report is not a specific taxation report, it still marks the

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162 Ibid. at 10.
163 Ibid. at 11-12.
164 Ibid. at 169-170.
beginning of international discussions on the development and transfer of software for tax purposes.

The 1985 report was followed by an OECD study in 1992,\textsuperscript{165} which, among other topics, studied the tax treatment of software, leading to significant amendments to the 1977 OECD Model Convention in the summer of 1992. As a product of this attention in 1992, the tax treatment of software became specifically addressed in the OECD Model Convention. The 1992 study concluded that there were no new issues of taxation, but existing issues were highlighted as presenting difficulties, for example, in determining the scope of the royalty article.\textsuperscript{166} The 1992 report, more importantly, set out how the royalty article should be interpreted for software transactions. The major guidelines in the 1992 report can be summarized as follows:

1) Payments made in connection with software only represent royalties where there is a limited grant of rights for the commercial development or exploitation of the software.\textsuperscript{167}

2) Payments for software acquired for personal/business use are not considered royalties.\textsuperscript{168}

\textsuperscript{165} OECD, \textit{Model Tax Convention: Four Related Studies}, supra note 130.

\textsuperscript{166} OECD Model Convention, \textit{supra} note 40, article 12(2) 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”.


\textsuperscript{168} \textit{Ibid.} article 12(14)
3) Payments made for the alienation of all rights attached to software are not royalties.\textsuperscript{169}

4) Payments made for some, but not all rights attached to software may result in alienation, and where it does, it is not a royalty.\textsuperscript{170}

5) Where the payments are mixed, the payments should either be apportioned to the different parts or, where some parts are ancillary, the principal part of the transaction should prevail.\textsuperscript{171}

6) Where there is a double taxation agreement that provides for source taxation, but only for some and not all royalties, software payments with the characteristics of royalties will normally be characterized as paid for copyrights.\textsuperscript{172}

These guiding principles were implemented in the OECD commentary and the commentary provides that a payment in respect of software will rarely be a royalty. Instead, that payment will likely be classified as a capital gain, business income or services income, depending on the circumstances. Furthermore, the commentary now states that where less than full ownership is transferred the consideration rarely represents a royalty. Moreover, the commentary states that it is of no relevance that the software is protected by copyright or that the use may be restricted.\textsuperscript{173} The 1992 report brought some clarification to the distinction between business and royalty income in that it determines

\textsuperscript{169} Ibid. article 12(15)
\textsuperscript{170} Ibid. article 12(15) and 12(16)
\textsuperscript{171} Ibid. article 12(17)
\textsuperscript{172} Ibid. article 12(13).
\textsuperscript{173} OECD Model Convention, supra note 40, commentary on article 12, commentary 12(13) and 12(14).
where the boundary lies between software payments that should properly be regarded as royalties and other payments.¹⁷⁴ An important distinction was drawn in the report between software for own use and software for commercial exploitation, as the former would generate business income since it was a mere purchase of a product, whereas the latter would give rise to royalty income, as the payment is for the use of the rights in the product.¹⁷⁵ Furthermore, the report dealt with the situation where rights to the software were alienated, and stated that where the full ownership is transferred, the payments cannot represent royalties.¹⁷⁶ Where there is a partial alienation, each case will depend on the specific facts, but that the result in general will be that they give rise to commercial income.¹⁷⁷ Lastly, where the payments are related to mixed contracts the payment should be broken down and the proper tax treatment should be applied thereto, but if one part by far constitutes the principal purpose, then no allocation shall be made.¹⁷⁸

The OECD has continued to have e-commerce taxation as a focus of study. The work with tax aspects of e-commerce and computer software transactions was stepped up in 1997 when a number of Technical Advisory Groups (TAG’s) were established by the OECD with the mandate to study tax issues arising from certain aspect of e-commerce. The idea was to develop a global acceptable approach to the taxation of e-commerce.¹⁷⁹ These TAG’s, which included members from both OECD member countries, non-OECD member countries, and private sector representatives, were initially given a two year

¹⁷⁴ 1992 Model Tax Convention, supra note 167, paragraph 12.
¹⁷⁵ Ibid. paragraph 13 and 14.
¹⁷⁶ Ibid. paragraph 15.
¹⁷⁷ Ibid. paragraph 16.
¹⁷⁸ Ibid. paragraph 17 cf. article 11.
mandate to advise the Committee on Fiscal Affairs on e-commerce tax policy matters. The TAG on income characterization\textsuperscript{180} reported its recommendations in a 2001 report\textsuperscript{181} and these recommendations were adopted into the OECD Model Convention and commentary in 2002. The report recommended characterization of 28 common e-commerce transactions, and offered guidance for distinguishing between business profits and property income in the context of e-commerce. The major guidelines of the 2001 Characterization Report\textsuperscript{182} can be summarized as follows:

1) Where payments are for the use of or the right to use a copyright, the characterization is based on the identification of the consideration for the payment that is the essential consideration. Thus, where the essential consideration is for something else than the use of, or the right to use the copyright, the use is disregarded in the analysis of the character of the payment.\textsuperscript{183}

2) Where payments are for knowhow, the contract for the supply concerns information that already exists or that has already been developed or created, and contains provisions dealing with the confidentiality of such information.\textsuperscript{184}

3) Payments for the use of or the right to use industrial, commercial or scientific equipment for digital products do not include time-limited use.\textsuperscript{185} In some circumstances payments involving computer equipment can give rise to royalty, but this will rarely be the case. The substance of the transaction should be taken

\textsuperscript{180} Supra note 99.
\textsuperscript{181} Characterization Report, supra note 3.
\textsuperscript{182} Ibid.
\textsuperscript{183} Ibid, paragraph 16 and paragraph 17.1-17.4 of the Suggested Commentary on article 12.
\textsuperscript{184} Ibid, paragraph 23 and paragraph 11.3 of the Suggested Commentary on article 12.
\textsuperscript{185} Ibid, paragraph 25 and 26.
into account when determining whether the agreement is a service contract or a lease.\textsuperscript{186}

4) For services, the basic distinction between a transaction resulting in the acquisition of property and a transaction for services is whether the consideration for the payment is the acquisition of property from the provider. Where the customer owns the relevant property after the transaction, but the property was not acquired from the provider, then the transaction should be treated as a services transaction.\textsuperscript{187}

5) Technical fees should be divided into three categories, namely technical services, managerial services, and consultancy services. Services will be considered of technical nature (technical services) when special skills or knowledge related to a technical field are required for the provision of such service.\textsuperscript{188} Services of a managerial nature are services rendered in performing management functions, and involve functions related to how a business is run as opposed to functions involved in carrying on that business.\textsuperscript{189} Consultancy services refer to services constituting in the provision of advice by someone, such as a professional, who has special qualifications allowing him or her to do so.\textsuperscript{190}

6) The principles for dealing with mixed payments are based on the essential consideration, and follow the principles under 1).\textsuperscript{191}

\begin{itemize}
\item \textsuperscript{186} \textit{Ibid.} paragraph 27-31.
\item \textsuperscript{187} \textit{Ibid.} paragraph 33 and 34.
\item \textsuperscript{188} \textit{Ibid.} paragraph 39-42.
\item \textsuperscript{189} \textit{Ibid.} paragraph 43 and 44.
\item \textsuperscript{190} \textit{Ibid.} paragraph 45.
\item \textsuperscript{191} \textit{Ibid.} paragraph 23 and paragraph 11-11.5 of the Suggested Commentary on article 12.
\end{itemize}
These principles have been adopted into the OECD commentary and as a result, the revised commentary provides the characterization outcome to some electronic commerce transactions. Further, the report analyzes various common e-commerce transactions and provides recommendations for the characterization of such transactions. It is worth noting, that only three out of the total of 28 transactions are considered to give rise to income from property; the remaining 25 to income from business.\(^ {192}\)

The general bias towards residence country taxation in the OECD Model Convention becomes evident through this examination. The convention furthermore suffers a disconnection from the theories underlying income taxation, as the benefit and entitlement theories are not given any attention. That being said, the Characterization Report applies a substance over form approach, which is highly recommendable, because it considers the actual nature of the transactions, thereby embracing the principle of neutrality. In general terms, the cross border transaction of digital goods will generate business profits, since the payment is essentially made for data transmitted in the form of digital signals and therefore is not a royalty.\(^ {193}\) Royalties may be generated by the transaction where digital goods are downloaded to commercial exploit the copyright.\(^ {194}\) The recommendations in the characterization report adopted into the OECD Model Convention strive to treat similar economic activity the same way regardless of the medium through which the commerce is conducted. Through this practice the principle of neutrality is achieved. The report clarifies the treatment of software payments and the


\(^{193}\) OECD Model Convention, *supra* note 40, Commentary on article 12, paragraph 17.3.

\(^{194}\) *Ibid.* paragraph 17.4.
taxation thereof in greater detail than any other report published in the area, but uncertainties and complications still remain in the taxation realm for computer software payments.\textsuperscript{195} Since 2002 there have been no significant changes or additions to the OECD Model Convention and the accompanying commentary for computer software transactions. The last update of the Model Convention and the commentary was made in 2005, but this included only a technical change to the commentary on the royalty provision.\textsuperscript{196} The guidance for the tax treatment of computer software payments therefore remains as of the 2002 Model Convention and commentary that adopted the 2001 recommendations from the TAG on income characterization.

II. **The Canadian Approach to the Taxation of Computer Software Transactions**

The rise of e-commerce has challenged the traditional income taxation rules in Canada, as it has elsewhere. In the absence of specific rules to address the unique situations presented by e-commerce, Canada has attempted to apply existing rules in the most effective way. This section reviews the historic and current Canadian tax treatment of withholding tax on software transactions.

\textsuperscript{195} See chapter four for a discussion of the uncertainties and complications in the area.

\textsuperscript{196} OECD, *The 2005 update to the Model Tax Convention, Public Discussion Draft*, March 15, 2005, adopted by the OECD on 15 July 2005, at 2 “Changes to the Commentary on Article 12 to clarify when payments for forbearance to grant rights to use property constitute royalties.” This update included the addition of paragraph 8.1 to the commentary on article 12.
A. Development of Income Tax Law for Computer Software Payments

Under Canadian income tax law, the general rule under which a withholding tax of 25%\textsuperscript{197} is imposed on royalty income was and is subject to several important exceptions. One very important exemption for the taxation of computer software payment exempts a payment for a royalty made on or in respect of the production or reproduction of any literary, dramatic, musical or artistic work.\textsuperscript{198} This exception disappeared with CRA’s reversal of policy in 1983 expressed in a information circular\textsuperscript{199}, where the view was that computer software was not copyrightable in Canada and payments did therefore not qualify for the exemption in the ITA.\textsuperscript{200} Such payments were therefore taxed under part XIII of the ITA.\textsuperscript{201}

The CRA’s 1983-policy position was changed by two events. First, the Supreme Court of Canada determined that common law copyright protection exists in computer software in the \textit{Apple Computer} case.\textsuperscript{202} Second, the \textit{Copyright Act}\textsuperscript{203} (CA) as of June 8, 1988 expressly included computer software under the definition “literary work”. When the Supreme Court of Canada released the \textit{Apple Computer} decision in 1990, the CRA acknowledged that payments to produce or reproduce software under a licensing agreement were exempt from withholding tax, regardless of where the payments were made. When the 1992 OECD report was adopted into the OECD Model Convention and

\footnotesize
\begin{itemize}
\item \textsuperscript{197} ITA, \textit{supra} note 21, paragraph 212(1)(d).
\item \textsuperscript{198} \textit{Ibid.} subparagraph 212(1)(d)(iv).
\item \textsuperscript{199} \textit{Information Circular} 77-16R2, November 26, 1983.
\item \textsuperscript{200} \textit{Ibid.}
\item \textsuperscript{201} ITA, \textit{supra} note 21, subparagraph 212(1)(d)(i).
\item \textsuperscript{203} \textit{The Copyright Act}, R.S.C. 1985, c. C-42, [CA], s. 2.
\end{itemize}
commentary, Canada noted its reservations, including its intention to treat software payments as royalties.\(^{204}\) Canada also noted that where there was a source code that must be kept confidential, payments would be treated as royalties. Despite this announcement to the OECD, the government, in 1993, wanted to reduce withholding taxation on, or even exempt computer software from withholding tax in its treaty negotiations.\(^{205}\) This is now a reality in many of Canada’s treaties on double taxation.\(^{206}\) Canada’s position on source code software (announced in 1992) changed with the CRA’s change of policy as of March 28, 2002.\(^{207}\) At that time, the Department of Finance withdrew the observation on article 12 for software payments.\(^{208}\) This means that Canada no longer views computer software payments where a source code must be kept confidential as royalties, a position in line with the OECD approach. However, this will not apply to those treaties where article 12 includes a reference to “a payment for the use of or right to use intangible property.” Where such a reference is included, the payment for the use of or right to use digital property is considered a royalty, since it is a payment for the use of intangible property. This policy on computer software transactions involving source codes remains the same in 2007.

The Canadian position on the taxation of computer software payments is generally OECD consistent however there is some divergence. For example, Canada views payments for

\(^{204}\) 1992 Model Convention, supra note 167, Commentary on article 12, at 12(28) to (30), 12(36), and 12(37).

\(^{205}\) Canada, Department of Finance, The Budget 1993, April 26, 1993, at 78.

\(^{206}\) See for example the Convention Between Canada and the United States of America With Respect to Taxes on Income and on Capital [Canada-US Tax Treaty], Article XII(3), online: The Department of Finance <http://www.fin.gc.ca/treaties/USA_e.html>.


maintenance and support of software as giving rise to royalties, whereas the OECD views such payments as giving rise to business income. And payments made for data access or retrieval are generally characterized as services income, but if contingent on use of the data, the payments are considered royalties. In contrast the OECD always considers such payments a giving rise to business income.

Canada has not introduced any specific rules for e-commerce and the taxation thereof. The taxation of income of an electronic nature therefore follows the general rules and principles found in Canadian tax law, and the rules and principles that apply to traditional commerce equally apply in the virtual environment.\textsuperscript{209} In general, the view is that the CRA should be able to apply the same principles to e-commerce that are applied to traditional commerce, and the view of the law is generally consistent with that of the OECD as expressed in the OECD Model Convention and the OECD Report.\textsuperscript{210}

\textsuperscript{209} The CRA has a statement on the web explaining that generally, all existing laws that apply to traditional commerce equally apply to commerce in an electronic environment, online: CRA <http://www.cra-arc.gc.ca/tax/business/topics/ecomm/faq-e.html#regul>.

\textsuperscript{210} ITNEWS 25, \textit{supra} note 208, at 2.
III. **THE CURRENT TAX TREATMENT OF SOFTWARE PAYMENTS: CHARACTERIZING SOFTWARE PAYMENTS IN CANADA**

A. Royalty Payments

i. Domestic Tax Treatment of Royalty Payments

a. Characterization of Royalties

No complete definition of royalty is provided under the ITA\(^\text{211}\) However, certain types of payments are included as royalties for withholding tax purposes under the ITA.\(^\text{212}\) The courts have dealt with the meaning of the term in several cases. A royalty is a payment calculated by reference of use or to the production or revenue from the use of the rights.\(^\text{213}\) It is important to distinguish royalties from sales and in the absence of statutory rules; the distinction is made on a case-by-case basis. Generally, if all the legal rights of a property are transferred the transaction is considered a sale. Where less than all the rights are transferred, the transaction is a license and the payments are considered royalties. Intangible properties are often transferred for consideration that depends on productivity because they are difficult to value, and as element of contingency in the payment is the essence of a royalty,\(^\text{214}\) payments for the use of intangibles are generally considered royalties. Where a payment is based on the productivity of the property, it may be considered a royalty payment although the form of the payment is a sale or a service.

\(^{211}\) ITA, *supra* note 21.

\(^{212}\) *Ibid.* Paragraph 212(1)(d) includes certain types of payments as royalties.

\(^{213}\) *MNR v. Wain-Town Gas and Oil Co. Ltd.*, [1952] CTC 147, 52 DTC 1138.

\(^{214}\) *Grand Toys Ltd. v. MNR*, [1990] 1 CTC 2165, 90 DTC 1059 (TCC).
b. Taxation of Royalties

Several types of payments are taxed as royalties for withholding tax purposes. For example, payments for the use of "any property, invention, trade-name, patent, trademark, design or model, plan, secret formula, process or other thing whatever" are taxed as royalties.\(^{215}\) Payments for computer software may be taxed as royalties under the ITA. According to the CRA's administrative practice,\(^{216}\) the characterization is based on the type of software and the extent to which rights are transferred. As a general rule, payments for shrink-wrap software are not royalties, but payments for the right to use customized software are royalties. Payments for software where the source code must be kept confidential are not royalties. These views echo the position taken by the OECD, however only to some extent, since Canada differs in some respect as mentioned earlier. Where the payment is regarded a royalty it is generally subject to a withholding tax of 25% under the ITA.\(^{217}\)

Some royalties are excluded from taxation under the ITA.\(^{218}\) One exemption is for copyrights in respect of the production or reproduction of any literary, dramatic, musical, or artistic work, as these are excluded from the withholding requirement, including film and television works. Under a number of Canada's tax treaties a similar exemption for royalties is found. The payments that are generally eligible for exemption under the treaties are (although with a wording variation in the specific treaties) copyright royalties and similar payments in respect of the production or reproduction of any literary,

\(^{215}\) Such payments are taxed under the ITA, \textit{supra} note 21, subparagraph 212(1)(d)(i).
\(^{217}\) ITA, \textit{supra} note 21, subparagraph 212(1)(d)(i).
\(^{218}\) \textit{Ibid.} subparagraph 212(1)(d)(vi).
dramatic, musical, or artistic work. But royalties in respect of motion pictures and works on film, videotape, etc. are carved out from the exemption.\footnote{219} Payments eligible for the exemption are therefore excluded from source-country taxation. Today it is taken for granted that computer software royalties in respect of the production or reproduction thereof are within this exemption, but that was not always the case. Before the changes to the 1988 Copyright Act\footnote{220} and the Supreme Court of Canada’s decision in the Apple Computer case\footnote{221}, the CRA had rejected this idea.\footnote{222}

c. Source of Royalties

Canada has no specific rules for the geographic source of a royalty. For the purpose of withholding tax, the source rules are based on the residence-of-payer rule\footnote{223} and the place-of-use of the property rule. The residence of the payer is determined under the taxation by relationship rules. The rules for defining place-of-use are not defined in the legislation. For tangible property the place of use is presumably where the property is located. For intangible property, the place of use is the country in which the right is used or exploited.\footnote{224} Where there is a conflict, the place-of-use rule prevails the residence-of-payer rule.\footnote{225}

\footnote{219} See for example the Canada-US Tax Treaty, \textit{supra} note 206, article XII(3)(a).
\footnote{220} CA, \textit{supra} note 203.
\footnote{221} Apple Computer Inc. \textit{v.} Mackintosh Computers Ltd. \textit{supra} note 202.
\footnote{223} This rule is accepted by the CRA for purposes of the foreign tax credit, Interpretation Bulletin number: IT270R3, November 25, 2004, Paragraph 29.
\footnote{224} \textit{Ibid}.
\footnote{225} Li, \textit{supra} note 7, at 148.
B. Business Profits

i. Domestic Tax Treatment of Business Profits

a. Characterization of Business Income

Business profit is a separate source of income under the ITA. As noted earlier, business is
statutorily defined to include a "profession, calling, trade, manufacture or undertaking of
any kind whatever and ... an adventure or concern in the nature of trade." The meaning is
naturally restricted to include only commercial activities. The word "business" is not
exclusively defined under the ITA and the ordinary meaning of the word must be
determined. The common law definition is "anything that occupies the
time, attention and labour of a man for the purpose of profit." The source of business
profit is dependant on the location of the activities of the business. Guidelines to
determining the location of a business have been set out by CRA and include for
intangibles, that the property is located where the purchase or sale decisions are normally
made; and for services that the location is where services are performed. Under
Canadian tax legislation, non-residents are subject to Canadian tax on their Canadian
sourced income. This includes income derived from carrying on a business in Canada.

There are various tests to determine whether a business is carried on under common law,
and in certain circumstances an economic activity is deemed to constitute "carrying on a
business" statutorily. Under the common law rules, "carrying on a business" is a
question of fact, determined in each case. The two most important tests are the place of

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226 ITA, supra note 21, Subsection 248(1).
227 The definition is found in Smith vs. Anderson (1880), 15 Ch. D. 247 (CA).
228 CRA, Interpretation Bulletin IT-270R3 “Foreign Tax Credit”, “Determination of the Location of a
229 ITA, supra note 21, subsection 2(3).
230 Ibid. section 253, certain economic activities are deemed to constitute “carrying on a business”.

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sales contract test and the place of operations and profits test. Statutory rules prevail over
the common law principles where they differ. A non-resident is also statutorily deemed to
have been carrying on business in Canada if the person "produces, grows, mines, creates,
manufactures, fabricates, improves, packs, preserves or constructs, in whole or in part,
anything in Canada whether or not the person exports that thing without selling it before
exportation."231 A non-resident person is deemed to have been carrying on business in
Canada if the person "solicits orders or offers anything for sale in Canada through an
agent or servant, whether the contract or transaction is to be completed inside or outside
Canada or partly in and partly outside Canada."232

b. Taxation of Business Income

Business income is taxed on a net basis according to the statutory rules generally at a rate
of 38%.233 Payments for transactions including computer software may be characterized
as business income. This could, for example, include payments for ordering and
downloading software for own use, since such a transaction would be characterized as
income from the sale of goods, and accordingly taxed as business income.

231 Ibid. paragraph 253(a).
232 Ibid. paragraph 253(b).
233 Ibid. subsection 123(1).
C. Services Income

i. Domestic Tax Treatment of Services Income

a. Characterization of Services Income

Under Canadian tax law, income from personal services can be earned either as income from an office or employment or income from a business or independent personal service. Generally, it can be difficult to draw distinctions between payments made for services rendered and for royalties. It can be hard to determine whether a service has been performed if, for example, virtual space is made available for storage on the web. Also, it can be difficult to determine whether an intangible product has been licensed if the product can only be used for a limited period. Where the services performed are of a technical character, the characterization is further complicated, as the service may give rise to royalty payments.\(^{234}\)

b. Taxation of Services Income

The taxation of services income follows the business taxation rules, since income from services is characterized as either income from “an office or employment” or “income from a business or independent personal services”.\(^{235}\) The income is therefore taxed on a net basis at the rate of 38% under the regular rules.\(^{236}\)

\(^{234}\) Ibid. subparagraph 212(1)(d)(iii) may tax service fees as royalties.

\(^{235}\) Ibid. section 3. This section includes in income, income from these places and taxes income from a business and independent personal services in the same way.

\(^{236}\) Ibid. subsection 123(1).
c. Source of Services Income

The source of income from services is determined on the basis of where the service is rendered.\(^{237}\) When determining whether an individual performs personal services in Canada one must look to whether the individual is physically present in Canada when performing the services. Where services are rendered remotely, for example, over the Internet as a support service, the services are not considered as rendered in Canada.\(^{238}\)

D. The Characterization and Taxation of Cross-Border Payments for Software

The situation faced by taxpayers relying on the Canadian rules can be summarized as follows. Computer software payments may be characterized under Canadian tax treaties as giving rise to property income, business income, or services income. In the treaty context the Canadian characterization is overridden by tax treaty provisions.\(^{239}\) The OECD commentary is adopted into the interpretation of Canadian treaties\(^{240}\) and the Canadian position on computer software payments\(^{241}\) is consistent with the position taken by the OECD, since Canada no longer has reservations regarding computer software.\(^{242}\)

The characterization of computer software payments is generally based on the type of software and the extent to which rights are transferred. Where fees are paid for the right

\(^{237}\) CRA, Interpretation Bulletin number: IT270R3, November 25, 2004. Paragraph 25 states that for the purpose of section 126, the source of income is the place where the duties normally are performed in case of employment income, the place where the directors meetings are held in case of director’s fees, the place where the effort expended for the purpose of gaining income in case of commission income.

\(^{238}\) Li, supra note 7, at 142.

\(^{239}\) Ibid, at 426.


\(^{241}\) Software of a limited duration or for single use.

\(^{242}\) ITNEWS-23, supra note 207, at 2.
to use custom software, the payment is characterized as a royalty and subject to tax.\textsuperscript{243} Where fees are paid for the right to use custom software, the payment is a royalty but is exempt from tax.\textsuperscript{244} Where the fees are paid for the use of "shrink wrap" software,\textsuperscript{245} they are not characterized as royalties, but as business income. Where the software payment is subject to a license agreement and the terms are clear to the customer, the software will be considered custom software, and hence a royalty payment. The determination of the nature of the software is a question of fact and is determined on a case-by-case basis by reviewing the license agreement associated with the right to use the computer software the payment is made in respect of. When services are provided it is common that information concerning industrial, commercial, or scientific experience is obtained as a result of the service provided by the person processing the information. It is important to distinguish service fees from such payments for information because when made to residents of treaty countries the definition of royalties will not extend to services under Canada's tax treaties. A fee for such a service is not a royalty for treaty purposes and therefore not subject to withholding tax but is considered business income for tax purposes. The terms of the agreement and the primary focus of the agreement are very important factors to consider when distinguishing the payments. Where the primary obligation is to provide specialized information, the payments are likely to be considered payments for information and not payments for services. The opposite is the result where the bulk of the contract is for services rendered and the resulting information did not exist

\textsuperscript{243} ITA, \textit{supra} note 21, subparagraph 212(1)(d)(iii) reduced under the treaty in place.
\textsuperscript{244} \textit{Ibid.} paragraph 212(1)(d)(iv).
\textsuperscript{245} "Shrink-wrap software" refers to software sold over the counter, pre-packed and licensed pursuant to a standard unsigned license agreement. The licensee may or may not have been aware of the terms at the time of purchase. Where pre-packed software programs are purchased on the Internet, the software may also be treated as "shrink-wrap" software.
at the beginning of the contract, as this will result in the payments being treated as service fees. Where the fees are dependent on production or use, the payment will be treated as a royalty. Where a payment is considered business income or services income it will be subject to tax at the regular progressive rates on a net basis, provided that the higher threshold of a permanent establishment or a fixed place in Canada is met. Business income and services income thereby receive preferential treatment under Canadian tax treaties, as taxation is limited under the treaty. Where the threshold is not met, the income is taxed only in the country of residence.

A taxpayer that relies on the Canadian rules and administrative practices may therefore expect the following outcomes for the taxation of computer software payments:

1) Payments for the use of software are subject to withholding tax under part XIII at 25%, reduced under any treaty in place.

2) Payments for the right to produce or reproduce software are not subject to withholding tax under part XIII or under any treaty.

3) Payments for shrink-wrap software are not royalties but business income.

4) Payments for computer services may be subject to withholding tax.

The question arises as to what the international picture for the taxation of computer software payments looks like. Is there international consensus in the area with reliance on the OECD recommendations found in the Model Convention and the commentary? To
get a snap shot of the current situation internationally, the next chapter examines four different jurisdictions and the tax treatment of computer software payments.
CHAPTER FOUR - INTERNATIONAL TAX TREATMENT OF SOFTWARE PAYMENTS

This chapter examines in detail the tax treatment of software payments in the United States, Australia, China and Chile. For each country, the domestic tax treatment of royalty payments, business profits, and services income is discussed, followed by a discussion of the effect of the tax treaty with Canada on that treatment. Each country discussion concludes by reviewing the specific characterization issues for software. For Canada, only the domestic treatment of royalty payments, business profits, and services income is discussed in order to introduce the measure of comparison in characterization.

I. CHARACTERIZING SOFTWARE PAYMENTS IN THE UNITED STATES AND UNDER THE CANADA-US TAX TREATY

The US has not introduced any specific rules for e-commerce and the taxation thereof. The taxation of e-commerce therefore follows the general rules and principles found in US tax law. Some guidance is however found in the "Software Regulations" that provide guidance for the characterization of e-commerce where digital products and services are involved.

246 Canada-US Tax Treaty, supra note 206.
A. Royalty Payments

i. Domestic Tax Treatment of Royalty Payments

a. Characterization of Royalties

The term royalty is not defined in US tax legislation. US courts have however defined a royalty as "... compensation for the use of property which is based as to amount entirely upon the use actually made of the property."

基本上任何支付使用无形财产的权利都被视为税目的“租金”支付，因为无形财产的性质使得考虑取决于生产力。

Where the distinction has to be made between a royalty, and for example, sales proceeds giving rise to business income, the US courts look at whether the right to exploit the property throughout its protected lifetime is granted exclusively, which gives rise to a sale, or whether it is granted for a period less than the protected lifetime, which gives rise to a license. For software payments, the characterization is made on the basis of the classification of the software as a copyright, a copyrighted article, a secret formula, knowhow, or services under the “Software Regulations.”

Where a copyrighted article is transferred, it is generally categorized as a sale of goods. Where a copyright right is transferred, a further distinction between a license and a sale must be made. A transfer of information that is not protected by copyright laws may be characterized as a transfer of knowhow or services. If any copyright rights are transferred in the transaction, the transaction is a transfer of copyright rights. Where no copyright rights are transferred, the transaction is a...

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249 Li, supra note 7, at 347.
250 I.R.C. Reg. section 1.861-18(b)(1). Software transactions are divided into four categories under the “Software Regulations”: 1) a transfer of a copyright right in the computer program, 2) a transfer of a copy of the computer program (a copyrighted article), 3) the provision of services for the development or modification of the computer program, 4) the provision of knowhow relating to computer programming techniques.
transfer of a copyrighted article. When this classification has been made a further
distinction determining whether the transfer is a sale, a lease or a license must be made.
For tax purposes, the right to reproduce a software program is determinative in
categorizing the transaction as a transfer of a copyrighted article or a transfer of copyright
rights. Only where the software program can be reproduced and distributed to the public
is it a transfer of a copyright right giving rise to a license, and therefore a royalty.
Otherwise the transfer is a transfer of a copyrighted article, giving rise to a sale, and
therefore business income. Where information or technical support is provided in
connection with the transfer of computer software, the distinction between transferring
knowhow or a service is relevant. Where a software company is contracted to develop or
modify the costumer’s software program under the instruction of the costumer, and the
rights belong to the costumer upon completion, the transaction is considered a transfer of
services.251 But where a software company assists a customer with knowledge on
programming techniques, allowing the customer to create their own programs more
efficiently, the transaction will be considered a transfer of knowhow, and therefore as
giving rise to a royalty.252

b. Source of royalties

The geographic source of a royalty under US tax law is the place where the property is
used. For tangible property, this is where the property is actually located, and for
intangible property the generally accepted rule is that the place of use is the place where

251 Ibid. section 1.861-18(h), Example 15.
252 Ibid. example 16.
the licensee is legally entitled to use the intangible property and where it is protected by intellectual property protection rules. In cases of a copyright or trademark, the place of use is generally the country in which the property is consumed and the place where laws protect the copyright. In the case of a transfer of knowhow, the place of use may be determined by the terms of the agreement under which the royalties are paid.

ii. Tax Treaty Treatment of Royalty Payments under the Canada-US Tax Treaty

Under the Canada-US Tax Treaty, the royalty definition is fixed and means:

[Payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work (including motion pictures and works on film, videotape or other means of reproduction for use in connection with television), any patent, trade mark, design or model, plan, secret formula or process, or for the use of, or the right to use, tangible personal property or for information concerning industrial, commercial or scientific experience, and ... includes gains from the alienation of any intangible property or rights described in this paragraph to the extent that such gains are contingent on the productivity, use or subsequent disposition of such property or rights.

Computer software payments, such payments made for the use of or the right to use computer software, generally fall within the definition and will be considered royalties. Both the residence and source state are accorded jurisdiction to tax royalties. The geographical source rule allocates the jurisdiction to tax royalty income earned in the US by a non-resident on the basis of the location of the consideration made. The geographic

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254 Rev. Rul. 68-443, 1968-2 CB 304 concluded that the place of use of a trademark was the place in which the products (to which the trademark was connected) were used or consumed and in which the use of the trademark was legally permitted.
255 Li, supra note 7, at 350.
256 Canada-US Tax Treaty, supra note 206, article XII(4).
257 Ibid. article XII(1) and article XII(2).
source rule prevails over the relationship rules by levying tax on the income from royalties earned by a non-resident taxpayer under the Canada-US Tax Treaty. The rates of withholding tax for source taxation of royalties vary by the type of royalty. The general withholding tax rate is 30% taxed on a gross basis. This rate is reduced to a withholding tax rate of 10% under the treaty.\textsuperscript{258} A special rule applies to computer software payments arising in the US and beneficially owned by a resident of Canada. Such payments are exempt from withholding tax at source, and shall only be taxed in the state of residence.\textsuperscript{259} The withholding tax at source is thereby eliminated for computer software payments. However, these rules do not apply where the Canadian beneficiary owner carries on business through a permanent establishment in the US, as the rules relating to business profits then apply.\textsuperscript{260}

B. Business Profits

i. Domestic Tax Treatment of Business Profits

Generally, non-resident individuals and foreign corporations are subject to US taxation only on US sourced income. Such income generally falls under two categories as either 1) business income or 2) fixed or periodical gains, profits and income, which includes investment income. A non-resident has business income if engaged in trade or business within the US. The determination of whether an activity constitutes a trade or business within the US is decided on a case-by-case basis according to case law.\textsuperscript{261} There are no clear rules for when a taxpayer has earned income from a trade or business, but the case

\textsuperscript{258} Ibid. article XII(2).
\textsuperscript{259} Ibid. article XII(3)(b).
\textsuperscript{260} Ibid. article VII, cf. article XII(5).
\textsuperscript{261} European Naval Stores Co., SA, 11 TC 127, at 132 (1948).

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law and administrative practice have drawn a fundamental distinction between commercial and business activities and passive income. As a guideline, activities that are profit seeking and regular, continuous, and extensive constitute the carrying on of a trade or a business. However, many factors influence that determination, including the motive of the taxpayer. Thus, the specific factors of a case will determine whether a trade or business is being carried on. In addition to the income from being engaged in a trade or business, effectively connected income earned by a non-resident individual or corporation is also taxed under US rules. The concept of effectively connected is statutorily defined under US tax legislation and includes US-sourced income as well as some foreign-sourced income. The definition of what is effectively connected income is influenced by the doctrine of the force of attraction rule under US tax law. This doctrine specifies that US-sourced business income from related activities, derived by foreign taxpayers through activities causing them to be engaged in trade in the US is effectively connected income. Also, income that is derived from activities unrelated to that business is effectively connected.

ii. Tax Treaty Treatment of Business Profits Under the Canada-US Tax Treaty

Under the Canada-US Tax Treaty the threshold for US taxation is raised so that only business income earned through a permanent establishment is subject to US tax. The underlying rationale for this rule in the treaty context is a historical hangover. The rules was originally grounded in a concern about foreign governments making too aggressive

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263 I.R.C. § 864 subsection (c).
264 Canada-US Tax Treaty, supra note 206, article XII(5).
taxing claims and was adopted as a safeguard to ensure that only the state in which the permanent establishment was located could levy source-based taxes. A permanent establishment is traditionally defined as a fixed place of business through which the business of a non-resident taxpayer is wholly or partly carried on. It includes a place of management, a branch, an office, a factory, a workshop, a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.\textsuperscript{265} The definition under the treaty is not fixed and can therefore include more than this. A person, other than an independent agent, acting on behalf of a resident and habitually exercising an authority to conclude contracts in the name of the resident is also deemed to constitute a permanent establishment.\textsuperscript{266} In the context of e-commerce, there is no clear rule that specifies a server as constituting a permanent establishment in the Canada-US Tax Treaty. Under the OECD Model Convention,\textsuperscript{267} servers now constitute a permanent establishment if the server performs integral aspects of a cross-border function, and the non-resident corporation owns or leases the server within the source country. Further, a permanent establishment can be constituted even if no human activity is required to program or service the foreign-based server. The rationale for giving servers permanent establishment status is that the Internet enables and facilitates remote economic activity and replaces traditional physical presence in a foreign jurisdiction. Substantial business could therefore be carried on without an ability for the source country to tax that income, since the server did not constitute a permanent establishment under the traditional rules.

\textsuperscript{265} Ibid., article V.
\textsuperscript{266} Ibid., article V(5). The term permanent establishment also includes a building site or construction or installation project that lasts for more than 12 months; the use of an installation or drilling rig or ship to explore for or exploit natural resources if use for 3 months in a 12 month period under article V of the treaty.
\textsuperscript{267} OECD Model Convention, \textit{supra} note 40.
It was asserted that traditional international tax rules and principles should generally be applied to e-commerce and subsequently recommended and adopted that servers should constitute permanent establishments under the OECD Model Convention.\textsuperscript{268}

The commentary on the Model Convention, although not legally binding, may serve as guidance for interpretation.\textsuperscript{269} The guidance is imported into the reading of the Canada-US Tax Treaty, and where no specific provisions are found in the treaty, the model is one authority to look to for guidance on how to determined uncertain situations. Under US law, statutes and treaties are both "the supreme Law of the Land."\textsuperscript{270} This has been interpreted by the US Supreme Court to represent "equal legal status."\textsuperscript{271} For the Canada-US Tax Treaty, this means, that a treaty may supersede a prior statute as a statute may supersede a prior treaty. Where there is a clear conflict between a statute and a treaty, the law that is latter in time will prevail. The law that is latter in time will also prevail where there is a clear intention to overwrite. There is however no rules under US tax legislation that qualify the presence of a server as constituting the carrying on of a trade or a business in the US. Therefore, the guidelines in the OECD Model Convention will serve as guidelines in determining whether the server constitutes a permanent establishment.

The jurisdiction to tax business income is further limited under the Canada-US Tax Treaty. Non-resident taxpayers are taxed only on their US sourced business income at a

\textsuperscript{268} Li et al., supra note 14, at 361-362.
\textsuperscript{269} Ibid., at 14, Commentaries on the articles, Paragraph 29: "Although the Commentaries are not designed to be annexed in any manner to the conventions signed by Member countries, which unlike the Model are legally binding international instruments, they can nevertheless be of great assistance in the application and interpretation of the conventions".
\textsuperscript{270} The US Constitution, art. VI, cl. 2.
\textsuperscript{271} Stanley I. Katz, "United States" in International Fiscal Association, Cahiers de droit fiscal international, vol. 78a, Interpretation of Double Taxation Conventions (Deventer, the Netherlands: Kluwer Law and Taxation Publishers, 1993) at 615.
flat rate of 30% for individuals\textsuperscript{272} or at a rate of 15-35\% for corporations\textsuperscript{273} and only where the threshold of a permanent establishment is met. Both individuals and corporations are taxed on a net basis on their business income. Moreover, taxpayers are protected from the "force of attraction rule" under the treaty, as only business income attributable \textit{to} the permanent establishment is taxable in the US.\textsuperscript{274} The attribution to the permanent establishment is made on the basis of the profits derived from the assets or activities of the permanent establishment. In connection with this, deductions are allowed on the basis of expenses incurred for the purpose of the permanent establishment, including executive and general administrative expenses, whether these arise in the State in which the permanent establishment is situated or elsewhere.\textsuperscript{275} Then, general administrative expenses from the head office in the other contracting state can be deducted as well with respect to the amount incurred for the purpose of the permanent establishment.

\section*{C. Services Income}

\subsection*{i. Domestic Tax Treatment of Services Income}

\subsubsection*{a. Characterization of Services Income}

Generally speaking, it can be difficult to draw the distinction between payments made for services rendered and for royalties. Where, for example, intellectual property is created or used the question is highly relevant. The theory is that where the creator has no underlying ownership interest in the property, the owner receives personal services

\begin{itemize}
\item \textsuperscript{272} I.R.C. § 871, subsection (a)(1)(A).
\item \textsuperscript{273} I.R.C. § 882 and § 11, subsection (b)(1)(A)-(D).
\item \textsuperscript{274} Canada-US Tax Treaty, \textit{supra} note 206, article VII(1).
\item \textsuperscript{275} \textit{Ibid}. article VII(3).
\end{itemize}
income and not royalties. In contrast, where the creator retains ownership rights in the underlying property and licenses the property, the compensation is a royalty. Furthermore, where services are provided in connection with intangibles, such as knowhow, it is necessary to determine whether the compensation is personal services income or royalty. Under administrative practice, the compensation is a royalty if the country in which the transferee uses the intangible, for example the knowhow, provides protection from unauthorized disclosure of the intangible. Otherwise, the compensation is considered services income.

b. Source of Services Income

The place where a service is performed is important, as the source of the service is generally the place of performance. This rule applies to both corporations as well as individuals. For example, where a corporation performs the service outside the US the income will be considered foreign-source income, while a service performed within the US will be considered US-sourced income. In the case of income from services performed in more than one country, an allocation will be made on the basis of time spent in each country. Income is allocated to US sources on the basis of the number of days spent in the US performing the service. This place of performance rule is based on case

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279 *IRC § 861 subsection (a)(3) and § 862 subsection (a)(3); Li, supra note 7 at 343.*
law and administrative rulings, establishing that the situs of the service is determined by the physical presence of the service provider.280

ii. Tax Treaty Treatment of Services Income under the Canada-US Tax Treaty

Under the Canada-US Tax Treaty, income from personal services earned by a non-resident individual is subject to residence-based taxation unless the person has a fixed place of business in the other state. Again a threshold is used as a safeguard in according jurisdiction to tax and is historically influenced as the permanent establishment threshold. Hence, services income receives preferential treatment under the treaty as taxation is limited by the threshold of a fixed place. The minimum presence fixed place of business entails a similar level of physical presence as the concept of permanent establishment. A fixed place of business could be “a physician’s consulting room or the office of an architect or a lawyer,” or “a centre of activity of a fixed or a permanent character.”281 Where a non-resident has a fixed place of business in the US, the taxpayer will be subject to source based taxation under the regular rates282 and the income will be taxed on a net basis as in case of business income.

280 British Timkel Ltd., 12 TC 880 (1949); acq. 1949-2 CB 1, and Rev. Rul. 60-55 1960-1 CB 270.
281 The OECD commentaries suggests that “a fixed place” covers these locations, but the OECD Model Convention has however been revised (2000) and the concept “a fixed place” is no longer found under art. 14. However, the concept is still found in the Canada-US Tax Treaty, and the old version of the commentary still serves as guidance.
282 Supra note 272 and 273.
D. The Characterization and Taxation of Cross-Border Payments for Software

Computer software payments might be characterized as giving rise to property income, business income or services income. The characterization depends on the extent to which the payment is made in consideration of the actual purchase of the software or the license to use it and where the ownership rights are held. The rationale for this distinction is that commerce, regardless of the nature, should be treated equally, whereby the principle of equity is enforced. No preferential treatment should be received just because the transaction is concerned with computer software. It is only where the purchase is concerned with the license that the transaction gives rise to royalties. As noted, the Canada-US Tax Treaty provides that a payment for software received as a consideration "... for the use of, or the right to use..." the software will be characterized as a royalty payment as it will fall into the category "copyright for literary ... work." To make the characterization, a distinction between the software as a copyright, a copyrighted article, a secret formula, know how or services must be made. Where there is a transfer of a copyright there is a further distinction between a sale and a license, where the sale gives rise to business income and only the license gives rise to a royalty income. Here the distinction is also made to ensure a fair treatment regardless of the nature of the product, and only the licensing of the copyright therefore gives rise to royalties. The business income will only be taxed in the source country where there is a permanent establishment and the services income will only be taxed in the source country where there is a fixed place, for the same reasons as given above. Both types of income are taxed on a net basis under the regular rules for non-residents. A royalty, however, will be subject to a

283 Canada-US Tax Treaty, supra note 206, article XII.
withholding tax of 30%, 10% or 0% depending on the type of royalty. The payment is subject to a very different treatment depending on its characterization. Where the software transaction also includes support assistance for the customer it becomes relevant to differentiate between a service and a transfer of knowhow, as knowhow might give rise to a royalty, leading to a different taxation than in case of services income.

i. Characterization examples

Five examples are given below to illustrate how software payments might be characterized under the Canada-US Tax Treaty. The examples look at a Canadian resident earning income from computer software used in the US.

1) Electronic ordering and downloading of digital products for personal use.

A Canadian resident corporation receives consideration for a computer software program downloaded from their website with the right to reproduce four copies. The payment is made by a customer in the US. The payment received may be a royalty because it is concerned with the right to reproduce four copies. But it may also be argued that the payment is business income because it is merely a way of obtaining five copies of the product and the underlying content of the transaction therefore, is a purchase. The "Software Regulations" under US tax law are consistent with the OECD position on these types of payments. The result is therefore that where the product is used for the purchaser’s own enjoyment the consideration gives rise to business income and not

284 The featured examples are all found in the Characterization Report, supra note 3, at 33-70.  
285 Ibid. the example is based on category 2, at 56.  
royalty. This business income may only be taxed in the US where the Canadian vendor meets the higher threshold of maintaining a permanent establishment in the US, otherwise the income is only taxed in the residence country. Where there is no permanent establishment situated in the US, there is no source and the threshold cannot be met. The income is then taxed only in the country of residence. However, where there, for example, is a server in the US and the product is downloaded here the source rule is satisfied and the threshold of a permanent establishment is met. The income is then taxed in the source country, e.g. the US at the regular rates for non-residents.

2) Electronic ordering and downloading of digital products for commercial exploitation of the copyright

A Canadian resident corporation receives consideration for a computer software programs downloaded from their website with the right to reproduce four copies for commercial exploitation. The payment is made by a customer in the US. To determine the character of the income from this transaction, the decision maker must look at the underlying content of the transaction. The payment received may be a royalty because it is concerned with the right to reproduce four copies. But it may also be argued that the payment is business income because it is merely a way of obtaining five copies of the product and the underlying content of the transaction therefore is a purchase as argued above. Again, U.S. tax law is consistent with the OECD position on characterizing this type of income. Where the product is exploited commercially, it will therefore give rise to

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287 Characterization Report, supra note 3, the example is based on category 3, at 57.
a royalty, as the consideration is made in respect of the copyright right.\textsuperscript{288} This results in the income being subject to a withholding tax rate at source on a gross basis. This rate is however reduced under the Canada-US Tax Treaty, and because the payment is from computer software, eliminated as it is reduced to 0\% under the treaty.\textsuperscript{289}

3) \textit{Software maintenance provided by an operator including software upgrades and online support to a non-resident customer who pays an annual fee.}\textsuperscript{290}

A maintenance and support function is provided in connection with a software program that has been downloaded from a Canadian provider by a US customer. The question is then whether this transaction gives rise to royalty income or services income. There is no clear cut answer to this question, as the support may be considered knowhow under the treaty, falling under \textit{“information concerning industrial, commercial or scientific experience”}\textsuperscript{291} or it may also be considered as \textit{“independent personal services”}\textsuperscript{292} rendered on demand. Where the payment is considered to be made for knowhow, it will give rise to a royalty. The income from a royalty is subject to a withholding tax at source, which is, however, reduced to 0\% under the treaty provisions in case of royalties arising from knowhow.\textsuperscript{293} Where the payment is in consideration of a service it will give rise to services income. The income from services is only taxed at source where the higher threshold of a fixed place in the US is met. Where the threshold is not met the income is

\textsuperscript{288} Canada-US Tax Treaty, \textit{supra} note 206, article XII(4).

\textsuperscript{289} \textit{Ibid.} article XII(3)(b).

\textsuperscript{290} Characterization Report, \textit{supra} note 3, the example is based on category 12 and 14, at 62-64.

\textsuperscript{291} Canada-US Tax Treaty, \textit{supra} note 206, article XII(3)(c).

\textsuperscript{292} The income will then be characterized under article XIV of the Canada-US Tax Treaty, \textit{supra} note 206.

\textsuperscript{293} Canada-US Tax Treaty, \textit{supra} note 206, article XII(3)(c).
subject to a residence-based taxation only under the treaty.\textsuperscript{294} The OECD Model Convention deals with the characterization of such transactions, and the commentary serves as a guideline under the treaty, where there are uncertainties. It is likely that the U.S. position on online support transaction will be guided by the principles in the software regulations, which are consistent with the OECD position.\textsuperscript{295} The factor determining the characterization is therefore the principal object of the contract. In this example no principal object can be determined, since the object is both to provide upgrades and to provide support. However, online advice, communications with technicians and access to a troubleshooting database, is not to be considered "information concerning industrial, commercial or scientific experience",\textsuperscript{296} as this is a service provided on demand.\textsuperscript{297} Therefore, the payment in the example will give rise to services income. Only where there is a fixed place of business in the US can this income be taxed at source on a net basis under the regular US tax rules. This threshold is not met in the example, and the income will therefore only be taxed in the country of residence.

4) \textit{The acquisition of content for a web site where a web site operator (1) pays one or more non-resident content providers for news, information and other online content with the purpose of attracting users to the web site and (2) pays for the creation of content for the web site.}\textsuperscript{298}

\textsuperscript{294} \textit{Ibid.} article XIV.
\textsuperscript{295} Li, \textit{supra} note 7, at 438.
\textsuperscript{296} Characterization Report, \textit{supra} note 3.
\textsuperscript{297} OECD Model Convention, \textit{supra} note 40, Paragraph 11.4, Commentary on article 12.
\textsuperscript{298} Characterization Report, \textit{supra} note 3, the example is based on category 25, at 69.
The consideration for the use of news, information, or other online content may be characterized as royalty or business income. The U.S. position on transactions of this character is consistent with the OECD position. Where the payment is concerned with the right to display otherwise copyrighted material, the payment will be considered a royalty as it is made for the right to use a copyright. This is the case for the first half of the transaction under (1). Royalty income is subject to withholding tax at source, which is reduced under the treaty provisions in case of royalties beneficially owned by a resident of Canada. The withholding tax is further eliminated in case of copyright royalties and computer software. Where the payments are made for the creation of new content to which the web site operator becomes the owner there is no payment for a copyright, as the copyright is owned by the operator. Rather, the payments will be considered business profits. This is the case for the other half of the payment under (2). The income from this transaction will therefore be subject to a source-based taxation on a net basis, which is however limited by the treaty, as the threshold of a permanent establishment must be met. Where there is no permanent establishment situated in the US there is no source and therefore no jurisdiction to tax.

299 Li, supra note 7, at 434.
300 Canada-US Tax Treaty, supra note 206, article XII(4).
301 Ibid. article XII(2).
302 Ibid. article XII(3)(a) and XII(3)(b).
5) Subscription to access an interactive web site provided by a Canadian web site operator allowing a US customer to interact with the site while online.\textsuperscript{303}

A Canadian provider makes a web site featuring digital content and information, music, games and activities available to a US subscriber, who pays a fixed periodic fee to access and interact with the website. No products or services are obtained from the website. The payment received may be characterized as services income or royalty. The OECD Commentary to the Model Tax Convention again offers guidance on the characterization. The position taken by the OECD on this transaction is likely to be adopted by the U.S.\textsuperscript{304}

Where the payments made are mainly for the interaction with the site for the purpose of own enjoyment it may be characterized as services income. Because no services of a technical, or consultancy nature are provided, the services cannot be considered "technical fees" that would give rise to a royalty.\textsuperscript{305} Therefore, the income is categorized as services income. It should be noted though, that where the Canadian provider receives the payment as the owner of the copyright for the right to display the content to the US subscriber, the payment will be characterized as a royalty. This is however not the case in the example. Accordingly, the income will be considered services income, and will be subject to a source-based taxation on a net basis, which is however limited by the treaty, as the threshold of a fixed base must be met. Where there is no fixed base situated in the US there is no source and no jurisdiction to tax.

\textsuperscript{303} Characterization Report, supra note 3, the example is based on category 21, at 67-68.
\textsuperscript{304} Li, supra note 7, at 434.
\textsuperscript{305} OECD Model Convention, supra note 40, Paragraph 11, Commentary on article 12; Characterization Report, supra note 3, Category 21, paragraph 35, at 68.
II. CHARACTERIZING SOFTWARE PAYMENTS IN AUSTRALIA AND UNDER THE CANADA-AUSTRALIA TAX TREATY

A. Royalty Payments

i. Domestic Tax Treatment of Royalty Payments

a. Characterization of Royalties

Australia has not introduced any specific rules for the taxation of e-commerce. The taxation of e-commerce transactions therefore follows the general rules and principles found in Australian tax law. Under domestic Australian tax law, the definition of royalty includes any amount paid or credited, however described or computed, regardless of whether the payment is periodical or not, to the extend that it is made in consideration of (1) the use of, or the right to use any copyright, patent, design, model etc. or (2) the use of or the right to use any industrial, commercial or scientific equipment, or (3) the supply of scientific, technical etc. knowledge or information, or (4) the supply of any assistance that is ancillary and subsidiary to (1)-(3) etc. The definition found under The Income Tax Assessment Act (ITAA) is very broad and it is inclusive. It also covers items within the “ordinary meaning” of the term royalty, which ordinary meaning has been established by Australian courts. The elements of a royalty are payments made in respect of the exercise of the right to take something that otherwise belongs to someone else and in particular has the features of (1) being made in return for the right to exercise

306 Convention Between Canada and Australia for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income [Canada-Australia Tax Treaty], online: the Department of Finance <http://www.fin.gc.ca/treaties/austral2e.html>.
307 The Income Tax Assessment Act 1936 [ITAA], subsection 6(1), online: the Australian Taxation Office <http://law.ato.gov.au/atolaw/Browse.htm?ImA=Collapse&Node=0-0-0-0&OpenNodes=0-0-0-0,0-0-0-1,0-0-0-2,0-0-0-3,0-0-0-6,0-0-0-2-2-0,0-0-0-31-3,0-0-0-2-4,0-0-0-31#0-0-0>.
308 Ibid. subsection 6(1).
309 Stanton v. FCT (1955) 92 CLR 630; McCauley v. FCT (1944) 69 CLR 235.
a beneficial right, (2) being made to the person who owns the right to confer that right and (3) being contingent on the use of the right acquired. This definition of a royalty is very broad and extends beyond the ordinary meaning of the term. Computer software payments may be characterized as royalties or, either sales proceeds, giving rise to business income, or service fees, giving rise to services income. Where a payment is characterized as a royalty the income is subject to a withholding tax at a rate of 30% on a gross basis.\textsuperscript{310} There is little guidance on the application of the distinction between (active) business income and (passive) property income. However, guidance can be found in the position taken in rulings of the Australian Taxation Office.\textsuperscript{311} Here, the types of income that are not considered royalties are explicitly listed. This administrative ruling shows that the position of the Australian Taxation Office is that the substance of the transaction is determinative in the characterization process.\textsuperscript{312}

b. Source of Royalties

Under Australian tax law, royalties paid by an Australian resident to a non-resident is considered to arise in Australia.\textsuperscript{313} In other situations, the source of a royalty will relate to where the underlying property is situated.\textsuperscript{314}

\textsuperscript{310} Income Tax (Dividends, Interest and Royalties Withholding Tax) Act 1974 [Withholding Tax Act], Subsection 7(1)(c), online: the Australian Taxation Office <http://law.ato.gov.au/atolaw/Browse.htm?ImA=fake&Node=0–0–11&OpenNodes=0–0–5,0–0–5–1,0–0–5–3,0–0&DBTOC=05%3APLR%3ATaxation%3AINCOME%20TAX%20(DIVIDENDS,%20INTEREST%20AND%20ROYALTIES%20WITHHOLDING%20TAX)%20ACT%201974%3AView%20list%20of%20provisions%3B#0–0–11>.


\textsuperscript{312} Ibid. Paragraph 27.

\textsuperscript{313} ITAA supra note 307, subsection 6(C)(1).
ii. Tax Treaty Treatment of Royalty Payments under the Canada-Australia Tax Treaty

Royalties are defined to mean "payments or credits, whether periodical or not, and however described or computed, to the extent to which they are made as consideration for"315 and the specific transaction types are then listed, including for the purpose of computer software royalties "the use of, or the right to use, any copyright, patent, design or model, plan, secret formula or process, trade mark or other like property or right"316 and "the use of, or the right to use, any industrial, commercial or scientific equipment"317 and "the supply of scientific, technical, industrial or commercial knowledge or information"318 and

[T]he supply of any assistance that is ancillary and subsidiary to, and is furnished as a means of enabling the application or enjoyment of, any such property or right as is mentioned in subparagraph a), any such equipment as is mentioned in subparagraph b) or any such knowledge or information as is mentioned in subparagraph c).319

The definition is fixed under the treaty and although it is fairly broad, no specific provision for computer software is found in the definition. Computer software payments may fall within the domestic definition of royalty and not be considered royalty under the treaty, as the definition found here is narrower. Under Australian law, tax treaties precede domestic law, where there is a conflict.320 Both the residence and source state are

315 Canada-Australia Tax Treaty, supra note 306, article 12(3).
316 Ibid. Subparagraph 12(3)(a).
317 Ibid. Subparagraph 12(3)(b).
318 Ibid. Subparagraph 12(3)(c).
319 Ibid. Subparagraph 12(3)(d).
320 The International Tax Agreements Act 1953 [International Tax Act], Section 4(2) and section 6A.
accorded jurisdiction to tax royalties under the Canada-Australia Tax Treaty. The geographical source rule allocates the jurisdiction to tax royalty income earned in Australia by a non-resident on the basis of the location of the consideration made. The geographic source rule thereby prevails over the relationship rules in levying tax on the income from royalties earned by a non-resident taxpayer under the Canada-Australia Tax Treaty. The rates of withholding tax for source taxation of royalties vary by the type of royalty. The general withholding tax rate is 30% taxed on a gross basis. This rate is however reduced to a withholding tax rate of 10% under the treaty. However, these rules do not apply where, for example, the Canadian entitled to the royalties carries on business through a permanent establishment in Australia, as the rules relating to business profits then apply.

B. Business Profits

i. Domestic Tax Treatment of Business Profits

a. Characterization of Business Profits

Generally, non-resident individuals and corporations are taxable on their Australian sourced income, derived directly or indirectly from all sources in Australia. There is no definition of source in the legislation, but Australian courts have said that source is a question of “practical, hard matter of fact” not of law. Generally, the source of business profits is where the undertakings are performed by the non-resident taxpayer.

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321 Canada-Australia Tax Treaty, supra note 306, article 12(1) and 12(2).
322 Withholding Tax Act, supra note 310, subsection 7(1)(c).
323 Canada-Australia Tax Treaty, supra note 306, article 12(2).
324 Ibid. article 12(4).
325 ITAA supra note 307, section 25(1) and Section 23(r).
326 Isaaca J in Nathan v FCT (1918) 25 CLR 183.
Where the contract that gives rise to the business profits is in another jurisdiction or the place of payment is in another jurisdiction the place of the work will most likely still be the source of the profits. Where the making of the contract is the key undertaking, the place where the contract is sourced might be held dominant.\textsuperscript{327} Where the business profits are domestically sourced, the income is generally subject to taxation on a net basis at a rate of 30\%.\textsuperscript{328} A non-resident has business income if it carries on active business in Australia. The determination of whether an activity constitutes a business in Australia is dominated by the question of fact and is decided on a case-by-case basis according to case law.\textsuperscript{329} The facts that will generally be considered relevant are (1) the subject matter of realization; (2) the length of period of ownership; (3) the frequency of number of transactions; (4) the presence of supplementary work on in connection with the property realized; (5) the circumstances that were responsible for the realization; (6) the motive for the transaction.\textsuperscript{330}

\textbf{ii. Tax Treatment of Business Profits under the Canada-Australia Tax Treaty}

Under the Canada-Australia Tax Treaty the threshold for Australian taxation is raised so that only business income earned through a permanent establishment is subject to Australian tax.\textsuperscript{331} The underlying rationale for the threshold is a safeguard in according jurisdiction to tax and is historically influenced as previously described. A permanent establishment is traditionally defined as a fixed place of business through which the

\textsuperscript{327} Waincymer, \textit{supra} note 314, at 470.
\textsuperscript{328} ITAA, \textit{supra} note 307, section 23(2).
\textsuperscript{329} Waincymer, \textit{supra} note 314, at 178-179.
\textsuperscript{330} \textit{Ibid.} at 180.
\textsuperscript{331} Canada-Australia Tax Treaty, \textit{supra} note 306, article 7(1).
business of a non-resident taxpayer is wholly or partly carried on. It includes a place of management, a branch, an office, a factory, a workshop, a mine, a quarry or any other place of extraction of natural resources, an agricultural, pastoral or forestry property, a building site or construction, installation or assembly project, which exists for more than 12 months.  

A person, other than an independent agent, acting on behalf of a resident and habitually exercising an authority to conclude contracts in the name of the resident is also deemed to constitute a permanent establishment. The definition is however not limited to the listed examples, as it includes but is not restricted to the examples, and other things may therefore constitute a permanent establishment. In the context of e-commerce, there is no clear rule that specifies a server as constituting a permanent establishment in the Canada-Australia Tax Treaty. The server was not yet invented when the treaty was drafted and is therefore not included under the permanent establishment definition. Under the OECD Model Convention, servers now constitute a permanent establishment if the server performs integral aspects of a cross-border function, and the non-resident corporation owns or leases the server within the source country. Further, a permanent establishment can be constituted even if no human activity is required to program or service the foreign-based server. The rationale for giving servers permanent establishment status is that the Internet enables and facilitates remote economic activity and replaces traditional physical presence in a foreign jurisdiction as previously described in this chapter under I.B.ii. The commentary on the Model Convention, although not

332 Ibid. subsection 5(a) through subsection 5(h).
333 Ibid. subsection 5(5). A permanent establishment is deemed to exist if there is: supervisory activities in that State for more than twelve months in connection with a building site, or a construction, installation or assembly project; or substantial equipment is being used in that State by, for or under contract with the enterprise other than in connection with a building site or construction, installation or assembly project of the enterprise under subsection 4(a) and 4(b).
334 OECD Model Convention, supra note 40.
legally binding, may serve as guidance for interpretation.\textsuperscript{335} Australian courts have referred to the commentaries as an aid in the interpretation of tax treaties.\textsuperscript{336} Thus, the guidance found in the commentary is imported into the reading of the Canada-Australia Tax Treaty, and where no specific provisions are found in the treaty, the model is one authority to look to for guidance on how to determined uncertain situations. There are no rules under Australia tax legislation that qualifies the presence of a server to constitute a permanent establishment. Therefore, the guidelines in the OECD Model Convention may serve as guidelines in determining whether the server constitutes a permanent establishment. There is, however, no obligation to follow these guidelines, as they are only recommendations and not part of a treaty actively entered into. The jurisdiction to tax business income is further limited under the Canada-Australia Tax Treaty. Non-resident taxpayers are taxed only on their Australian sourced business income attributable to the permanent establishment. A safeguard in according jurisdiction to tax is again the underlying rationale for the threshold and is historically influenced as previously described. The Australian sourced business income is taxed on a net basis at a rate of 30\%.\textsuperscript{337} The attribution to the permanent establishment is made on the basis of the profits derived from the assets or activities of the permanent establishment. In connection with this, deductions are allowed on the basis of expenses incurred for the purpose of the permanent establishment, including executive and general administrative expenses,

\textsuperscript{335} Ibid. at 14, Commentaries on the articles, Paragraph 29: "Although the Commentaries are not designed to be annexed in any manner to the conventions signed by Member countries, which unlike the Model are legally binding international instruments, they can nevertheless be of great assistance in the application and interpretation of the conventions."

\textsuperscript{336} Thiel v. FCT, 90 ATC 4717, "... the "supplementary means of interpretation" are the 1977 OECD Model Convention for the Avoidance of Double Taxation with respect to Taxes on Income and on Capital, which was the model for the Agreement, and a commentary issued by the OECD in relation to that model convention."

\textsuperscript{337} ITAA, supra note 307.
whether these arise in the State in which the permanent establishment is situated or elsewhere.\textsuperscript{338}

C. Services Income

i. Domestic Tax Treatment of Services Income

a. Characterization of Services Income

Under Australian tax law, services income can be earned through services performed by individuals as employees or in carrying on a business.\textsuperscript{339} Services income is taxed on a net basis at a progressive rate ranging from 29\% to 45\% in the top tax bracket.\textsuperscript{340} The taxation of services income is limited under the Canada-Australia Tax Treaty.

b. Source of Services Income

The source of services income is generally the place where the service is performed.\textsuperscript{341} In some circumstances, the contract of the services can itself be so important to the income derived from it, that the place of the contract is more important than the where the actual service is performed.\textsuperscript{342} In the context of software payments, the place of performance of

\begin{footnotesize}
\begin{enumerate}
\item Canada-Australia Tax Treaty, supra note 306, article 7(3).
\item ITAA, supra note 307, section 6(1), Definitions, Income from personal exertion or income derived from personal exertion.
\item Income Tax Rates Act 1986 [Tax Rates Act], Schedule 7, Part II, Subsection 1(b), online: the Australian Taxation Office <http://law.ato.gov.au/atolaw/view.htm?dbwidetocone=06%3APLR%3ATaxation%3AINCOME%20TAX%20RATES%20ACT%201986%3ASCHEDULE%20PART%20II%20NON-RESIDENT%20TAXPAYERS%3A%2300001%231.%20Subject%20to%20clauses%20to%20and%20%20the%20rates%20of%20tax%20on%20the%20taxable%20income%20of%20non-resident taxpayers>.
\item FCT v French (1957) 98 CLR 398.
\item Waincymer, supra note 314, at 471.
\end{enumerate}
\end{footnotesize}
services related to the software will likely be the determinative factor in defining the source of the income.

ii. Tax Treaty Treatment of Services Income

Under the Canada-Australia Tax Treaty, income from personal services earned by a non-resident individual is subject to residence-based taxation unless the person has a fixed place of business in the other state. Hence, services income receives preferential treatment under the treaty as taxation is limited by the threshold of a fixed place. The threshold acts as a safeguard in according jurisdiction to tax as previously described. The minimum presence of a fixed place of business entails a similar level of physical presence as the concept of permanent establishment. Where a non-resident has a fixed place of business in Australia, the taxpayer will be subject to source based taxation under the regular progressive rates and the income will be taxed on a net basis.\(^{343}\)

D. The Characterization and Taxation of Cross-Border Payments for Software

Computer software payments may be characterized under the Canada-Australia Tax Treaty as property income, business income or services income. The concept of royalty is very broadly defined under Australian tax law. The characterization is generally based on what is being transferred rather than how this transfer is made. The rationale for this is that commerce, regardless of the nature, should be treated similarly and that the substance of the transaction is more important than the form. The equity principle is

\(^{343}\) Canada-Australia Tax Treaty, supra note 306, article 14(1).
enforced through this approach. Thus, where a copyright right is transferred, the income will be characterized as a royalty if the software can be exploited commercially. But where the transaction is a mere sale in a digital form, for example software downloaded for own use and enjoyment, the substance is a sale and not the transfer of a royalty. Where a service is provided, it is common that information on “industrial, commercial or scientific equipment” is involved in connection with the transaction. This is treated as royalty income under the Canada-Australia Tax Treaty.\(^{344}\) However, where there is an actual use of special skills or knowledge and these skills are required to provide the transaction, the income should be characterized as services income because the substance of the transaction is the performance of a service. Moreover, where the service results in the customer becoming the “owner” of a digital product after the transaction, but the digital product was not acquired from the service provider, the transaction shall be characterized as a service. Only where the digital product was also acquired from the provider shall the income give rise to a royalty. The rationale underlying this distinction is that the digital nature of the product should not change the tax treatment of the transaction. Where payments are classified as royalties the income is subject to a withholding tax at a rate of 30% on a gross basis.\(^{345}\) This withholding tax is reduced to 10% under the treaty provisions.\(^{346}\) Where the income is characterized as business income, the taxation is made on a net basis at a rate of 30%.\(^{347}\) Services income is also


\(^{345}\) Withholding Tax Act, *supra* note 310, subsection 7(1)(c).

\(^{346}\) Canada-Australia Tax Treaty, *supra* note 306, article 12(2).

\(^{347}\) *ITAA*, *supra* note 307, section 23(2).
taxed on a net basis, however under the progressive rate system, ranging from 29% to 45% for non-residents.\textsuperscript{348}

\section*{i. Characterization Examples}

Five examples\textsuperscript{349} are presented to illustrate how software payments may be characterized under the Canada-Australia Tax Treaty. The examples look at a Canadian resident earning income from computer software payments arising in Australia.

1) \textit{Electronic ordering and downloading of digital products for personal use.}\textsuperscript{350}

A Canadian resident corporation receives consideration for a computer software programs downloaded from their website with the right to reproduce four copies. The payment is made by a customer in Australia. The payment received may be a royalty because it is concerned with the right to reproduce four copies. But it may also be argued that the payment is business income because it is merely a way of obtaining five copies of the product and the underlying content of the transaction is, therefore, a purchase. To determine the character of the income, the decision-maker must look at the substance of the transaction, as this is the determinative factor in the characterization process.\textsuperscript{351} The OECD position on this type of income is likely to be adopted by Australia for the reasons discussed above. Where the product is used for the purchaser's own enjoyment the consideration gives rise to business income and not royalty because the substance of the

\begin{footnotesize}
\begin{enumerate}
\item \textsuperscript{348} Tax Rates Act, \textit{supra} note 340, Schedule 7, Part II, Subsection 1(b).
\item \textsuperscript{349} The features examples are all found in the Characterization Report, \textit{supra} note 3, at 33-70.
\item \textsuperscript{350} \textit{Ibid.} the example is based on category 2, at 56.
\item \textsuperscript{351} Taxation Ruling TR 93/12, Paragraph 4, \textit{supra} note 311.
\end{enumerate}
\end{footnotesize}
consideration made in respect of the transaction is the purchase of the product, although in a digital form, not the right to use the copyright. The business income may only be taxed in Australia where the Canadian vendor meets the higher threshold of maintaining a permanent establishment in Australia, otherwise the income is only taxed in the residence country. Where there is no permanent establishment situated in Australia, there is no source and the threshold is not met. The income is then taxed only in the residence country.

2) Electronic ordering and downloading of digital products for commercial exploitation of the copyright.\textsuperscript{352}

A Canadian resident corporation receives consideration for a computer software program downloaded from their website with the right to reproduce four copies for commercial exploitation. The payment is made by a customer in Australia. To determine the character of the income from this transaction, the decision-maker must again look at the substance of the transaction. The OECD position is also likely to be adopted for this type of income. The payment received may be a royalty because it is concerned with the right to reproduce four copies. But it may also be argued that the payment is business income because it is merely a way of obtaining five copies of the product and the underlying content of the transaction therefore is a purchase. The decision-maker must again look at the substance of the transaction, as this is the determinative factor in the characterization process. Where the software is commercially exploited the consideration is made for the copyright and therefore gives rise to a royalty. The income is then subject to a

\textsuperscript{352} Characterization Report, \textit{supra} note 3, the example is based on category 3, at 57.
withholding tax at source on a gross basis at a rate of 30%, which rate is however reduced to 10% under the Canada-Australia Tax Treaty.\textsuperscript{353}

3) \textit{Software maintenance provided by an operator including software upgrades and online support to a non-resident customer who pays an annual fee.}\textsuperscript{354}

A maintenance and support function is provided in connection with a software program that has been downloaded from a Canadian provider by an Australian customer. The question is whether this transaction gives rise to royalty income or services income. The substance of the transaction must be determined in order to characterize the transaction. There is no clear answer to this transaction, as the support may be considered knowhow under the treaty, falling under "the supply of scientific, technical, industrial or commercial knowledge or information"\textsuperscript{355} or it may also be considered "professional services or other independent activities."\textsuperscript{356} The OECD Model Convention deals with the characterization of such transactions and the factor determining the characterization is what the principal object of the contract is. In this example no principal object can be determined, since the object is both to provide upgrades and to provide support. However, online advice, communications with technicians and access to a troubleshooting database, are not to be considered a royalty, as these are services provided on demand.\textsuperscript{357} Therefore, the payment in this example is likely to be characterized as services income, as the decision-maker will look to the OECD Model

\textsuperscript{353} Canada-Australia Tax Treaty, \textit{supra} note 306, article 12(2).
\textsuperscript{354} Characterzation Report, \textit{supra} note 3, the example is based on category 12 and 14, at 62-64.
\textsuperscript{355} Canada-Australia Tax Treaty, \textit{supra} note 306, article 12(3)(c).
\textsuperscript{356} \textit{Ibid.} article 14(1).
\textsuperscript{357} OECD Model Convention, \textit{supra} note 40, Paragraph 11.4, Commentary on article 12.
Convention for guidance. But only where there is a fixed place of business in Australia can this income be taxed at source on a net basis under the regular progressive Australian tax rules. This threshold is not met in the example, and the income will therefore only be taxed in the country of residence.

4) The acquisition of content for a web site where a web site operator (1) pays one or more non-resident content providers for news, information and other online content with the purpose of attracting users to the web site and (2) pays for the creation of content for the web site.\(^{358}\)

The consideration for the use of news, information, or other online content may be characterized as royalty or business income. The OECD position on content acquisition is likely to be adopted for this transaction. Where the payment is concerned with the right to display otherwise copyrighted material, the payment will then be considered a royalty as it is made for the right to use a copyright.\(^{359}\) This is the case for the first half of the transaction under (1). The income is accordingly characterized as a royalty subject to withholding tax on a gross basis at source at a rate of 30% reduced under the treaty to 10\%.\(^{360}\) Where the payments are made for the creation of new content to which the web site operator becomes the owner there is no payment for copyrights, as the copyright is owned by the operator. Rather, the payments will be considered business profits, since the substance of the transaction is the acquisition of the content itself, not a right to display it. This is the case for the other half of the payment under (2). The income related

\(^{358}\) Characterzation Report, supra note 3, the example is based on category 25, at 69.

\(^{359}\) Canada-Australia Tax Treaty, supra note 306, article 12(3)(a).

\(^{360}\) Ibid. article 12(2).
to this part of the transaction is subject to taxation on a net basis under the regular progressive rates, only where the higher threshold of a permanent establishment is met. Where there is no permanent establishment situated in Australia there is no source and therefore no jurisdiction to tax. The income is then only taxed in the residence country.

5) *Subscription to access an interactive web site provided by a Canadian web site operator allowing an Australian customer to interact with the site while online.*

A Canadian provider makes a web site featuring digital content and information, music, games and activities available to an Australian subscriber, who pays a fixed periodic fee to access and interact with the website. No products or services are obtained from the website. The payment received may be characterized as services income or royalty. Again, the substance of the transaction is the determinative factor in the characterization process. The OECD Commentary to the Model Tax Convention again offers guidance on the characterization, which is likely to be adopted by the Australian courts. Where the payments made are mainly for the interaction with the site for the purpose of own enjoyment it may be characterized as services income. Because no services of a technical, or consultancy nature are provided, the services cannot be considered “technical fees” that would give rise to a royalty. Therefore, the income is likely to be categorized as services income. It should be noted that where the Canadian provider receives the payment as the owner of the copyright for the right to display the content to the Australian subscriber, the payment would likely be characterized as a royalty. This is not the case in the example. Thus, the income will likely be considered services income, and

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361 Characterization Report, *supra* note 3, the example is based on category 21, at 67-68.
362 OECD Model Convention, *supra* note 40, Paragraph 11, Commentary on article 12; Characterization Report, *supra* note 3, Category 21, paragraph 35, at 68.
will be subject to a source-based taxation on a net basis, which is limited by the treaty, as
the threshold of a fixed base must be met. Where there is no fixed base situated in
Australia there is no source and no jurisdiction to tax. The income is then only taxed in
the residence country.

III. CHARACTERIZING SOFTWARE PAYMENTS IN CHINA AND UNDER THE CANADA-
CHINA TAX TREATY

A. Royalty payments
i. Domestic treatment of Royalty Payments
a. Characterization of Royalties

The taxation of e-commerce follows the general rules and principles found in Chinese tax
legislation. No special rules or policies have been introduced for the taxation of e-
commerce in China. Under domestic Chinese tax legislation the term “royalty” is not
used, rather the phrase “fees for the use of proprietary rights” is employed. For the
sake of reference the term royalty is used in this part of the chapter and covers “fees for
the use of proprietary rights.” Royalties include (1) fees for the use in China of
patents, proprietary technology, trademarks, copyrights and other rights, (2) fees for
the use of technical information, technical training, and technical services related to the

363 Agreement Between the Government of Canada and the Government of the People’s Republic of China
for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes of
Income [Canada-China Tax Treaty], online: the Department of Finance
<http://www.fin.gc.ca/scripts/Publication_Request/request_e.asp?doc=china_e.pdf&title=Canada-
China+Income+Tax+Agreement>. 364 Li, supra note 7, at 216.
365 Ibid.
366 The Income Tax Law of the People’s Republic of China Concerning Foreign Investment Enterprises
and Foreign Enterprises [FEIT Law]; Detailed Regulations for the Implementation of the FEIT law [FEIT
Regulations], article 6.

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use of patents or proprietary technology,\textsuperscript{367} (3) compensation received from Chinese enterprises for renting films, videotapes, and audio tapes, and (4) fees paid for technical assistance and services provided for the purpose of facilitating proper use of rights to use proprietary technology (patents, copyrights and designs, and technical, industrial, or commercial knowledge). Computer software payments may be characterized as royalties or purchase payments depending on the rights transferred. Where no copyright is transferred, the transaction will be characterized as a sale of goods giving rise to business income. Where copyright rights are transferred the transaction will also be characterized as a sale giving rise to business income. Where the transaction is a transfer of software with conditions restricting the terms of use of the software, but no copyright is transferred, the transaction will be characterized as a royalty.\textsuperscript{368} Where technical services are rendered without a transfer of copyrights in the software the transaction may also be considered a royalty.\textsuperscript{369} Where the payments are characterized as royalty payments the income is subject to withholding tax at a rate of 20\% on a gross basis.\textsuperscript{370} There are no guidelines on what constitutes a sale of software products. The form of the transaction is possibly the determinative factor.\textsuperscript{371} The transfer of shrink-wrap software may therefore give rise to royalty income because a license agreement generally imposes restrictions on the use of the software, which is considered to give rise to a royalty as described above. Where the transfer is concerned with software that is packaged and includes

\textsuperscript{367} \textit{Ibid.} article 59.
\textsuperscript{368} SAT, "Reply concerning the Taxation of Use Fees Charges by Foreign Business Entities for Their Provision of the Right To Use Computer Software" (86) Cai Shui Wai Zi, No. 253, August 29, 1986.
\textsuperscript{369} \textit{Ibid.}
\textsuperscript{370} \textit{Individual Income Tax Law of the People's Republic of China [IIT Law]}, article 3(5).
\textsuperscript{371} Li, \textit{supra} note 7, at 217.
communication equipment and installed software the part of the payments that can be allocated to the software is considered a royalty.\textsuperscript{372}

b. Source of Royalties

Under Chinese tax law, royalties are considered to arise and be sourced in China if they are paid "for the use in China of patent, proprietary technology, trade marks, copyright, etc."\textsuperscript{373} Where a non-resident pays a royalty to its Chinese branch the payment is then considered Chinese-sourced income. The meaning of "...use in China..." is not defined, but the view seems to be that payments made by Chinese enterprises are Chinese-sourced income without regard to where the actual use takes place.\textsuperscript{374}

ii. Tax Treaty Treatment of Royalty Payments under the Canada-China Tax Treaty

Royalties under the treaty means "payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films and films or tapes for radio or television broadcasting, any patent, know-how, trade mark, design or model, plan, secret formula or process, or for the use of, or the right to use, industrial, commercial or scientific equipment, or for information concerning industrial, commercial or scientific experience."\textsuperscript{375} There is no separate provision on computer software as is frequently seen in other Canadian tax


\textsuperscript{373} FEIT Regulations, \textit{supra} note 366, article 6.

\textsuperscript{374} Li, \textit{supra} note 7, at 218.

\textsuperscript{375} Canada-China Tax Treaty, \textit{supra} note 363, article 12(3).
treaties. The definition is conclusive, and a payment must fit under the definition to qualify as a royalty. Computer software payments earned by non-residents may fall within the general definition of royalties where they are also considered royalties under domestic law, for example where the use of software is restricted under a license even though the software is considered shrink-wrap software. This is because the royalty definition is broader under this treaty. Where there is inconsistency between domestic law and treaty provisions, the treaty provisions prevail. Where the transaction is concerned with the use of or the right to use a copyright it will accordingly be considered a royalty under the treaty although the domestic law does not consider a transaction of that kind to give rise to royalty income but rather business income. The geographical source rule allocates the jurisdiction to tax royalties earned in China by a non-resident on the basis of the location of the payor. If the payor is a Chinese resident the payment will be sourced to China. But if the payor is a Canadian resident the payment will not be sourced to China, although the income is earned here. In other words, the geographic source rule is based on the location of the payor irrespective of the place where the actual use takes place. Where royalties are sourced in China, the income will be subject to a withholding tax of 20% for corporations with the rate reduced to 10% under the Canada-China Tax Treaty if the recipient is the royalty owner. Where the non-resident carries on business in China or performs personal services and meets the threshold of permanent establishment and fixed place, the royalty rules shall not apply, as the income shall be

See for example the Canada-US Tax Treaty, supra note 206, article XII(3)(b).
Li, supra note 7, at 211.
Canada-China Tax Treaty, supra note 363, article 12(2).
treated according to the business profits or the services income provisions of the treaty.\textsuperscript{379} Both business and services income hereby receive preferential treatment under the treaty rules since a higher threshold must be met before China has jurisdiction to tax these types of income earned by non-residents. The threshold requirements for the Canada-China treaty also has the underlying rationale in the historic safeguard position as described previously.

B. Business Profits

i. Domestic Tax Treatment of Business Income

a. Characterization of Business Income

Non-residents carrying on business in China are only taxable on the business profits if the thresholds of "establishment" or "site" are met. Where business profits are attributable to an "establishment" or "site" the income is subject to a tax on a net basis at a rate of 33\%.\textsuperscript{380} An "establishment" includes a "management office, business site, office, factory, place of extraction of natural resources, site for projects, site for the furnishing of services, and a business agent."\textsuperscript{381} Where an agent habitually concludes and negotiates contracts in the name of the non-resident, or habitually stores goods and makes deliveries to third parties on behalf of the non-resident, the agent is deemed to constitute an establishment.\textsuperscript{382} Where the minimum presence required under Chinese tax legislation is not met, the business income earned by a non-resident is exempt from taxation. This

\textsuperscript{379} Ibid. article 12(4).
\textsuperscript{380} ITT Law, supra note 370, article 3(5).
\textsuperscript{381} Ibid. article 3.
\textsuperscript{382} Ibid.
indicates a preferential treatment of business income under Chinese tax legislation as a higher presence is required for active income compared to passive income.

ii. Treatment of Business Profits under the Canada-China Tax Treaty

Under the Canada-China Tax Treaty the permanent establishment concept sets the threshold for Chinese taxation. The underlying rationale is again the historic safeguard position. This threshold is different from the domestic threshold in two aspects. First, treaty rules distinguishes between independent and dependant agents - which differentiation is not made under domestic law. Under the treaty, a dependant agent is deemed to be a permanent establishment of a non-resident. An independent agent is not deemed to be a permanent establishment as a starting point; however, if the agent is an exclusive agent and exercises the power to conclude contracts in the name of the non-resident he is likewise deemed to be a permanent establishment. Second, a project can only constitute a permanent establishment under the treaty where the time threshold of 6 months is met, but under domestic law a project may be deemed an “establishment” or “site” where the presence is shorter. In the context of e-commerce, there is no rule that specifies a server as a permanent establishment under the Canada-China Tax Treaty. Under the OECD Model Convention, servers now constitute a permanent establishment if the server performs integral aspects of a cross-border function, and the non-resident corporation owns or leases the server within the source country. Further, a

383 Canada-China Tax Treaty, supra note 363, article 5(5).
384 Ibid.
385 Ibid. article 5(3).
386 FEIT Regulations, supra note 366, article 3.
387 OECD Model Convention, supra note 40, Paragraph 42.1-42.4 of the Commentary on article 5.
permanent establishment can be constituted even if no human activity is required to program or service the foreign-based server. The rationale for giving servers permanent establishment status in the OECD Model Convention is that the Internet enables and facilitates remote economic activity and replaces traditional physical presence in a foreign jurisdiction as described in this chapter under section I.B.ii. The commentary on the Model Convention, although not legally binding, may serve as guidance for interpretation.\footnote{Ibid. at 14, \textit{Commentaries on the articles}, Paragraph 29: "Although the Commentaries are not designed to be annexed in any manner to the conventions signed by Member countries, which unlike the Model are legally binding international instruments, they can nevertheless be of great assistance in the application and interpretation of the conventions.”} The guidance found in the commentary is imported into the reading of the Canada-China Tax Treaty, and where no specific provisions are found in the treaty, the model is one authority to look to for guidance on how to determined uncertain situations. It is likely that China will adopt the interpretation found in the OECD Model Convention.\footnote{Li, supra note 7, at 427 and 430.} The jurisdiction to tax business income is further limited by the Canada-China Tax Treaty, as non-residents are taxable only on the business income attributable to the permanent establishment.\footnote{Canada-China Tax Treaty, supra note 363, article 7(1).} The safeguard rationale is again the reason for this rule. The profits of a permanent establishment must be calculated on the basis of what the profits would have been, were the dealings with the head office at arm’s length.\footnote{Ibid.} This means that the profits should be computed as if the conditions and prices were those of the ordinary market. When computing the business profits of a permanent establishment, deductions are allowed for expenses relating to the permanent establishment including administrative expenses without respect to where the expenses

\footnote{388 Ibid. at 14, \textit{Commentaries on the articles}, Paragraph 29: “Although the Commentaries are not designed to be annexed in any manner to the conventions signed by Member countries, which unlike the Model are legally binding international instruments, they can nevertheless be of great assistance in the application and interpretation of the conventions.”
389 Li, supra note 7, at 427 and 430.
390 Canada-China Tax Treaty, supra note 363, article 7(1).
391 Ibid.}
However, no deductions are allowed where expenses are incurred in the form of royalties or fees for the use of patents or other intangibles. Where income is earned as business profit and the threshold of permanent establishment is met the income will be subject to taxation at a rate of 33% under the regular domestic rules for non-residents.

C. Services Income

i. Domestic Tax Treatment of Services Income

a. Characterization of Services Income

Under Chinese tax law, income from services can be earned through services provided by individuals, including accountants, lawyers, doctors, engineers, architects, entertainers and other professionals. Services are further categorized in services provided by an independent contractor and services provided by an employee. The two types are taxed differently as the former is taxed at a flat rate of 20% and latter at a progressive rate ranging from 5-45%. The taxation of services income is, however, limited under treaty law.

b. Source of Services Income

Income from personal services is sourced to the place of performance and the place of

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392 Ibid. article 7(3).
393 Ibid.
395 Ibid. article 21(1); IIT Law, supra note 370, article 3, section 4.
contract or payment is irrelevant. Thus, where the service is performed in China, the income will be sourced in China even though the payment, for example, is made to a Canadian independent contractor indirectly through a Canadian company.

ii. Tax Treaty Treatment of Services Income

Under the Canada-China Tax Treaty income from personal services earned by a non-resident individual is subject to residence-based taxation unless the person has a fixed place of business in the other state. As with the permanent establishment threshold, the fixed base threshold is a historic safeguard position, and represents the rationale for this rule. This presence requirement must be met before China has jurisdiction to tax the income from a non-resident earning services income. Where a non-resident has a fixed place of business in China, the taxpayer will be subject to source-based taxation under the regular progressive rules of 5-45% on a net basis where the taxpayer is an employee, and at a flat rate of 20% on a net basis where the taxpayer is an independent contractor.

D. The Characterization and Taxation of Cross-Border Payments for Software

Computer software payments may be characterized under the Canada-China Tax Treaty as giving rise to property income, business income or services income. The concept of royalty is broadly defined under Chinese tax law. The characterization is generally based on the restrictions imposed on the terms and use of the software. No copyrights necessarily have to be transferred in order for the transaction to generate royalty income.

396 Ibid. article 5(1).
397 Canada-China Tax Treaty, supra note 363, article 14(1)(a).
Where, for example, digital products are ordered and downloaded a royalty will arise if there is a restriction on the use of the software, as this transaction will be regarded as a license. Where there is no restriction on the downloaded software the income will be characterized as business income. When services are provided it is common that information concerning industrial, commercial or scientific experience is obtained as a result of the service provided by the person processing the information. Payments for proprietary information or technical services are characterized as royalties and subject to withholding tax under Chinese rules, but there are no clear rules for the classification of such services leading to uncertainty in the area. Where payments are classified as royalties the income is subject to a withholding tax of 20% at source on a gross basis reduced to 10% under the treaty provisions. Where income is characterized as business income it will be subject to taxation at a flat rate of 33% on a net basis under domestic Chinese rules, where the threshold of permanent establishment is met. Where income is characterized as services income, it will be subject to a graduated taxation of 5-45% on a net basis under the regular domestic rules, provided that the higher threshold of fixed place is met.

i. Characterization Examples

Five examples are given below to illustrate how software payments might be characterized under the Canada-China Tax Treaty. The examples look at a Canadian resident earning income from computer software used in China.

398 The featured examples are all found in the Characterization Report, supra note 3, at 33-70.
1) Electronic Ordering and Downloading of Digital Products for Personal Use

A Canadian resident corporation receives consideration for a computer software programs downloaded from their website with the right to reproduce four copies. The transaction is made by a customer in China. The payment received may be a royalty because it is concerned with the right to reproduce four copies. But is may also be argued that the payment is business income because it is merely a way of obtaining five copies of the product and the underlying content of the transaction therefore, is a purchase. Where the use of the software or the right to use the software is restricted, the transaction is characterized as a royalty payment under Chinese law, regardless of whether copyrights are transferred. Thus, as the use is restricted by a license prohibiting more than reproduction of four copies, there is a restriction of the use, and therefore the transaction will be characterized as a royalty under Chinese tax legislation. The payment will fall under the royalty category of the treaty, as this covers payments made “for the use of, or the right to use” a copyright. This royalty income is subject to a withholding tax at source at a rate of 20% on a gross basis, which rate is reduced to 10% under the treaty.

2) Electronic Ordering and Downloading of Digital Products for Commercial Exploitation of the Copyright

A Canadian resident corporation receives consideration for a computer software program downloaded from their website with the right to reproduce four copies for commercial exploitation. The payment is made by a customer in China. To determine the character of

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399 Ibid. the example is based on category 2, at 56.
400 Canada-China Tax Treaty, supra note 363, article 12(3).
401 Ibid. article 12(2).
402 Characterization Report, supra note 3, example based on category 3, at 57.
the income from this transaction, the decision-maker must again look at whether the use of the software or the right to use the software is restricted, as the payment will give rise to royalty where there is a restriction in the use. The payment received may be a royalty because it is concerned with the right to reproduce four copies, the use of which is restricted. But it may also be argued that the payment is business income because it is merely a way of obtaining five copies of the product, with no restriction of use imposed, and that the transaction therefore is a purchase as argued above. Where the product is exploited commercially, it will give rise to a royalty, as there is a restriction on the use of the software. The consideration is made in respect of the copyright right. This results in the income being subject to a withholding tax rate of 20% at source, taxed on a gross basis. This rate is reduced under the treaty provisions to 10%, limiting the Chinese jurisdiction to tax the income.

3) **Software Maintenance Provided by a Canadian Operator Including Upgrades and Online Support to a Chinese Customer who Pays an Annual Fee**

A maintenance and support function is provided in connection with a software program that has been downloaded from a Canadian provider by a Chinese customer. The question is whether this transaction gives rise to royalty income or services income. There is no clear cut answer to this, as the support may be considered knowhow under the treaty as it may fall under "information concerning industrial, commercial or scientific

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403 Canada-China Tax Treaty, *supra* note 363, article 12(3).
405 Characterization Report, *supra* note 3, the example is based on category 12 and 14, at 62-64.
experience. At the same time it may also be considered a service rendered on demand under the treaty. Where the payment is considered to be made in respect of knowhow it will give rise to a royalty. Where the payment is in consideration of a service it will give rise to services income. Under Chinese tax law, payments for “proprietary” information and technical service is taxed as royalties. As mentioned above, there are no clear rules for the classification of such transactions. It is however likely, that China will take a liberal interpretation of what falls into the category “royalty” in such transactions, thereby protecting the source-based taxation. The OECD Model Convention deals with the characterization of such transactions, and the commentary serves as a guideline under the treaty, where there are uncertainties. The factor determining the characterization is the principal object of the contract. In this example there is no principal object, since the object is both to provide upgrades and to provide support. However, online advice, communications with technicians and a trouble shooting database, is not to be considered “information concerning industrial, commercial or scientific experience”, as this is a service provided on demand. It is however unlikely that China will follow the commentary, as this would compromise the source-based taxation. Therefore, it is most likely, that payments in such transaction will be characterized as royalties, giving rise to a source-based taxation at a rate of 20% on a gross basis, which rate is reduced under the treaty to 10%.

406 Canada-China Tax Treaty, supra note 363, article 12(3).
407 Ibid. article 14.
408 Li, supra note 7, at 437.
409 Canada-China Tax Treaty, supra note 363, article 12(3)(c).
410 OECD Model Convention, supra note 40, Paragraph 11.4 of the Commentary on article 12.
411 Canada-China Tax Treaty, supra note 363, article 12(2).
4) The Acquisition of Content for a Web Site Where a Chinese Web Site Operator 1) Pays one or More Canadian Content Providers for News, Information and other Online Content with the Purpose of Attracting Users to the Web Site and 2) Pays for the Creation of Content for the Web Site

The consideration for the use of news, information, or other online content may be characterized as royalty or business income. China has yet to take a position on such transactions. It is however likely that they will comply with the OECD position on these types of transactions. Where the payment is concerned with the right to display otherwise copyrighted material, the payment will be considered a royalty as it is made for the right to use a copyright. Where the payments are made for the creation of new content to which the web site operator becomes the owner there is no payment for copyrights, as the copyright is owned by the operator. Rather, the payments will be considered business profits. The payment under (1), concerned with the use of copyrights, will then be categorized as a royalty. Royalty income is subject to withholding tax at source at 20% on a gross basis, which is reduced under the treaty provisions to 10% in case of royalties beneficially owned by a resident of Canada. The payment under (2), are made for the creation of new content to which the web site operator becomes the owner there is no payment for copyrights as the copyright is owned by the operator. The income from this transaction will therefore be characterized as business income, and subject to a source-based taxation on a net basis, which is limited.

412 Characterization Report, supra note 3, example based on category 25, at 69.
413 Li, supra note 7, at 434.
414 Canada-China Tax Treaty, supra note 363, article 12(3).
415 Ibid. article 7.
416 Ibid. article 12(2).
by the treaty, as the threshold of a permanent establishment must be met.\(^{417}\) Where there is no permanent establishment situated in China there is no source, and the therefore no jurisdiction to tax. The income is then only taxed in the residence country.

5) Subscription to Access an Interactive Web Site Provided by a Canadian Operator Allowing a Chinese Customer to Interact with the Site while Online\(^{418}\)

A Canadian provider makes a web site featuring digital content and information, music, games and activities available to a Chinese subscriber, who pays a fixed periodic fee to access and interact with the website. No products or services are obtained from the website. The payment received may be characterized as services income or royalty. The characterization of such transaction is unfortunately not very clear in China. If the transaction involves a formal right to use copyrighted material the transaction may give rise to royalty income. This is also the case where the license imposes a limitation on use for the end user. No clear answer can therefore be given on the characterization of transactions involving data access or delivery through a web site.

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\(^{417}\) Ibid, article 7(1).

\(^{418}\) Characterization Report, supra note 3, the example is based on category 21, at 67-68.
IV. CHARACTERIZING SOFTWARE PAYMENTS IN CHILE AND UNDER THE CANADA-
CHILE TAX TREATY

A. Royalty Payments

i. Domestic Tax Treatment of Royalty Payments

a. Characterization of Royalties

Chile has not introduced any specific rules for the taxation of e-commerce. The taxation
of transactions of an electronic nature therefore follows the general rules and principles
found in Chilean tax law. Under Chilean domestic law, a very broad definition of
royalties is used, and royalties are understood as any kind of payments received for the
use of intellectual property and know-how. The determining factor in characterizing
computer software payments as royalties or business income is whether the transfer of
software results in a complete transfer of copyright in the program or only a partial
transfer of copyright in the program. The complete transfer of copyrights gives rise to
business income, whereas the partial transfer gives rise to a royalty. Chile generally
employs a form over substance principle. The SII has, however, issued a ruling,
determining that all transfers of copyrights are partial, as a copyright itself is not
perpetual. The transfer of a copyright can therefore only generate royalty income, as it
will be characterized as the use of or right to use the copyright, meaning that whenever

419 Convention between Canada and the Republic of Chile for the Avoidance of Double Taxation and the
Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital [Canada-Chile Tax Treaty],
Tax Notes Int’l 1625, at 632.
421 Servicio de Impuestos Internos [SII], (Chilean Internal Revenue Service).
422 SII Ruling No. 5184, December 2004.
copyrights are transferred, a royalty will arise. Where a payment is characterized as a royalty, the income is subject to a withholding tax at a rate of 35% on a gross basis.423

b. Source of Royalties

Under Chilean tax law, royalties are considered to arise in Chile where the payments are made by a Chilean resident to a non-resident. The geographical source rule is thereby based on the location of the payor not where the consideration is actually made.424

ii. Tax Treaty Treatment of Royalty Payments under the Canada-Chile Tax Treaty

Royalties are defined to mean:

[Payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, dramatic, musical, artistic or scientific work ... for the use of, or the right to use, industrial, commercial or scientific equipment, or for information concerning industrial, commercial or scientific experience.]425

The definition is fixed under the treaty and although it is fairly broad, no specific provision for computer software is found in the definition. Computer software payments may fall within the domestic definition of royalty and not be considered royalty under the treaty, as the definition found here is narrower. Treaties signed by Chile are considered part of domestic law according to Chile’s Constitution and domestic law.426 Since treaty law is integrated in domestic law and therefore must be considered equally binding, a

424 Ibid.
425 Canada-Chile Tax Treaty, supra note 419, article 12(3).
conflict in domestic law and treaty law should not appear, as treaty law is domestic law. This must also mean that where there is inconsistency in the two sources of law, the treaty law will be followed. Both the residence and source state are accorded jurisdiction to tax royalties under the Canada-Chile Tax Treaty.\textsuperscript{427} The geographic source rule allocates the jurisdiction to tax royalty income earned in Chile by a non-resident on the basis of the location of the payor making the payment. The rates of withholding tax for source taxation of royalties vary by the type of royalty. The general withholding tax rate is 35% taxed on a gross basis,\textsuperscript{428} which rate is reduced to a withholding tax rate of 15% under the treaty.\textsuperscript{429} These rules do, however, not apply where, for example, the Canadian entitled to the royalties carries on business through a permanent establishment in Chile, as the rules relating to business profits apply instead.\textsuperscript{430}

B. Business Profits

i. Domestic Tax Treatment of Business Profits

a. Characterization of Business Profits

Generally, non-resident individuals and corporations are taxable on their Chilean sourced income, derived directly or indirectly from all sources in Chile. What constitutes a permanent establishment is not precisely defined, but the law offers as examples, branches, offices, agents and representatives.\textsuperscript{431} This lack of precise definition exposes taxpayers to possible subjective definitions by the authorities. Chile employs a broad

\textsuperscript{427} Canada-Chile Tax Treaty, \textit{supra} note 419, article 12(1) and 12(2).
\textsuperscript{428} The Canadian Trade Commissioner Service, \textit{supra} note 423.
\textsuperscript{429} Canada-Chile Tax Treaty, \textit{supra} note 419, article 12(2).
\textsuperscript{430} \textit{Ibid.} Paragraph 12(4).
\textsuperscript{431} \textit{Ibid.}
definition of “Chilean-sourced” income, as "income shall be considered Chilean source if it is derived from assets situated in Chile or from activities carried out in Chile, whatever the residence or domicile of the taxpayer." Payments to non-residents are generally taxed at a withholding tax rate of 35%. Chile also imposes a 17% tax at the corporate level, but a credit is allowed, and the combined rate is therefore only 35%.

ii. Tax Treaty Treatment of Business Profits

Under the Canada-Chile Tax Treaty the threshold for Chilean taxation is raised so that only business income earned through a permanent establishment, as understood under the treaty, is subject to Chilean tax. A permanent establishment is traditionally defined as a fixed place of business through which the business of a non-resident taxpayer is wholly or partly carried on. It includes a place of management, a branch, an office, a factory, a workshop, a mine, a quarry or any other place relating to the exploration for or the exploitation of natural resources, a building site or construction, installation or assembly project, which exists for more than six months. Also, the furnishing of services, including consultancy services, by an enterprise through employees or other individuals engaged by the enterprise if the presence is in excess of 183 days in a 12 months period” is considered a permanent establishment. A person, other than an independent agent, acting on behalf of a resident and habitually exercising an authority to conclude contracts

434 Canada-Chile Tax Treaty, supra note 419, article 7(1).
435 Ibid. article 7(3)(b).
in the name of the resident is also deemed to constitute a permanent establishment. The definition is not limited to the listed examples, as it includes but is not restricted to the examples, and other things may therefore constitute a permanent establishment. In the context of e-commerce, there is no clear rule that specifies whether a server constitutes a permanent establishment in the Canada-Chile Tax Treaty. Under the OECD Model Convention, servers now constitute a permanent establishment if the server performs integral aspects of a cross-border function, and the non-resident corporation owns or leases the server within the source country. Further, a permanent establishment can be constituted even if no human activity is required to program or service the foreign-based server. The commentary on the Model Convention, although not legally binding, may serve as guidance for interpretation.

Chile is a non-member of the OECD but serves as an observer in the OECD, attending OECD hosted forums, among others on e-commerce issues. Chile, as all other countries, has no obligation to follow guidelines issued by the OECD, since these are merely recommendations and not part of a treaty actively entered into with Canada. Moreover, Chile has not expressed that they will follow the recommendations from the OECD. The jurisdiction to tax business income is limited under the Canada-Chile Tax Treaty in that non-resident taxpayers are taxed only on their Chilean-sourced business income attributable to a permanent establishment. The Chilean-sourced business income earned by non-resident individuals or foreign juridical entities is

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436 Ibid. article 5(5).
437 OECD Model Convention, supra note 40.
438 Ibid. at 14, Commentaries on the articles, Paragraph 29: "Although the Commentaries are not designed to be annexed in any manner to the conventions signed by Member countries, which unlike the Model are legally binding international instruments, they can nevertheless be of great assistance in the application and interpretation of the conventions."
subject to a flat rate of 35% additional withholding tax.\footnote{The Canadian Trade Commissioner Service, \textit{supra} note 423.} Only the income attributable to a permanent establishment is taxed in Chile, but the law fails to convey what income is attributable to a permanent establishment. Here the treaty offers guidance, as the attribution to the permanent establishment is made on the basis of the profits derived from the assets or activities of the permanent establishment. In connection with this, deductions are allowed on the basis of expenses incurred for the purpose of the permanent establishment, including executive and general administrative expenses, whether these arise in the State in which the permanent establishment is situated or elsewhere.\footnote{Canada-Chile Tax Treaty, \textit{supra} note 419, article 7(1), (2), and (3).}

\textbf{C. Services Income}

\textbf{i. Domestic Tax Treatment of Services Income}

\textbf{a. Characterization of Services Income}

Under Chilean tax law, services income can be earned by individuals or entities receiving remuneration from different activities performed in Chile or paid to a Chilean resident. Where individuals are earning remuneration, such income will be characterized as services income where for example technical assistance, engineering work and consulting services are rendered. Where entities are earning income from, for example, technical assistance, such income will also be characterized as services income.\footnote{The Canadian Trade Commissioner Service, \textit{supra} note 423.} As a general rule there is a withholding tax of 35\% on service fees paid to non-residents. Where amounts are paid to non-residents for the use of trademarks, patents, formulas, royalties,
know-how and similar items a tax rate of 30% is imposed. Where fees are paid to non-residents for technical assistance or engineering work rendered in Chile or to a Chilean resident the tax rate is reduced to 20%.442

b. Source of Services Income

Generally, income will be Chilean-sourced where the income is from activities carried out in Chile, regardless of the residence or domicile of the taxpayer.443 The source rule for services income is therefore based on the place of performance of the services rendered by the individual or the entity.

ii. Tax Treaty Treatment of Services Income

Under the Canada-Chile Tax Treaty the taxation of income earned by non-residents is contingent on the presence in Chile of a fixed place, which generally entails the same level of activity or presence as the concept of a permanent establishment.444 A fixed place generally includes the delivery of services, including consulting services, undertaken by a company through employees or other personnel engaged by a Canadian company. Therefore, services income receives preferential treatment under the treaty as taxation is limited by the threshold of a fixed place. Where a non-resident has a fixed place of business in Chile, the taxpayer will be subject to source-based taxation under the additional withholding tax rate of 35% on a gross basis. This rate is reduced to 10%

442 McLeese et al., supra note 432, at 427.
443 Ibid., at 412.
444 Canada-Chile Tax Treaty, supra note 419, article 14(1).
under the treaty. If a non-resident has a fixed base in Chile all income attributable to the fixed place will be subject to domestic tax treatment and taxed at a flat rate of 35% (additional) withholding tax on a gross basis.

D. The Characterization and Taxation of Cross-Border Payments for Software

Computer software payments may be characterized under the Canada-Chile Tax Treaty as property income, business income, or services income. Since Chile generally employs a form over substance principle, the characterization will generally be based on how the transfer is made rather than what is being transferred. The form is, in other words, more important than the substance. Payments for software may be characterized as either royalty income, if it is for the “use of or right to use” the intangible or as business income (or services income), where the consideration is made for procurement of services. Where a service is provided, it is common that information on “industrial, commercial or scientific experience” is involved in connection with the transaction. This is treated as royalty income under the Canada-Chile Tax Treaty. However, where there is an actual use of special skills or knowledge and these skills are required to provide the transaction, the income should be characterized as services income under this principle, because the substance of the transaction is the performance of a service. Moreover, where the service results in the customer becoming the “owner” of a digital product after the transaction, but the digital product was not acquired from the service provider, the

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445 Ibid.
446 The Canadian Trade Commissioner Service, supra note 423.
447 Gonzalez-Bendiksen, supra note 420.
448 Canada-Chile Tax Treaty, supra note 419, article 12(3).
transaction should be characterized as a service. Only where the digital product was also acquired from the provider should the income then give rise to a royalty. Where payments are classified as royalties, the income is subject to withholding tax at a rate of 35% on a gross basis. This withholding tax is reduced to 15% under the treaty provisions.\textsuperscript{449} Where the income is characterized as business income, it is taxed on a net basis at a rate of 35%.\textsuperscript{450} Services income is taxed under a slightly different system, as the withholding tax rate varies between 35%, 30% and 20% depending on the type of service income rendered.\textsuperscript{451}

### i. Characterization Examples

Five examples are presented to illustrate how software payments may be characterized under the Canada-Chile Tax Treaty.\textsuperscript{452} The examples look at a Canadian resident earning income from computer software payments arising in Chile.

#### 1) Electronic Ordering and Downloading of Digital Products for Personal Use\textsuperscript{453}

A Canadian resident corporation receives consideration for a computer software programs downloaded from their website with the right to reproduce four copies. The payment is made by a Chilean customer. The payment received may be a royalty because it is concerned with the right to reproduce four copies. But it may also be argued that the payment is business income because it is merely a way of obtaining five copies of the

\textsuperscript{449} Ibid. Paragraph 12(2).
\textsuperscript{450} Byrne, \textit{supra} note 433.
\textsuperscript{451} The Canadian Trade Commissioner Service, \textit{supra} note 423.
\textsuperscript{452} Characterization Report, \textit{supra} note 3.
\textsuperscript{453} Ibid, the example is based on category 2, at 56.
product and the underlying content of the transaction therefore, is a purchase. To
determine the character of the income, the decision-maker must look at whether the
transfer of software results in a complete transfer of copyrights in the program or a partial
transfer of copyrights in the program since this is the determinative factor in the
characterization process. However, the SII has issued a ruling, determining that all
transfers of copyright are partial, as a copyright itself is not perpetual. The transfer of a
copyright can therefore only generate royalty income, as it will be characterized as the
use of or right to use the copyright. The income arising from this transaction is therefore
classified as royalty income and subject to a withholding tax of 35% on a gross basis
which rate is reduced to 15% under the treaty.

2) Electronic Ordering and Downloading of Digital Products for Commercial
Exploitation of the Copyright

A Canadian resident corporation receives consideration for a computer software program
downloaded from their website with the right to reproduce four copies for commercial
exploitation. The payment is made by a Chilean customer. To determine the character of
the income from this transaction, the decision-maker must again look at whether the
transfer of software results in a complete transfer of copyright in the program or a partial
transfer of copyright in the program since this is the determinative factor in the
characterization process. However, the SII ruling determines that all transfers of
copyrights are partial, as a copyright itself is not perpetual. The transaction can therefore

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454 SII Ruling No. 5184, supra note 422.
455 Canada-Chile Tax Treaty, supra note 419, article 12(2).
456 Characterization Report, supra note 3, the example is based on category 3, at 57.
457 SII Ruling No. 5184, supra note 422.
only be characterized as royalty income and is subject to a withholding tax rate of 35% on a gross basis, reduced under the treaty to 15%.\textsuperscript{458}

3) \textit{Software Maintenance Provided by an Operator Including Software Upgrades and Online Support to a Customer who Pays an Annual Fee}\textsuperscript{459}

A maintenance and support function is provided in connection with a software program that has been downloaded from a Canadian provider by a Chilean customer. The question is whether this transaction gives rise to royalty income or services income. The decision maker must look at the substance of the transaction to determine the characterization of the transaction. There is no clear answer to the characterization of this transaction. The support may be considered knowhow under the treaty, falling under "information concerning industrial, commercial or scientific experience"\textsuperscript{460} or it may also be considered "professional services."\textsuperscript{461} It is uncertain how this transaction will be characterized by the Chilean decision-maker. Chile is not a member of the OECD and has not made any statement as to whether the OECD recommendations will be followed. The bilateral treaties Chile has entered into are based on the OECD Model Convention, but this does not mean that the recommendation will be adopted into domestic decision making. It is therefore uncertain whether the position taken by the OECD will be adapted in characterizing income from e-commerce.

\textsuperscript{458} Canada-Chile Tax Treaty, \textit{supra} note 419, article 12(2).
\textsuperscript{459} Characterization Report, \textit{supra} note 3, example based on category 12 and 14, at 62-64.
\textsuperscript{460} Canada-Chile Tax Treaty, \textit{supra} note 419, article 12(3).
\textsuperscript{461} \textit{Ibid.} article 14(1).
4) *The Acquisition of Content for a Web Site where a Web Site Operator (1) Pays one or more Non-resident Content Providers for News, Information and other Online Content with the Purpose of Attracting users to the Web Site and (2) Pays for the Creation of Content for the Web Site* \(^{462}\)

The consideration for the use of news, information, or other online content may be characterized as royalty or business income. Where the payment is concerned with the right to display otherwise copyrighted material, the payment will be considered a partial transfer of copyright giving rise to royalty income according to Chilean administrative practice \(^{463}\) and be characterized under the treaty as such. \(^{464}\) This is the case for the first half of the transaction under (1). The income is then subject to withholding tax on a gross basis at a 35% rate, reduced under the treaty to 15%. \(^{465}\) Where the payments are made for the creation of new content, to which the web site operator becomes the owner, as described in the second half of the transaction under (2), it can be argued that there is no payment for copyright, given that the operator owns the copyright. Therefore the payments should be considered business profits, given that the substance of the transaction is the acquisition of the content itself, not the right to display it. The income related to this part of the transaction would then be subject to taxation on a net basis under the additional withholding tax rules at a rate of 35%, but only where the higher threshold of a permanent establishment is met. Where there is no permanent establishment situated in Chile there is no source and therefore no jurisdiction to tax. The income is then only taxed in the residence country. But at the same time it can also be

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\(^{462}\) Characterization Report, *supra* note 3, the example is based on category 25, at 69.

\(^{463}\) SII Ruling No. 5184, *supra* note 422.

\(^{464}\) Canada-Chile Tax Treaty, *supra* note 419, article 12(3).

argued that there is a transfer of copyrights when the creator makes and transfers the content to the website owner. Under this argument there is a partial transfer of copyrights and the income can therefore only be characterized as royalty income. This income would then be subject to a withholding tax rate of 35% on a gross basis, reduced under the treaty to 15% but with jurisdiction to tax in Chile.\textsuperscript{466} No clear answer can be given to the characterization of income arising in this example for the same reasons as described in the previous example.

5) Subscription to Access an Interactive Web Site Provided by a Canadian Web Site Operator Allowing a Chilean Customer to Interact with the Site while Online\textsuperscript{467}

A Canadian provider makes a website featuring digital content and information, music, games and activities available to a Chilean subscriber, who pays a fixed periodic fee to access and interact with the website. No products or services are obtained from the website. The payment received may be characterized as royalty or services income. Again, the transfer of copyrights and the substance of the transaction are the determining factors in the characterization process. It is likely that the characterization argument will be that the Canadian provider receives the payment from the Chilean subscriber for the right to use the copyright and display the content to the Chilean subscriber. Because there is a partial transfer of copyrights the payment can then only be characterized as royalty, and Chile will have the jurisdiction to tax. The income will then be subject to withholding tax at 35% reduced to 15% under the treaty.\textsuperscript{468}

\textsuperscript{466} \textit{Ibid.}
\textsuperscript{467} Characterization Report, \textit{supra} note 3, the example is based on category 21, at 67-68.
\textsuperscript{468} Canada-Chile Tax Treaty, \textit{supra} note 419, article 12(2).
V. CHARACTERIZATION OUTCOME UNDER THE EXAMINED TREATIES

Several differences in the characterization of software payments are revealed in the preceding discussion. Some jurisdictions characterize income from software payments in a way that is fully consistent with the OECD approach and the decision-makers adopt the Model Convention and commentaries into domestic law. Some jurisdictions are partly OECD-consistent in their characterization of computer software payments and have yet to take a position on some categories of income. Finally, other jurisdictions have yet to take a position on all categories of computer software payments examined, and whether they will adopt the OECD position is uncertain.

A. Country Standpoints

i. Electronic Acquisition of Computer Software for Personal Use

This first type of transaction raises the essential question of whether the income should be characterized as business or property income. The issue is whether the copying or downloading of the product amounts to the use of a copyright. The mere act of copying a copyright protected product qualifies as the use of a copyright in many jurisdictions. The OECD TAG therefore points out that a determination of whether the customer obtains the right to use the copyright or only the right to make incidental copies of the product for own use is the factor to consider. The OECD position on this type of payment is that where it is for personal use, it gives rise to business income.\(^{469}\) The underlying theory on the doctrinal material is the economic allegiance theory in that both the residence and source country is recognized in claiming tax jurisdiction. In characterizing the income as

\(^{469}\) Characterization Report, supra note 3, example based on category 2, paragraph 3.
business profits, the income is given a greater connection to the residence country than the source country, in that a higher threshold has to be met before source taxation is allowable.

a. Country Positions
The Canadian position is that these payments are generally characterized as the sale of goods and that the act of copying the product to a hard disk or downloading the product is incidental. The dominant nature of the transaction is the sale of the digital product and the transaction therefore gives rise to business income. The Canadian position is generally consistent with the OECD, but where limitations are imposed on the use of the digital products, the payments may be treated as royalties and taxed at source.470 The U.S. position regarding software for personal use is consistent with the OECD position. Under the U.S. Software Regulations the characterization is based on the economic substance rather than the legal form of the transaction and the form of delivery is irrelevant. Australia has taken a similar position on the characterization as the U.S. and the substance rather than the form of the transaction is the determinative factor. Also, it is likely that the OECD position will be adopted fully by Australia on this type of payment. China has taken a slightly different position on the electronic acquisition of software for personal use. If restrictive conditions on scope, form or use of the software are imposed, the payments made will be characterized as royalty income, although no copyright has been transferred. Thus, electronic acquisitions with restrictive conditions on use, which they will always have to some extent, would be considered to give rise to royalty income.

470 ITA, supra note 21, article 212(1)(d).
Where no restrictions are imposed the payments will be characterized as sales proceeds. Chile has taken yet a different position on the characterization of digitally downloaded software, and employs a form over substance approach. The characterization is made on the basis of whether the transfer of software results in a complete transfer of copyright in the program or a partial transfer of copyright in the program. Administrative practice has, however, determined that all transfers of copyright are partial, as a copyright itself is not perpetual. This type of transaction will therefore always give rise to a royalty, since a copyright is transferred with the program.

ii. Electronic Acquisition of Computer Software for Commercial Exploitation

The second type of transaction is similar to the first, except that the copyright is exploited commercially and the costumer obtains the right to use the copyright. The OECD position is to characterize payments from such transfers as royalties. The underlying theory is again the economic allegiance theory. Where the income is characterized as property income the source country is accorded the jurisdiction to tax that income, as the connection here is the significant one.

a. Country Positions

Again, Canada, the U.S. and Australia have adopted OECD-consistent approaches. Canada characterizes these payments as royalty income, as the dominant nature of the transaction is the use of the copyright. This position is consistent with the OECD position

\[471\] Characterization Report, supra note 3, example based on category 3, paragraph 4.
on such payments. The U.S. has taken a similar position and the software regulations are consistent with the OECD position on commercially exploited software. Australia takes the position that the decision-maker should look at the substance of the transfer when determining how to characterize it. This is also consistent with the position taken by the OECD on this type of transfer. China employs a different approach than the other jurisdictions. Under Chinese tax law, payments for "proprietary" information and technical services are taxed as royalties. It is very likely that China will take a liberal interpretation of what falls into the category "royalty" in such transactions, and include commercially exploited copyrights. As with the first case, under the Chilean approach, a form over substance approach is engaged. The characterization is made on the basis of whether the transfer of software results in a complete transfer of copyright in the program or a partial transfer of copyright in the program. Administrative practice has determined that all transfers of copyright are partial, as a copyright itself is not perpetual. The transaction therefore gives rise to royalty income, since a copyright is transferred with the program.

iii. Software Maintenance and Support

Payments made for transfers involving maintenance and online support must be examined more closely to determine whether the payments are made for "information concerning industrial, commercial or scientific experience" or "knowhow" under the OECD Model. The terms are, however, not defined in the model convention. Where actual services are being provided on demand through online advice and communication

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472 Ibid. example based on category 12, paragraph 19 and category 14, paragraph 21-26.
with technicians, the income will be considered services income. Where undivulged technical information for a product is being transferred the payment will be considered knowhow and a royalty. The underlying theory of the OECD position continues to be the economic allegiance theory. In characterizing the income as services income, the nexus is accorded to the residence country, unless the higher threshold in the source country can be met. Where the income is regarded as royalties, the nexus is accorded to the source country.

a. Country Positions

Canada generally considers payments for technical support to be services income and not royalties, unless the payment is dependent on the use of the support. Payments made for technical support may, therefore, be considered royalties. This is contrary to the OECD position on technical online support, as this is considered a traditional service delivered in a digital form and therefore a payment giving rise to services income and not royalties. Both the U.S. and Australia will likely follow the OECD position. The U.S. position on payments for software maintenance is consistent with the OECD overall and it is likely that the OECD position on online support also will be adopted. Australia is likely to adopt the OECD position on this type of payment and characterize it as services income, as the decision-makers will look to and follow the OECD Model Convention. Like Canada, payments for “proprietary” information and technical services are taxed as royalties in China. It is likely that China will take a liberal interpretation of what falls into the category “royalty” in such transactions, thereby protecting source-based taxation. The Chilean approach is to look at the form over the substance of the transaction and
determine the characterization of the transaction on the basis of that examination. How this transaction will be characterized is uncertain, just as it is unknown whether the position taken by the OECD will be adopted.

iv. Content Acquisition

For payments made for content made available by a web site operator and/or the creation of content for a web site, the ownership must be examined to determine the character of the income. The OECD focuses on the ownership of the copyright to the content when determining the characterization of a payment of this type.\textsuperscript{473} Where the web site operator acquires the right to display the content on the web site, and the provider owns the copyright, the payments made for the transfer are considered royalties. But if the operator has content created and becomes the owner of this, the payments for the transfers are considered business profits. The theory underlying the position is the economic allegiance theory. The characterization of the income as business profits, accords the nexus to the residence country, unless the higher threshold in the source country can be met. The characterization of the income as royalties differently accords the nexus to the source country, as the activity is regarded more closely connected to this place.

a. Country Positions

Both Canada and the U.S. have OECD-consistent position on this category. Canada’s position on transfers relating to content acquisition is accordingly dependent on whether

\textsuperscript{473} ibid. example based on category 25, paragraph 39.
the payment is for the use of copyright or for the creation of new content and focused on ownership. The former is treated as royalty income, the latter as services income. The U.S. Software Regulations look at the intent of the parties, who owns the copyright in the content and how the risks are allocated. Australia is likely to adopt the OECD position on content acquisition transfers. Then, where the payment is made for the right to display the copyrighted material on the website it will be considered a royalty. If the payment is made for the creation of new content, the payment will be considered services income. Again, the developing countries differ from the other sample jurisdictions. China has yet to take a position on content acquisition transactions. It is likely that China will comply with the OECD position on these types of transactions, as China focuses on the transfer of copyrights.\footnote{Li, supra note 7, at 434.} Then, where the payment is for new content, the characterization result will be services income, and where the payment is for the right to display copyrighted material on the website, the result will be a royalty characterization. Chile’s position on such payments will likely not follow the OECD position but the leading domestic administrative ruling,\footnote{SII ruling no. 5184, supra note 422.} and the result will then be that there is a partial transfer of copyrights and therefore the payment gives rise to royalty income.

\textbf{v. Data Access}

This illustrative case highlights a provider who makes available a website featuring digital content, information, music, games, etc. to a subscriber. No products or services are obtained from the website. In a data-access transaction, the users will pay the provider
a fixed periodic fee for allowing them to access and search information. Payments involving data access are considered by the OECD to generate business profits.\textsuperscript{476} The theory underlying the position is the economic allegiance theory. The characterization of the income as business profits, accords the nexus to the residence country, unless the higher threshold in the source country can be met. This shows that the activity is regarded more closely connected to the residence country, unless certain ties are found in the source country.

\textbf{a. Country Positions}

For tax purposes under Canadian law, payments made for data access or retrieval are generally characterized as services income. If the payment is contingent on use of the data, the payment may fall within the royalty category. The U.S. is likely to take the same position on data access and retrieval as the OECD position. This means that payments from such transfers will be characterized as business profits. Australia looks to the substance of the transaction in determining the character of a transaction. Australia's position on data retrieval and access is unknown, although it is likely that the OECD position will be adopted by the Australian decision-makers, since the Model Convention and the commentary are used in the decision-making process. China does not have a clear position on the characterization of data access and retrieval. Where the license connected with the use imposes restrictions on the end user, the payments may be characterized as royalties. Chile's position on data access and retrieval is unknown. Based on the factors the decision-maker will consider, it is likely that the characterization

\textsuperscript{476} Characterization Report, \textit{supra} note 3, the example is based on category 21, paragraph 35.
argument will be that the Canadian provider receives the payment from the Chilean subscriber for the right to use the copyright and display the content to the Chilean subscriber. Because this is viewed as a partial transfer of copyright the payment can only be characterized as royalty.

E. International Uniformity

The examination of the jurisdictions reveals some consistency among the country positions. However, it appears that there is inconsistency in the characterization for some of the computer software categories across the jurisdictions.

The OECD generally views the personal use category as generating business income. Canada and the U.S. are consistent with this view, and Australia might adopt this position based on their OECD membership and general OECD conform position. China and Chile are, in contrast, inconsistent with this view. For China, the characterization is dependent on whether or not there is a restriction on use. For Chile, the characterization is dependent on whether the copyright is partially or completely transferred and what the form of the transfer is. Where the same transaction is concerned with commercial exploitation of the copyright, the OECD position is that the payments are royalties. Canada, the U.S., and Australia are consistent in this view. China and Chile also consider such transactions to generate royalty income, but for the same reasons as in the personal use category. Under the maintenance and support category there is not much consistency with the OECD position, which is most likely to find that the transfer generates business income. Only the U.S. is likely to adopt this position. Canada, Australia, and China all
view such payments as royalties for different reasons. Chile’s position is unknown. A little more consistency is again found in the content acquisition category, where the OECD position is based on the ownership of the copyright. Canada, the U.S., and Australia are consistent with this position. China is likely to follow the OECD position but has yet to take position on this type of transaction. Chile is likely to characterize the income as royalty income, according to the administrative practice, since there is a partial transfer of a copyright, which can only generate royalty income. In the last category examined, there is also inconsistency. The OECD takes the position that such payments generate business income. Canada takes the same view, but where the payment is contingent on use, the payment will be characterized as royalty. The U.S. is likely to adopt the OECD position on this category. Australia’s position is unknown, but it is likely that the OECD position will be adopted. China considers such payments royalties if restrictions are imposed on the use and Chile likewise considers the payments royalties, but for the reason of the copyright being partially transferred.

Some overall consistency is found between the OECD position and the examined jurisdictions. Some results are, however, based on different reasons. When each jurisdiction is compared there is more inconsistency as to the reasons for characterizing income as giving rise to a certain type of income. Generally, a different approach is employed by China and Chile compared to the U.S., Canada, and Australia. The approach is also different from the one taken by the OECD. Generally speaking, there is consistency in the characterization for the payments examined under one, two, and four, between Canada, the U.S. and Australia. Mostly, the jurisdictions favour characterization
as royalties where there is inconsistency across jurisdictions and towards the OECD position. This is not a big surprise, as the royalty characterization results in source-based taxation, facilitating a collection of tax revenues in the source jurisdiction. Where the income is characterized a business income, a higher threshold for domestic taxation must be met, making it harder to raise revenues from such income. The different result in characterization becomes a problem where there is inconsistency between the treaty partners. Under the tax treaties, double taxation relief is generally available. But where the source country characterizes the income as a royalty and subjects it to a withholding tax and the residence country characterizes the income as a business income there are complications. The states may be unwilling to relieve double taxation by granting a tax credit for any withholding tax imposed. 477 No double taxation relief will then be available. Whether or not the OECD position will be fully adopted for all income arising from computer software payments is still uncertain, since this might mean giving up jurisdiction to tax for the traditional source countries, as a higher threshold has to be met before tax can be imposed where the income is characterized as business income or services income as opposed to royalty income.

Another important aspect of the characterization issue is whether the categorizing of e-commerce income as either active business income or passive property income is still of relevance. The examination of e-commerce income characterization magnifies an already existing issue in international taxation, which is the legitimacy of the income categories as examined in chapter three. The issue that e-commerce furthermore reveals is the base

477 Doernberg, supra note 75 at 2419.
erosion that occurs when the royalty category becomes narrowed. If e-commerce transactions are more commonly characterized as giving rise to business income as suggested by the OECD TAG Group in their 28 examples of common computer software transactions in e-commerce, the source countries can experience an erosion of their traditional source based system of taxation, when the higher permanent establishment threshold for taxation cannot be met. The nature of e-commerce with no presence in the source state exactly illustrates this problem. The question of how the underlying tax policy of the examined jurisdictions influences the positions taken on the different categories of software transactions will be examined in chapter five to determine the underlying rationale of developed and developing countries in the characterization and taxation of income from e-commerce transactions.
CHAPTER FIVE - SHARING THE GLOBAL TAX BASE BETWEEN DEVELOPED AND DEVELOPING COUNTRIES

This chapter focuses directly on the problem of equity in international income taxation in relation to the theoretically connected tax base. It then reviews possible solutions to current inequalities, concluding with recommendations for a reformed system that will ensure a fairer sharing of the global tax base between developed and developing countries.

I. THE CURRENT IMBALANCE IN SHARING THE GLOBAL TAX BASE

The discussion in the previous chapters illustrate that the international tax arena is controlled by the developed countries, and in particular that the OECD Model Convention and Commentary is biased towards developed countries. The OECD Model Convention, after the implementation of the 2001 Characterization Report, now recommends that the vast majority of common e-commerce transactions be characterized as giving rise to business income. Because business income can only be taxed at source where there is a permanent establishment, this characterization approach serves to erode the tax base of developing countries. In other words, since the developing countries produce consumers, but not many producers, of e-commerce they are missing the opportunity to collect their fair share of the global tax base arising from e-commerce through the current system.

Source taxation for royalties is allowed under all the treaties examined, and royalty characterization permits developing countries to collect their share of the global tax base.
However, the e-commerce transactions are rarely characterized as royalties, and software payment royalties are often exempt from taxation. The software exemption aggravates the revenue collection problem for the developing countries.

As prominent scholars write, the survey of national responses to e-commerce tax-challenges reveals a cautionary approach by governments to these challenges.\textsuperscript{478} Several reasons are given for this precaution,\textsuperscript{479} the main reason being the lack of evidence of actual base erosion and the severity of it. Further, this lack of evidence suggests that the reform path taken by the OECD and the insistence on traditional principles and the same tax rules used for traditional commerce and e-commerce, was likely the better route. More importantly though, as also noted, in the longer term an increase in international e-commerce may call for a revision of the traditional rules and principles.\textsuperscript{480} This is exactly what is argued in this part of the thesis, focusing on inequity in international income taxation.

The e-commerce characterization issues are simply one part of a larger problem, that is the fiscal globalization of the world resulting in increased interaction between national economies with fewer essential economic activities associating or locating the activity with a particular jurisdiction.\textsuperscript{481} The growing separation between economic reality and the assumptions underlying the current international tax system needs to be rectified. Of

\textsuperscript{479} Ibid. at 162-166.
\textsuperscript{480} Ibid. at 170.
course, we can turn the blind eye to the economic reality faced in developing countries as for example Chile and China. But as developed countries, I believe that we have an obligation and a great opportunity to ensure a fair sharing of the global tax base arising from this relatively new form of commerce, since the current rules, already ripe for revision, present unfavourable solutions to the sharing of the global tax base, particularly for the developing countries.

II. THEORETICAL FOUNDATION FOR TAXING INTERNATIONAL INCOME

Source taxation in the context of e-commerce is justified under the economic allegiance theory, benefit theory, entitlement theory and the ability-to-pay principle. The economic allegiance theory was introduced by Georg von Schanz\(^{482}\) and if consistently applied it would entail a fair and equitable distribution of tax burden between nations.\(^{483}\) George von Schanz's recommendation was to use consumption or business activities as the determinative factor for a taxpayer's economic allegiance to a country. But the League of Nations developed a more detailed assessment of economic allegiance based on four factors: (1) the acquisition of wealth, (2) the location of wealth, (3) the enforceability of rights to wealth, and (4) the consumption of wealth. Of the four factors, the acquisition of wealth (which corresponds to where wealth originates) and the consumption of wealth (which corresponds to residence or domicile) were considered more important factors than the others. Under the economic allegiance theory, both the country where income originates (residence country) and the country where the income is consumed (the source

\(^{482}\) Li, *supra* note 7, at 49.

country) is accorded jurisdiction to tax that income. The doctrine does not quantify the economic interest of the taxpayer in the source and residence country and therefore does not determine the type or extent of taxation only the domain in which its subjects are subject to taxation. Georg von Schanz argued that once the liability for tax had been defined, then the liability may be fixed on the foundation of different norms. He advocated that the country of residence should get less than the country of source and that the tax base should be divided, so that three-fourths was taxable in the source country and one-fourth taxable in the residence country. The level of detail employed by Schanz was not adopted by the League of Nations. It instead suggested a rough system of justice, where each interested country would receive revenue on the basis of the quantification of its interest using the economic allegiance theory. Where the capital flows between the countries are roughly equal a mutual exemption of non-residents is preferable, since this yields for each country about the same amount of revenue, that they would otherwise have collected under the economic allegiance theory. Where equal exemption is unacceptable, the League of Nations recommended that countries might agree by treaty to equal rules for certain classes of income and apply these equally by only a percentage of the normal rates of tax on such income.

\[\text{Li, supra note 7, at 51 and 584.}\]
\[\text{Peter A. Harris, Corporate/Shareholder Income Taxation and Allocating Taxing Rights Between Countries: A Comparison of Imputation Systems (Amsterdam: International Bureau of Fiscal Documentation, 1996), quoting from G. Schanz, "Zur Frage der Steuerpflicht", vol. 9, no. 2 (FinanzArchiv, 1892) at 365.}\]
\[\text{Vogel, supra note 15, at 219.}\]
\[\text{League of Nations, Report on Double Taxation, supra note 115 at 48-49.}\]
The approach taken by the League of Nations was subject to criticism from both Schanz and Adams.\textsuperscript{488} Schanz opposed to the approach, mainly because it culminated in residence taxation, which he did not find appropriate for capital-importing countries, but also because the approach depended on a distinction between different classes of taxes and income.\textsuperscript{489} Adams criticized the theory because it was a generalized label covering a number of separate judgments, and the conclusions were based upon diverse considerations, which are not true for the business habits and state of development of the various jurisdictions in the world. Furthermore, he claimed that the theory lead to exaggerated claims, partly due to the advocates of the claims being residents of the creditor countries.\textsuperscript{490} The League of Nations was not convinced by these criticisms, and the recommendations given by the economists of the League of Nations became the building blocks for today’s international tax system, where we indeed see a bias against source country taxation.

The benefit theory asserts that those who benefit from public services of a country should be charged for the use of the services. Benefits might be provided by the residence country as well as the source country. The source country provides benefits in the form of the necessary environment to carry out its production and other activities that generate profit and the residence country provides the environment that supports business activities, such as the laws that protects a corporation where it is incorporated. The benefit theory therefore supports both residence and source taxation. Although the benefit

\textsuperscript{488} Thomas S. Adams, infra note 490.
\textsuperscript{489} Edwin S.A. Seligman, \textit{Double Taxation and International Fiscal Cooperation}, (New York: Macmillan, 1928), at 151-152, reviews the methods.
\textsuperscript{490} Thomas S. Adams, “Interstate and International Double Taxation”, in \textit{Lectures on Taxation} (Chicago: Commerce Clearing House, 1932) at 102.
theory is often used to support source taxation, some scholars argue that blind application of the theory could be a significant disadvantage for developing countries, since the governments of developed countries have greater reserves of wealth accessible and are in a position to provide greater benefits. The benefit theory may therefore entitle them to claim an extended jurisdiction to tax on account of the developing countries. 491 The League of Nations specialists did not see the benefit theory as being able to account for double taxation when both the source and residence country provide benefits. 492 The theory did not therefore win ground with the League of Nations.

Entitlement theory allows a country to levy tax as a national rental charge for the use of the country’s investment environment and natural resources. 493 Some scholars argue that both the source and residence countries are entitled to a part of revenues generated by cross-border investments. 494 The theory therefore seems most persuasive where a source country possesses natural resources or provides a skilled labour force, 495 or even where it provides a customer base. Others find the entitlement theory somewhat more favourable than the benefit theory in terms of the taxation of corporations that lack a physical presence in the source country. If entitlement to tax is based on economic presence, source taxation of income of remote vendors seems solid despite the non-presence in the

492 League of Nations, supra note 115, at 18.
495 Ibid. at 46-53.
jurisdiction. In the context of e-commerce this is a particularly important point, as both tangible and intangible property and services can be transferred over the internet, remotely. The entitlement theory can also support residence taxation, as residence countries may feel entitled to claim jurisdiction for their fair share of international income arising from activities their residents are carrying out based on, for example, the use of the investment environment of the residence country. The entitlement theory does unfortunately not answer the question of which country contributes more to the production of the income taxable.

In Canada, as well as in other countries, the ability-to-pay principle is the foundation of the progressive personal income taxation system. The ability to pay is measured by net income, and the formulation by Haig-Simons is recognized as the most enduring definition of the income tax base. This definition is the foundation of the comprehensive income tax base, which was recommended by the Carter report and has become accepted as a model tax base in many countries, although no country approximates the tax base suggested by the Haig-Simons definition of income. Internationally, the ability-to-pay principle has been relied on to claim tax jurisdiction for both residence and source countries, and it was the basis of the economic allegiance theory discussed above. The principle was used by the economists of the League of Nations to provide detailed rules

497 Vogel, supra note 15, at 218.
499 Ibid.
for determining the origin of wealth and income together with residency or domicile where wealth is consumed. Through this approach, a taxpayer is considered to have the ability to pay in both the source and the residence country, which justifies the jurisdiction to tax for both countries.

Using the ability-to-pay principle to justify taxing jurisdiction can also be promote inter-taxpayer equity, because source-based and residence-based taxation promotes horizontal equity, which rationalizes the jurisdiction to tax the income earned both by residents and non-residents. The principle of horizontal equity requires that both taxpayers pay more or less the same amount of tax from the same amount of income-generating activity. The redistribution of income to maximize social welfare is the main objective of progressive income taxation based on the ability-to-pay principle. However, such redistribution takes place only at national level and it is argued by scholars that the idea of redistributing income globally is utopian. This being said, it is my belief that we, as developed nations, have an obligation to do what we can in redistributing income internationally, and bridging the gap between economic reality and the current international tax system. This can be promoted through the sharing of the global tax base arising from e-commerce, where the developing countries as capital-importers are often robbed of the ability to tax foreign activities under our current international tax regime. As some have put it, we have a higher likelihood of maximizing global welfare if everyone takes into

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500 Bird and Mintz, supra note 481, at 428.
account the actions of others to some extent – if a cooperative game rather than a competitive game is played.\(^{501}\)

III. **The Importance of Sharing International Tax Revenues**

The purpose of collecting income tax was originally, and continues to be, the raising of revenue to finance government spending, and income tax is a very important source of revenue in many jurisdictions, including Canada, the U.S., and Australia. Non-residents provide a significant potential source of tax revenue. In fact, a significant theme of the Carter Commission’s recommendations\(^{502}\) for international taxation was, for example, to “soak the non-residents”, since this would increase taxes by $271 million on non-residents and reduce taxes on residents.\(^{503}\)

From an administrative perspective, source taxation is much more desirable, because it is easier to enforce than residence taxation. For cross-border income, source countries are generally in the best position to enforce taxes, since they can monitor the income by requiring local enterprises to report payments made to non-residents and also require that residents withhold tax from such payments. Where the income is business income and it is earned though a permanent establishment it is not subject to withholding tax, but the non-resident generally, as a result of the permanent establishment, has assets that are available for tax enforcement. Because source taxation is usually harder to avoid than residence taxation, it serves a second purpose, which is to fight tax avoidance.

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\(^{501}\) Ibid. at 423.


Administrative efficiency does not strongly support residence taxation, at least for corporations, since such taxation can be difficult to enforce, particularly when corporate residence is easily manipulated. To elaborate, it is difficult to obtain accurate information on foreign income and corporate residence is very mobile and corporations can conduct their tax planning so that they incorporate in a foreign jurisdiction or so that they locate their place of central management and control in a foreign jurisdiction. Source taxation is arguably preferable from an administrative efficiency point of view.

The current international tax system, as found in the OECD Model Convention, on which most bilateral tax treaties are built, and that underlies the examined treaties, fails to mirror the theories discussed above. The theory and the doctrinal material suffer a disconnect in that the rules often violate the theories underlying international income taxation. This is partly because some theories do not work in practice. For example, the entitlement theory does not answer the question of which country contributes more to the production taxable income. It is therefore not possible to found the taxation of income solely on this theory. But it is also because the decision has been made not to use the theories.

The current international tax system is furthermore biased against source countries. First, the current system fails to promote the economic allegiance theory in that it prevents the country where business income originates to tax that income, unless it is earned through the higher threshold of a permanent establishment. Second, it prevents source country taxation of royalties. Third, consumption or place of sale is not recognized in
establishing jurisdictional nexus. Fourth, it provides the residence country with the residual right to tax income while limiting source country taxation.

In order to conquer the bias against source countries all the factors underlying economic allegiance theory should be employed in determining tax jurisdiction. Under the economic allegiance theory, countries where one of the factors (benefits from public services, use of investment environment, or use of natural resources) is present will be entitled to share in the taxation of the income regardless of the character of the income as business or property income under our current system. Moreover, the place of residence is often not equivalent to the place of consumption, as envisioned by the League of Nations when constructing the permanent establishment rule. The place of consumption should therefore be given significant recognition in the allocation of taxing jurisdiction. For electronic commerce purposes, the place of consumption as the factor that informs tax jurisdiction would ensure that countries that provide a consumer base are entitled to tax the income arising from foreign vendor activities.

The benefit theory is also violated under the current tax rules. Again the theory and the doctrinal material suffer a disconnect as there is no taxation based on the benefits received through public service of a country. Taxpayers who benefit from public services, for example infrastructure provided by the source country, are not subject to tax in those countries. The benefit theory provides that the country that incurs expenditures in providing infrastructure for income producing activities is entitled to tax income from those activities. Both the economic allegiance theory and the benefit theory provide
justification for residence as well as source countries for claiming tax. In order to counter
the violations and bias against source taxation under the current rules, and ensure that
both residence and source countries get a fair share of the international tax base, new
rules have to be developed.

When developing new rules, a few fundamental principles should be respected. First, in a
perfect world international income would not be taxed more or less than income earned
domestically and the tax on that income would be shared fairly by the countries entitled
to tax that income. I am therefore a proponent of the argument that international taxation
should be guided by the principle of single taxation and inter-nation fairness. The single
taxation principle provides that cross-border income should be subject to tax once, and
once only.\textsuperscript{504} Both the goal of preventing double taxation and the efforts in preventing
under-taxation are incorporated in this principle. Income may be taxable in both the
source and residence country as long as such taxation does not exceed the total level of
taxation in the residence country. Therefore, the rate of taxation in the source country
should not exceed the residence-based rate of taxation in order for both countries to share
the taxation of cross-border income without over-taxation.

Second, a fair share of the international tax base must be allocated among the players to
accomplish inter-nation fairness.\textsuperscript{505} Indeed, the primary objective of international taxation
should be inter-nation fairness, which should override other policy objectives such as
capital export neutrality, capital import neutrality, and inter-taxpayer equity, objectives

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\textsuperscript{504} Reuven S. Avi-Yonah, "International Taxation of Electronic Commerce" (1997) 52 Tax L. Rev. 507 at
517.

\textsuperscript{505} Bird and Mintz, \textit{supra} note 481, at 420.
that are often conflicting and insufficient in theory and practice.\textsuperscript{506} When talking about “fairness” the question as to what constitutes fairness naturally arises. It is a complicated concept to use in international taxation, since countries do not necessarily share a common understanding of “fairness”. Using common interpretive tools under Canadian jurisprudence, the dictionary meaning of “fair” includes “just or appropriate”, “treating people equally”,\textsuperscript{507} and “free from bias, dishonesty, or injustice”.\textsuperscript{508} In the public finance literature, “tax fairness” has a specific meaning: the distribution of the tax burden among individuals or inter-taxpayer fairness.\textsuperscript{509} Inter-nation fairness is more than that, since it is concerned with tax entitlement, a fair level of source taxation, fair dealing among countries, and a fair redistribution of international income among countries.\textsuperscript{510} In inter-nation fairness, both under the economic allegiance theory and the benefit theory, entitlement to tax income would be fair where the country that claims tax jurisdiction has made economic contributions to the earning of the income. Under this approach, both the source and residence country are entitled to claim tax jurisdiction. Furthermore, a fair level of taxation at source has to be maintained to ensure inter-nation fairness. The level of sharing among the countries collecting and claiming the tax, through base and level of rates, has to be fair as well. Generally, the tax rates should be established on the basis of domestic policy concerns, and the source country should levy the same rates on foreign and domestic taxpayers to ensure fairness. Inter-nation fairness, moreover, requires fairness in the dealing among nations, which would mean that the international tax policy

\textsuperscript{506} Li, \textit{supra} note 7, at 586.
\textsuperscript{510} Li, \textit{supra} note 7, at 587.
process has to be open and allow countries to participate. Nations would have to work together with other nations towards a fair sharing of the international tax base while maintaining their sovereignty. The task to be carried out in a reformed system is the establishment of a measure of economic allegiance for dividing the tax base that will be generally accepted as fair and feasible.\(^{511}\)

A last and very important component of a revised approach is the redistribution of international income among developed and developing countries to maximize global welfare. Where redistribution is done on a national level under the ability-to-pay principle, the justification is found in vertical equity. The globalization of the world has increased the need for inter-nation redistribution, and there appears no sound justification for limiting redistribution to take place only on a domestic level.\(^{512}\) If there was a world taxing authority redistributing income on a world wide basis, it would be justified in redistributing wealth.\(^{513}\) A system where redistribution is undertaken through the design of tax rates would be particularly interesting in relation to developed and developing countries.\(^{514}\) The problem is that no country has ever made a genuine commitment to worldwide equity,\(^{515}\) and inter-nation equity has never become widely adopted, even by advocates of inter-nation equity.\(^{516}\) However as already argued, developed countries have an obligation to do what they can in redistributing income internationally, and

\(^{511}\) Bird and Mintz, *supra* note 481, at 421.


\(^{513}\) *Ibid.*


\(^{516}\) Bird and Mintz, *supra* note 481, at 424.
bridging the gap between economic reality for developed and developing countries. A controversial issue when suggesting global redistribution is the fact that developed countries will have to give up tax revenues for developing countries to ensure a fairer sharing of the global tax base. This is problematic because the developed countries have to do this without receiving any direct compensation or other benefits. One argument for giving up revenues is that developed countries, by ensuring that developing countries are getting a fair share of the international tax revenue collected from e-commerce, will not have to support the same countries in other ways in the future. Another argument is that the developed countries are globally responsible in giving up tax revenues to ensure that developing countries are not left back in an emerging economy. Such revenue might be used by the developing countries in improving infrastructures and reducing pollution by using more advanced technology, ultimately benefiting the world globally. Realistically, however, it is going to be a complicated task to convince countries to give up revenues for the benefit of others. But in the time and age we live in one can only hope that global fairness arguments weigh heavy enough to convince governments of developed countries to give up international tax revenues.

It is my position that inter-nation fairness has to be the primary objective of a reformed international policy for taxation of electronic commerce. I base my preference on the following reasons. Inter-nation fairness serves as a more critical component in international policy making compared to capital export and capital import neutrality. These principles have not successfully managed to influence international tax policy, despite much literature on international taxation urging the qualities of world efficiency
as a goal of tax policy. Furthermore, because treaty law is a result of negotiations between countries, and therefore often reflects compromises, arguments are often about fairness and not efficiency. In addition, countries are accountable to their residents and therefore will not choose economic efficiency on a worldwide basis on account of domestic economic efficiency. The controversial issue of giving up sovereignty is not challenged by inter-nation fairness, since the sovereignty of the countries is respected, because it leaves the question of distributing tax burdens to be decided within the country under domestic policy objectives. The highlighted objectives all serve to ensure a fairer sharing of the international tax base between developed and developing countries.

IV. SOLUTIONS TO THE PROBLEMS OF INTERNATIONAL TAXATION

There are several suggestions on how to implement this proposed approach to revenue sharing in international taxation. One type of approach is to implement some grand design by either restructuring the form of taxation or to delegate the problem solving to a higher, and presumably wiser, international authority than the OECD.\textsuperscript{517} The problem with this approach is that it only solves the problem if implemented simultaneously everywhere, which in reality seems unlikely to happen in major countries. Another problem is that in the absence of an overriding sovereign jurisdiction it is unlikely that an international authority will prove productive, since no country’s tax administration is likely to give high priority to enforce another country’s taxes. Such holistic approaches are, as argued by some,\textsuperscript{518} overly ambitious.

\textsuperscript{517} See Bird and Mintz, \textit{supra} note 481, at 422-425.
\textsuperscript{518} \textit{Ibid.} at 423.
Because the action of one affects the reality of others, it is my opinion, that joint welfare internationally will be maximized if everyone takes the actions of other countries into account to some extent. I am therefore a proponent of a holistic approach to the problem of international taxation. As long as there was a rough correspondence between economic and financial realities between the countries that ‘play the tax game’, it might not have mattered too much whether the territorial tax base was determined on the basis of the characteristics of the transaction, entities, or something else by the individual players. But where such correspondence is no longer present, which seems to be the case more often, the mainstay of the OECD consensus and principles are unlikely to suffice.\footnote{ Ibid. at 424.} Because such principles and consensus have emerged over time, the guidelines on how to divide the tax base under a given economic reality are no longer present because the economic reality has changed with e-commerce transactions. New guidelines are therefore needed. The best solution to developing new principles is through a cooperative game, through repeated discussion, and interactions. A rough agreement on fundamental principles for dividing the tax pie internationally has to be found.

V. Reformed System Proposal

A. Proposal

As argued above, under a reformed system of international taxation, inter-nation fairness should be the primary objective and single taxation should be the guiding principle.
Different systems could accomplish this goal, but I prefer a tax system where characterization is not necessary. My proposal is to subject all income arising from e-commerce transactions to a withholding tax of 10% collected in one common pool of taxes and distributed to the treaty partners on the basis of the activity of e-commerce through the Internet in the particular country. Whether the transactions are generating business or property income is no longer a question. This common pool system would have to allocate global e-commerce profits between the players and resembles a profit split method. The factors used to allocate profits between the players should be based on the economic factors that contribute to generating profit. The profits is to be allocated on the basis of the e-commerce activity of the transactions, both the producing activities and the receiving activities, and then shared between all participants of the game.

i. Benefits

There are several benefits under the proposed system. First, the residence country and the source country, as we know them now, would receive a portion of the tax collected, which would promote inter-nation equity and fairness. Second, the abuse of the permanent establishment threshold would be accounted for as well, which would partly eliminate the base erosion problem, and also promote equity. Third, the proposal aligns with the benefit and entitlement theory. Fourth, the difficulties of characterization would be eliminated, which would lead to ease and reliance both for taxpayers and authorities, thereby promoting administrability. Fifth, the proposal would present a more balanced

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sharing of the overall tax revenues, whereby inter-nation equity and fairness would be accomplished. It would in other words ensure a fairer sharing of the global tax base than what we currently have. The common pool method would ensure a better sharing of the international tax base in three ways. First, it would promote inter-nation fairness by ensuring a more equitable allocation of income among countries. Both e-commerce importers, providing a market base, and e-commerce exporters, providing the vendors, developers and advanced technology would share the global profit from e-commerce. The shackles of an ancient system would no longer prevent the traditional developing countries in sharing the fruit of the future harvest from technology. Second, it is in line with economic theories of allegiance, benefit and entitlement. The idea of splitting income at a ratio of three fourths to one fourth between developed and developing countries based on the benefit theory was developed by Schanz in 1892 but the economists appointed by the League of Nations suggested that countries could agree by treaty to develop reciprocal rules of origin or source for specific income classes and apply only a percentage of the normal tax rates to such income. The developments under initially the League of Nations and subsequently the OECD, were an attempt to find concepts and pragmatic solutions on which to base a split among the countries. But in today’s world, the realm under which the rules and principles were developed is no longer the same. The common pool method therefore seeks to apportion income from e-commerce among the players in the tax game on a formula base on the connection between the income and each jurisdiction with a genuine claim to tax that income. Third, it is simple and easy to administrate and thereby promotes the principle of simplicity and efficiency. The proposed system benefits from several advantages compared to the
currently employed system. It would be more equitable and fair in allocating income among jurisdictions and would prevent artificial characterization of income and thereby very creative tax planning. It would also be more consistent with economic theory and the economic reality of today’s international tax arena, where e-commerce is a reality.

ii. Drawbacks

This suggested solution is, however, not flawless. First, the tax rate on the withholding tax suggested would be lower than that applied today. Overall, countries would experience a slight decline in revenues collected, because the overall amount would be collected at a lower rate. The base erosion problem is therefore still an issue under this solution. Second, developed countries would have to give up tax revenues to the developing countries, which might prove problematic. Third, e-commerce transactions could possibly receive a different tax treatment over the same transactions in conventional commerce, which would violate neutrality. Fourth, further development or adjustments will likely be necessary in order for the method to work in the real world. Fifth, to implement a new and reformed tax system, international consensus is required. This is an enormous obstacle to the proposal. At the moment there does not seem to be such consensus. One way to reach consensus will have to be through repeated discussions in an international forum. It is important that benefits for the developed countries are brought out since it is likely that these countries – who have to give up revenues – will be opposed to the proposal. Arguments of global responsibility and global welfare will hopefully be able to prevail. Sixth, the strengthening of the source apportionment will more likely benefit developing countries, which are likely to argue for
the rules, whereas the developed countries are likely to argue for rules based more on residence. Since the majority of the OECD countries are developed countries, it will likely be complicated to reach an agreement on such rules. Finally, because the system splits the income from e-commerce between taxing jurisdictions that have a connection with the earning of the income, the current concept of permanent establishment in the treaty context would have to be expanded.

iii. Solutions

Some of the drawbacks of the common pool system could possibly be solved. First, the lower withholding tax rate could be promoted by the argument of an international bigger perspective. It is more desirable to get a smaller piece of the pie, while promoting the important features of a good tax system, and ensuring that the developing countries are not left hanging behind by playing the taxation game cooperatively rather than competitively. Second, the need for further development or adjustments could be achieved through discussions in an international forum, as already being done now. Third, the issue of international consensus has to be actively solved; it is however my hope that consensus will develop internationally as there seems to be a general understanding that the current international tax system is ripe for reform. Discussions in an international forum would be the tool through which consensus actively is to be established. The long-term global benefits of welfare and responsibility have to be strongly promoted in order to persuade the developed countries of redistribution. On the argument of global responsibility for the benefit of all, a requirement could be that a portion of revenues given up should be used by the developing countries to expand
infrastructures or reduce pollution by switching to more advanced technology. Finally, the expansion of the permanent establishment concept could be done by including not only a ‘physical presence’ but also an ‘economic presence’, based on the profits generated in order to enable e-commerce importing countries to levy tax on profits from electronic transactions.
CHAPTER SIX - CONCLUSION

The previous chapters examine the international tax system in the context of e-commerce transactions involving computer software transactions. The application of international taxation rules in electronic commerce is examined, and problems of international taxation are identified. The current rules are based on justifications that are no longer valid, thereby complicating taxation, creating arbitrary characterization outcomes, and ultimately unfairly dividing the global tax base between developing and developed countries. A system that takes all e-commerce activities, both based on consumption and on production, into account would ensure a more fair sharing of the international tax base. The division on the basis of volume would be fair in that it allocates on the basis of the activities undertaken by both the e-commerce importers and exporters and therefore gives to both countries. As such, a simpler system that will ensure a fairer sharing of the international tax base is proposed.

As discussed, a controversial issue when suggesting global redistribution is the fact that developed countries will have to give up tax revenues for developing countries to ensure a fairer sharing of the global tax base. This is problematic because the developed countries have to give up revenues without receiving any direct compensation or other benefits. There are however convincing arguments for developed countries to give up revenues in favour of developing countries. First, developed countries, by giving up revenues, are ensuring that developing countries are getting a fair share of the international tax revenue collected from e-commerce, and will not have to support the same countries in other ways in the future. This redistribution is similar to tax
expenditures in the domestic setting. Second, the developed countries are globally responsible in giving up tax revenues to ensure that developing countries are not left back in an emerging economy. Such revenue might be used by the developing countries in improving infrastructures and reducing pollution by using more advanced technology, ultimately benefiting the world globally. Realistically it is a tremendous task to convince countries to give up revenues for the benefit of others. But in the time and age we live in one can only hope that global fairness and welfare arguments are taken serious enough by governments of developed countries convincing them to give up international tax revenues.

Chapter two's examination of the income characterization rules suggests that the distinction between business and property income is not inevitably valid in the context of e-commerce. Three motives for characterizing income are identified. First, historical reasons and administrative efficiency are a rationale for characterizing income and distinguishing between income from different sources. Incentive reasons are also a significant justification. Administrative efficiency comes at a high price, base erosion, especially for developing countries, but also for developed countries. Second, the limitation of tax abuse is a reason for characterizing income by its source. The problem with this argument is, however, that the international characterization process cannot account for the problem in the same way the domestic rules can. The characterization of income as business income under the current rules divergently opens the door to possible abuse. The limitation of tax abuse argument is therefore not valid in the context of e-commerce. Third, incentive rules are a reason for characterizing income. By offering
certain special rules for taxation and deductions for one type of income (business income) that are unavailable for another type of income (property income), countries support the earning of income from an active business in the expectation that the behavior of the taxpayers will be changed by the preferential treatment. To promote active business through such rules, however, violates the neutrality principle and disturbs inter-nation equity. Incentive rules are therefore not a feature that it is desirable to base international tax rules on. Overall, the rationale for characterizing income internationally is a historical hangover and there is no convincing rationale supporting the continued distinction between the two types of income. In fact, the distinction seems to aggravate the difficulties experienced with income taxation arising in the e-commerce arena. I therefore suggest that the characterization concept is replaced with a different system, one that does not require characterization and that promotes and ensures the features of a good tax system.

Chapter three examines the development in international guidance found in the OECD Model Convention with recommendations for the application of the traditional rules to e-commerce transactions. The examination reveals a general bias against source country taxation. The guidance in the OECD Model Convention strives to treat similar economic activity the same way regardless of the medium through which the commerce is conducted and clarifies the treatment of software payments and the taxation thereof. Traditional rules and concepts are modified to accommodate e-commerce transactions, but uncertainties and complications arise in the realm of computer software payments. The rules are getting more and more complex. At the same time these rules are getting
more and more problematic as they are forced to fit transactions they were not developed
to tax. The bias against source country taxation under the international guidance and the
application of rules developed in the pre-e-commerce area, are becoming outdated.
Moreover, the rules support an unbalanced sharing of the global tax base between
developed and developing countries.

Chapter four's examination of the international position on the characterization of e-
commerce transactions involving computer software discloses some overall consistency
between the OECD position and the examined jurisdictions. Several results are,
however, based on different reasons. When each jurisdiction is compared there is mostly
inconsistency in the reasons for characterizing income as giving rise to a certain type of
income. Generally, a different approach is employed by China and Chile compared to the
U.S., Canada, and Australia. It is worth repeating here, that the divide is between the
developing countries and developed countries, as well as from the approach taken by the
OECD. Mostly, jurisdictions favour a characterization as royalties where there is
inconsistency across jurisdictions and towards the OECD position. Again, this is not
surprising, as the royalty characterization results in source-based taxation, facilitating a
collection of tax revenues in the source jurisdiction. Where the income is characterized a
business income, the higher threshold for domestic taxation must be met, making it
harder to raise revenues from such income. This difference in characterization is a result
of the imbalance in the sharing of the international tax base between the countries. The
different results in characterization, moreover, become a problem where there is
inconsistency between the treaty partners. Consistency in the characterization of income in the jurisdictions is therefore very important.

Whether or not the OECD position will be fully adopted for all income arising from computer software payments is still uncertain, since this will mean giving up jurisdiction to tax for the traditional source countries, as a higher threshold has to be met before tax can be imposed where the income is characterized as business income or services income as opposed to royalty income. This will further erode the share of the global tax base from e-commerce for developed countries. Again, the issue of the validity of categorizing of e-commerce income as either active business income or passive property income is raised. The examination of the characterization practices magnifies an already existing issue in international taxation, which is the legitimacy of the income categories as examined in chapter three. The problem that e-commerce furthermore reveals is the base erosion, when the royalty category becomes narrowed and the business income category becomes widened. When e-commerce transactions are more commonly characterized as giving rise to business income as recommended by the OECD Model Convention and commentary the source countries experience an erosion of their traditional source based system of taxation, when the higher permanent establishment threshold for taxation cannot be met. The current international taxation rules for e-commerce fail to secure a fair sharing of the global tax base.

Chapter five’s examination of the sharing of the international tax base reveals that the theoretical basis for taxing international income is not supported to a full extent under the
current regime for international taxation of income. Furthermore the gap between
developing and developed countries in sharing the international tax base is widening.
The current international tax system on which most bilateral tax treaties build, as found in
the OECD Model Convention, and that underlies the examined treaties, fails to mirror the
theoretical foundation and is biased against source countries. In order to conquer the bias
against source countries, the factors underlying economic allegiance theory should be
employed in determining tax jurisdiction. This way, countries where one of the factors is
present will be entitled to share in the taxation of the income regardless of the character
of the income as business or property income under our current system. In order to
counter the violations and bias against source taxation under the current rules, and ensure
that both residence and source countries get a fair share of the international tax base, I
argue that new rules have to be developed.

I suggest a reformed system where characterization is not necessary and that is more
focused on the benefits and facilities that enable the non-resident to derive income from
foreign sources. All income arising from e-commerce transactions is subject to a
withholding tax of 10% under this system, collected in one common pool of taxes and
distributed to the treaty partners on the basis of the activity of e-commerce through the
Internet in that particular country. International consensus is of course required for this
system to work. The question of whether such consensus will develop internationally
remains unanswered. However, it appears that the general understanding internationally
is that the current international tax system is ripe for fundamental reform. A reformed tax
system might therefore be closer than it appears.
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