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

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Abstract

The proposal made in this paper is a modest one: that high-income countries should further the cause of reducing global inequality by ensuring that in their tax treaties with low-income countries they do not usurp needed revenues by reducing low-income countries' ability to collect tax on income with a source in the low-income country. This argument is made in the specific context of the taxation of royalty payments, which present one of the most extreme examples of high-income countries unfairly confiscating revenues that appropriately belong to their low-income treaty partners. The Organisation for Economic Co-operation and Development (OECD) model tax treaty, which most high-income countries in the world closely follow in negotiating their own tax treaties, provides that to avoid double taxation, source countries (invariably low-income countries) should reduce their rate of withholding tax on royalty payments to zero. Thus low-income countries that enter into tax treaties modelled on the OECD model convention are unable to levy a tax on royalty payments that

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

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

A number of well-known development economists have recently called for urgent and drastic action to deal with the crises in world poverty and inequality. Jeffrey Sachs, known for his work as economic advisor to governments around the world and director of Columbia University's Earth Institute, has published a plan calling for roughly $150 billion in additional foreign aid a year. He contends that properly disbursed this amount could bring an end to mass destitution (such as the 1.1 billion extremely poor living on less than $1 a day) within 20 years.[3] Branco Milanovic, an economist with the Carnegie Endowment for International Peace and the World Bank, in a book in which he scrupulously documents the increasing income inequalities between countries, calls for global redistribution through taxes that would be levied on the world's rich by an inte their rate of withholding tax on royalties payments to zero.[5] Thus low-income countries that enter into tax treaties modelled on the OECD model convention are unable to levy a tax on royalty payments that have a source in their jurisdiction. In many cases, as is argued in more detail below, this simply results in a net transfer of revenue from the low-income country's treasury to the treasury of the high-income country.

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

The suggestion that high-income countries should use their tax systems and, in particular, tax treaties, to assist low-income countries, is not novel.[6] Almost from the emergence of tax treaty negotiations in the 1920s and 1930s, low-income countries have recognized the importance of appropriately drafted tax treaties in preserving their revenue raising capacities. The United Nations has had the problem under on-going review since the late 1960s. A number of articles have been written over the years making the case for strong source taxation generally and arguing that this jurisdiction to tax should be preserved in treaties.[7] Recently, Karen Brown, a tax professor at George Washington University Law School, has written a series of articles arguing that the United States should modify its tax treaty stance and its domestic tax rules to protect the tax bases of low-income countries.

conference was held in Mexico. The conference was attended by the United States, Canada, Mexico, Argentina, Chile and a number of other Latin American countries. The immediate objective of the conference was to settle tax problems between countries in the Western Hemisphere; however, an important issue for discussion was the continuing conflict over residence versus source principles. A majority of the participants, who represented low-income countries, approved a draft model treaty that gave taxation rights almost exclusively to

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

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

[23] Argentina, Brazil, Chile, France, Federal Republic of Germany, Ghana, India, Israel, Japan, the Netherlands, Norway, Pakistan, the Philippines, Sri La

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

Although the privileging of residence-based taxation of royalty payments has always been unfair to source countries, that unfairness has been exacerbated by two trends over the last forty years. First, due to a number of factors the value of royalty payments has grown significantly: the upsurge in reliance on outsourcing (and the related transfer of technical knowledge); the dramatic increase in the use of computers, computer processes and software, which are transferred to almost every jurisdiction where an enterprise carries on operations; and, the increased ease with which intangible property giving rise to royalty payments may be relocated anywhere in the world. Second, the increasing ease of characterizing the consideration for the with low income countries – only 17 of its tax treaties (or just over 40%) have been individuals (this argument does not apply equally to corporations) to total their income from all sources, the residence state alone can impose tax based on taxpayer's ability to pay; and finally, the taxation of worldwide income in the state of residence preserves capital export neutrality, which means that taxpayers will be tax-indifferent between exploiting their property for the purpose of earning royalty income in their home jurisdiction or in another jurisdiction.[37] However, at best these are arguments for preserving some ability of the residence country to tax royalties, and not a justification for exclusive jurisdiction.[38] Indeed, based on economic nexus, the source country has an arguably stronger claim to tax the revenues produced by the use of the royalty-producing property. The income arose from the property's use in that jurisdiction, so there is an obvious economic connection to the source state. The benefits provided by the source state are significant. On a general level, the source country provides the benefit of infrastructure, including communications (e-commerce) infrastructure, and the right to incorporate separate legal entities.[39] In addition, the source state may provide a well-educated, highly-skilled workforce that can be employed in the technology sector. It will, as well, provide an orderly market place for the taxpayer to exploit.[40] More specifically in the context of royalty payments, where the property that gives rise to the income is an intangible, the intellectual property protections provided by the source country dwarf in significance those provided by the residence state.[41] Moreover, where the source state is a low-income country, the ability to tax the royalty income at source might be seen as one way of compensating low-income countries for complying with the intellectual

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

[38] Some commentators, eg, Klaus Vogel, have argued that ideally royalties should be taxed in both the source and residence state as a way of preserving neutrality and equity. Vogel argues that to be perfectly neutral the "interest" component of a royalty payment should be taxed at the place of residence of the lessee/user, while the "sales price" (the amortization of the underlying right) and the risk (services) portions of the royalty payment should be taxable in the state of residence. Accepting the practical limits of unbundling a royalty payment into its three component parts, Vogel proposes that a fixed share of the payment should be taxable by both the residence and source states (¼ to the state of residence, and ¾ to the state of source); a solution that is similar to that proposed in this paper. Vogel, 'Worldwide vs. source taxation of income – A review and re-evaluation of arguments' (Pt 2) (1988) 10 *Intertax* 310, 317–318; and 'Worldwide vs. source taxation of income – A review and re-evaluation of arguments' (Pt 3) (1988) 11 *Intertax* 393, 402.

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

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

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

property regimes imposed by high-income countries.

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

Third, exclusive residence-based taxation is sometimes justified on the ground of administrative ease. Administrative justifications for residence-only taxation fall into four categories: first, the difficulty of determining the geographical location of the

assist in combating abusive schemes. The non-taxation of royalty payments at source creates additional incentives for taxpayers to avoid taxation by inflating the royalty payments received from a particular jurisdiction. Where royalty payments are not subject to tax, but payments characterized as from another source (for example, business profits) are subject to tax, taxpayers will seek either to recharacterize their cross-border payments as royalty payments to access the tax exemption or increase the value assigned to the royalty property so that larger royalty payments can be made tax-free.[54] Unduly large royalty payments may particularly be a problem for low-income countries that lack transfer pricing rules, or the ability to enforce those rules.[55] Unjustifiably increasing royalty payments may be particularly appealing if the royalty payment were not subject to tax in the residence country either, say, because the residence-country parent company was non-taxable or had losses.[56] In addition, investor making a transnational investment must also comply with the tax rules of the source country. In most cases the costs of complying with source country taxes will be a small percentage of the additional costs of exporting or doing business abroad. In any event, flat-rate withholding taxes on gross receipts that are withheld by the payer in the source country are the simplest taxes to calculate and pay.

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

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

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

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

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

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

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

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

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

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

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

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

[61] See paragraphs 8 and 9 of the commentary to the UN model convention.

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

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

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

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

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

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

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

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

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

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[64] For example, at the 2005 International Fiscal Association Congress in Buenos Aires several panel members discussed whether particular payments in four different cases would appropriately be considered to be "royalties" given the definition of royalties in the OECD model convention. In each of those cases the panel members differed about whether particular payments were properly royalties, business profits, capital gains, or payments for services. See Catherine Bobbett and John Avery Jones, 'The Treaty Definition of Royalties' 60(1) *Bulletin for International Taxation* 23. See also Sheppard, (Pt 2), above

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

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

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

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

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

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[72] UN model convention, above n 24, commentary para 10.

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

[74] Canada, Department of Finance, *Special Report: The Federal Budget* (1993) 20.

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

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

Canada has negotiated exemptions from the royalties withholding tax in 26 of its 35

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

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

The OECD model convention provides that source countries should not provide a withholding tax on royalty payments. This aspect of the model treaty has been followed in many of the US treaties with low-income countries and has been implemented among states of the European Union. However, both Canada and Australia have allowed source countries to collect withholding taxes in their treaties with low-tax countries. Although each of these countries has made some effort to provide low-income countries with a greater

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

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

COUNTRY	GDP (PPP)	TREATY PARTNER		RATE WITHHELD		EXEMPTION FROM WITHHOLDING										REDUCTION FROM WITHHOLDING RATE									
						Canada					Australia					Canada					Australia				
		Can	Aus	Can	Aus	Cultural	Patent	Software	Scientific	Other	Cultural	Patent	Software	Scientific	Other	Cultural	Patent	Software	Scientific	Other	Cultural	Patent	Software	Scientific	Other
Algeria	6,107	•		15			•	•																	
Argentina	12,106	•	•	15	15											•	•		•	•	•			•	
Armenia	3,671	•		10																					
Australia	29,632	•		10				•																	
Austria	30,094	•	•	10	10	•	•	•	•																
Azerbaijan	3,617	•		10													•	•	•						
Bangladesh	1,770	•		10																					
Barbados	15,720	•		10		•																			
Belgium	28,335	•	•	10	10	•	•	•	•																
Brazil	7,790	•		15																					
Bulgaria	7,731	•		10		•																			
Cameroon	2,118	•		15/20*																•					
Canada	30,677		•		10								•												
Chile	10,274	•		15																					
China	5,003	•	•	10	10																				
Croatia	11,080	•		10																					
Cyprus	18,776	•		10		•																			
Czech Republic	16,357	•	•	10	10																				
Denmark	31,465	•	•	10	10	•	•	•	•																
Dominican Republic	6,823	•		18		•																			
Ecuador	3,641	•		15															•						
Egypt	3,950	•		15																					
Estonia	13,539	•		10																					
Fiji	5,880		•		15																				
Finland	27,619	•	•	10	10	•				•															
France	27,677	•	•	10	10	•	•	•	•	•															
Gabon	6,397	•		10																					
Germany	27,756	•	•	10	10	•	•	•	•																
Guyana	4,230	•		10																					
Hungary	14,584	•	•	10	10	•																			
Iceland	31,243	•		10		•	•	•	•																
India	2,892	•	•	15	15														•					•	
Indonesia	3,361	•	•	10	15																			•	
Ireland	37,738	•	•	10	10	•	•	•	•																
Israel	20,033	•		15		•																			
Italy	27,119	•	•	10	10	•											•	•	•						
Ivory Coast	1,476	•		10																					
Jamaica	4,104	•		10																					
Japan	27,967	•	•	10	10										•										
Jordan	4,320	•		10																					
Kazakhstan	6,671	•		10																					
Kiribati	800		•		15																				
Kenya	1,037	•		15																					

COUNTRY	GDP (PPP)	TREATY PARTNER		RATE WITHHELD		EXEMPTION FROM WITHHOLDING										REDUCTION FROM WITHHOLDING RATE									
						Canada					Australia					Canada					Australia				
		Can	Aus	Can	Aus	Cultural	Patent	Software	Scientific	Other	Cultural	Patent	Software	Scientific	Other	Cultural	Patent	Software	Scientific	Other	Cultural	Patent	Software	Scientific	Other