Nothing quite compares to the exhilaration that an author feels when her work is being reviewed by her peers. I was flattered by the reviews of my book by Dov Begun, Arthur Cockfield, and Niv Tadmore. I now face the challenge of replying to some of the interesting issues raised by them. I thank Neil Brooks for giving me this opportunity to write a brief response.

Begun reviews the book and nicely captures its thesis. I thank him for that. Cockfield and Tadmore each focus their respective comments on one particular aspect of the book: Cockfield takes me to task on my support for global formulary allocation of business profits, and Tadmore expands my analysis of income characterization. All three reviews touch on the issue of tax enforcement. After reading their comments, I wished that I had had another year to complete the book.

On the assumption that many readers have not yet read the book, I will first summarize its main arguments and then address the issues of income characterization, administrative constraints on tax reform, and national sovereignty. I will focus on the sovereignty question because a high level of international coordination is critical to any international tax reform.

**MAIN ARGUMENTS OF THE BOOK**

The book is a study of the current state of international tax law and its application (or non-application) to electronic commerce in Canada, China, Hong Kong, Japan, Singapore, and the United States (chapters 1 to 11). Its purpose is to examine the extent to which current theories and principles of international taxation remain valid and the extent to which the fundamental issues need to be rethought in the age of electronic commerce.

Chapter 12 argues that the existing concepts and principles have served the world well in the “old” economy, but decreasingly serve to carve up the international tax
base in a reasonable and sustainable way in the “new” economy.\(^1\) I discuss why the concepts of corporate residence, characterization of income, source, and permanent establishment are increasingly difficult to apply. I also analyze why transfer-pricing rules are problematic in terms of economic theory, administrative efficiency, and the interpretation of article 9 of the model tax convention prepared by the Organisation for Economic Co-operation and Development (OECD).\(^2\) Chapter 12 concludes with the following statement:

A fundamental tension underlying the whole international tax system is that MNEs [multinational enterprises] operate on a global basis, whereas tax authorities operate on a national basis. The reality of the contemporary world is that separate national governments are not in a position to adequately monitor intrafirm transactions. When tax administrators everywhere do their best to get a “fair” share from an MNE’s global income, the absence of effective international coordination is bound to give rise to overtaxation or undertaxation of the MNE’s income.\(^3\)

Chapter 13 argues that the beginning of the 21st century, with an increasingly global economy, offers a golden opportunity to re-evaluate and reform the international tax system, which is largely a creature of the industrial age at the beginning of the 20th century.\(^4\) I maintain that the theoretical foundations of the international tax system (that is, the economic allegiance theory and the benefit theory) remain valid and should be given their original intent and scope. I also emphasize that the principles of “single taxation” and “inter-nation fairness” should continue to guide international tax reform.

Cockfield and Tadmore seem to agree with me up to page 558 of the book. Their comments zero in on the last 30 pages, where I propose a reform package consisting of a uniform withholding tax on portfolio income and a global profit-split method for the allocation of business profits. In making the proposal, I assumed that (1) countries continue to rely on income taxation as a useful instrument for raising revenue and redistributing social income; (2) a nation asserts as much sovereignty in tax policy as possible without endangering its economic relations with other nations; and (3) tax havens will continue to exist and have little interest in cooperating with other countries. I acknowledge several limitations, including practical difficulties of administration.

I maintain that the proposal is “evolutionary and pragmatic.”\(^5\) It is based on some old ideas of international taxation. From the outset, countries have imposed

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3 Supra note 1, at 556.
4 Ibid., at 583-84.
5 Ibid., at 591.
withholding taxes on investment income earned by non-residents, primarily because these taxes are easier to enforce than taxes assessed directly on non-residents. Formulary allocation of profits was widely used until the arm’s-length standard was entrenched in tax treaties and domestic law in the 1960s and 1970s. It is currently used in Canada and the United States with respect to allocation of income at a subnational level. There has also been a gradual shift toward the use of formulary allocation in transfer-pricing adjustments. I argue, moreover, that the global profit-split method is theoretically sound since it reflects the nature of multinational enterprises. Combined with the uniform withholding tax, the global profit-split method could remove the attraction of tax havens by allocating business profits to locations where substantive economic activities take place. In theory, the proposal is more effective than the OECD-led campaign against harmful tax competition. The main challenges to the proposal are transition difficulties and the development of an international consensus.

**INCOME CHARACTERIZATION**

The characterization of income is crucial to the scheme of international taxation. In the book, I discuss the importance and application of this concept in the context of tax treaties and the domestic law of the six jurisdictions in the study. I also analyze the difficulties associated with the characterization of income derived from electronic commerce transactions. I attempt to mitigate the difficulties of characterization by reducing the need for it. Instead of classifying income according to numerous categories (such as business profits, income from dependent personal services, dividends, interest, royalties, and capital gains), I propose to characterize income as either “portfolio” income or business profits.

As Tadmore correctly points out, however, my book maintains the distinction between royalties as part of portfolio income and active business profits without explaining how royalties may be distinguished from business profits. I thank Tadmore for his critical and more thorough analysis of the characterization issue. I share his concerns with the potential erosion of source-based taxation of income from digital transactions. I also agree with him that mere reinterpretation of the existing concepts in the electronic commerce context “can only go so far” and that new approaches, including tax administrative solutions, need to be studied.

**ADMINISTRATIVE CONSTRAINTS**

The importance of administrative capabilities in international tax reform cannot be emphasized enough. Tadmore quotes Thomas Adams (1932): “[T]ax should not be assigned to a jurisdiction which cannot effectively administer and collect the tax.”

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6 Ibid., at 607-12.
7 Ibid., at 420–44.
Cockfield quotes Richard Bird (2003): “Changes in tax policy and tax structure reflect changes in administrative realities as much [as] or more than they do changes in policy objectives.”9 As stated in my book, I am in total agreement: “Pragmatic concerns have shaped the current international tax system, and they will undoubtedly influence its development in the future.”10

The proposed uniform withholding tax and global profit-split method are theoretical at this stage, but their implementation is not impossible. Tax compliance and administrative capabilities improve over time. Tadmore suggests that the enforcement solutions to the proposed uniform withholding tax could be similar to those currently being designed for collecting the value-added tax in the European Union. Cockfield implicitly assumes that technological solutions are possible, because such solutions are necessary to implement his proposed quantitative economic presence threshold to replace the current permanent establishment threshold.

Compliance and enforcement difficulties associated with the proposed global profit-split method are different in nature. These involve the computation of profit in accordance with standardized accounting and tax rules, the identification of “integrated business,” and the determination of the factors for purposes of formulary allocation. It will take much longer for the world community to reach a consensus on these issues, but the difficulties are not insurmountable. I agree with Cockfield that the key question is how to get there from here. One of the hurdles is national tax sovereignty.

**TAX SOVEREIGNTY**

“No area of the law is closer to the subject of sovereignty than taxation.”11 As long as diversity of cultural, economic, political, and fiscal factors leads countries to adopt a wide range of income tax systems, countries will try their best to preserve their tax sovereignty.12 In the absence of “true” international tax law in the sense of a multilateral tax convention or legislation of an international tax organization, national tax sovereignty will result in divergent policies and principles governing the taxation of international income. Therefore, any tax reform that requires a high level of international coordination or cooperation must deal with the sovereignty hurdle. It is important to highlight, however, that national tax sovereignty is not absolute, and “complete sovereignty is impossible, except perhaps for a country that is totally isolated from external influences, such as Burma.”13

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10 Supra note 1, at 591.
There are numerous examples of circumstances in which countries limit their tax sovereignty owing to market forces, pragmatic concerns, treaty negotiations, regulatory emulation, and external influences:

1. Because capital is highly mobile, countries generally set their withholding tax on portfolio income and corporate income tax rates at a competitive level.\(^\text{14}\) The corporate tax rates among OECD countries have recently moved closer together.\(^\text{15}\) Similarly, countries voluntarily limit their jurisdictional

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\(^{14}\) See, for example, Jack M. Mintz, “Is National Tax Policy Viable in the Face of Global Competition?” (1999) vol. 19, no. 1 *Tax Notes International* 99-107, at 101 (“A country with a high corporate income tax rate can, therefore, lose revenue to other jurisdictions”); and McLure, supra note 13, at 329 (“To avoid loss of tax revenues, a nation may thus be forced to impose lower statutory rates on income from capital than otherwise”).

\(^{15}\) For example, if the highest rate and the lowest rate are ignored, the rates have converged at a cutoff rate of 40 percent in 2002.

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<tr>
<th>Country</th>
<th>Top corporate income tax rate</th>
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<td>Belgium</td>
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<td>Canada</td>
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<td>Denmark</td>
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<td>Finland</td>
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<td>France</td>
<td>34</td>
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<tr>
<td>Germany</td>
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<td>Greece</td>
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claims to economic activity located in that country or persons residing in that country.\textsuperscript{16}

2. Countries also give up tax sovereignty through bilateral treaty negotiations. In reality, the existence of the extensive treaty network, which is based on the OECD model convention, means that countries have agreed to a common set of international tax rules irrespective of differences among domestic tax laws. There is little sovereignty left when it comes to the meaning of “permanent establishment,” withholding taxes on dividends, interest, and royalties, and other issues covered by tax treaties. More important, with respect to the allocation of international business profits earned by multinational enterprises, article 9 of the OECD model convention has been widely adopted in bilateral tax treaties, and the interpretation of this provision is largely governed by the guidelines prepared by the OECD.\textsuperscript{17} For China and other countries that are developing their international tax rules, there is really no option other than to follow the OECD transfer-pricing guidelines.

3. While maintaining national tax sovereignty, many countries change their tax rules to ensure that they do not impose burdens on mobile factors dissimilar to those imposed by other countries, or that their anti-avoidance rules are as effective as those in other countries. Among the North American free trade agreement countries, there is evidence that Canada and Mexico have emulated the United States.\textsuperscript{18} The “controlled foreign corporation” rules in Canada and other OECD countries also have been largely modelled on the US rules.\textsuperscript{19}

4. External forces may make a country give up its sovereignty. One example is the OECD-led harmful tax competition campaign. Tax haven jurisdictions that are considered to have engaged in harmful tax competition are “encouraged” to mend their ways. If that fails, the OECD apparently intends to propose that its members undertake joint efforts to put pressure on tax havens. Therefore, sovereignty is limited not only for an individual tax haven country,


but also for each OECD member country. This example also demonstrates that OECD countries are prepared to sacrifice their sovereignty for the purpose of a common good. Another example of external forces limiting tax sovereignty is the rise of electronic commerce. As I explain in my book, the OECD has been at the forefront in developing a concerted approach to the taxation of electronic commerce. Many OECD member and non-member countries have formally or informally followed the lead of the OECD.

In the new economy, countries are much more connected than in the old economy. While in legal theory countries are totally able to determine their own internal tax policies, in reality these same internal policies have an impact far beyond the country’s borders and are a legitimate concern of other sovereign nations. Therefore, countries should be persuaded to coordinate their tax policies and cooperate in tax administration, through negotiation, accommodation, or policy emulation.

Otherwise, the tax system [of each country] will be “gamed” by taxpayers as transactions circle the globe in milliseconds via the Internet, and tax inspectors remain chained to the borders of each country. Interestingly, international cooperation will help nations preserve national control over tax policy and thus strengthen their fiscal sovereignty.20

With respect to the proposed global profit-split approach, what is important is coordination, not harmonization. I disagree with Cockfield’s statement that “effective formulary taxation will require an even greater sovereignty sacrifice because it will require the harmonization of corporate tax bases and possibly even tax rates.” As Cockfield mentions, the European Commission has moved away from corporate tax rate harmonization toward mere corporate tax base consolidation. This indeed, in Cockfield’s words, “offer[s] the tantalizing prospect of movement in the direction of formulary taxation.” Even with respect to corporate tax base, harmonization is not necessary. Presumably, profit could be computed in accordance with standardized national tax rules, and then allocated in accordance with a formula that is relatively accurate and widely accepted. The key difference between the current transfer-pricing methods and the proposed global profit-split method is not the computation of global profits of multinational enterprises, but the manner in which the profits are allocated to each jurisdiction. As Couzin writes,

[m]ultinational enterprises carrying on business through branches and subsidiaries around the world do, in effect, “apportion” their global profits. They do so, for example, by applying the arm’s-length standard to functions said to be performed or undertaken in various locations and by identified entities.21

The proposed global profit-split method would allocate the profits by using a formula.

It is perhaps time to appreciate the fact that while the concept of tax sovereignty remains, the cost of sovereignty keeps on going up.22 In order to regain the “sovereign powers they have ceded to multinational enterprises by establishing for themselves the jurisdictional reach of their corporate tax,”23 national governments should work hard on negotiating a workable formula for global profit allocation.24 The growing convergence or coordination of national tax rules gives tax “purists,” such as myself, reason to hope that the sovereignty hurdle to international tax reform could be overcome in the near future.

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24 For some recent comments on the pros and cons of the formulaic allocation method, see McIntyre, ibid.; Couzin, supra note 21; and J. Scott Wilkie, “Locating Corporate Business Income: Reconsidering the Tenets of International Tax Jurisdiction” (2003) vol. 51, no. 4 Canadian Tax Journal 1574-94.