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AN EQUITY-BASED, MULTILATERAL APPROACH FOR SOURCING INCOME AMONG NATIONS

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Abstract:

The source of income rules used in the United States and elsewhere in large part establish the contours of tax jurisdiction exercised by countries. The source rules play a vital role in the foreign tax credit system applicable to U.S. persons with foreign investment or business activities. The source rules also play a central role in the United States’ exercise of source taxation over foreign persons with U.S. businesses or investments. Other countries likewise use source rules or their equivalent in applying foreign tax credit or territorial systems to their residents and exercising source taxation over nonresidents. The current approach for sourcing income suffers from two related problems. First, the source rules lack coherence in that they fail to advance a consistent normative tax policy. More fundamentally, the rules fail to reflect the consistent application of the key principle appropriate for allocating nations’ primary taxing rights — namely, the benefits principle. The second problem is the variation in the source rules used worldwide. This may produce double taxation or non-taxation. This Article addresses both of these problems by offering an approach for sourcing income that has the potential for being adopted by countries on a multilateral basis. The Article develops an equity-based standard for sourcing that would allow for the derivation of source rules for various types of income. The core idea underlying the proposed sourcing standard is the benefits principle: income should be sourced to the country that provides the taxpayer with significant governmental benefits related to the derivation of the income. Specifically, the Article develops a standard that would devise source rules by evaluating the source of income on the basis of three factors: the destination of the services, property or capital giving rise to income; the location(s) of the activities giving rise to income; and the residence of the person receiving income. Based on this evaluation, the rule for a given type of income may divide the source of the income among multiple locations. By basing the source rules on an equity-based standard that allows source to be divided when appropriate, this Article seeks to rationalize and harmonize the provisions used to source income for purposes of taxing cross-border investment and business activities.
I. INTRODUCTION

The source of income rules used in the United States and elsewhere in large part establish the contours of income tax jurisdiction that is exercised by countries.\(^1\) Source rules do this by allocating a taxpayer’s income for purposes of assigning countries their rights to tax such income.\(^2\) Thus, source rules are of critical importance in the functioning of the income tax rules that apply to cross-border business and investment activities.

The source rules play a vital role in the foreign tax credit system applicable to U.S. persons with foreign investment or business activities. This is because a U.S. taxpayer is subject to an annual foreign tax credit limitation, which is generally equal to the taxpayer’s average U.S. tax rate multiplied by the taxpayer’s foreign source income as determined under the source rules.\(^3\) The source rules also play a central role in the United States’ exercise of taxation over foreign persons with U.S. businesses or investments. For the most part, only U.S. source income is subject to tax under the U.S. tax regimes that apply to foreign persons.\(^4\) Moreover, if the United States were to move to a full or partial territorial system for taxing U.S. persons, the source rules would assume even greater importance given that they would determine whether the United States would impose any tax (as opposed to a residual tax) on the income of U.S. persons from cross-border activities.\(^5\) Other countries likewise use source rules or their equivalent in applying foreign tax credit or territorial systems to their residents and exercising source taxation over nonresidents.\(^6\)

The current approach for sourcing income suffers from two related problems. First, the source rules lack coherence in that they fail to advance a consistent normative tax policy.\(^7\) While the U.S. rules are generally based

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2 This is to be compared to the use of the arm’s length method for allocating income among commonly controlled entities. See, e.g., I.R.C. § 482. Thus, whereas the arm’s method is used to allocate income among taxpayers, the source rules are used to allocate income within a particular taxpayer.

3 See I.R.C. § 904(a). All section references are to the Internal Revenue Code of 1986 as amended.

4 See I.R.C. §§ 871, 881, 882, 864.


7 See infra note 82-102 and accompanying text.
on the notion of sourcing income according to the location of economic activities that generate the income, they also promote other policy concerns, such as taxing income that is not likely to be taxed by foreign countries and encouraging U.S. export activities. More fundamentally, the source rules used by the United States and other countries fail to reflect the consistent application of the key principle appropriate for allocating nations’ primary taxing rights – namely, the benefits principle, under which income should be sourced to the country that provides the taxpayer with significant governmental benefits related to the derivation of the income. The connection to governmental benefits should be the guidepost for designing source of income rules, because the source rules define the scope of source taxation and source taxation is justified by governmental benefits provided to a nonresident by the host country. Furthermore, even where the source rules attempt to implement an economic approach for sourcing income -- an approach that can be consistent with the benefits principle -- the rules in the United States and elsewhere often produce distorted binary results: that is, generally all of the income from a transaction is either domestic or foreign source even though the relevant economic factors suggest that a division of the income is warranted. The results produced by these “single” source rules at times are arbitrary.

The second problem is the variation in the source rules used worldwide. This may produce double taxation -- two or more countries taxing the same income, a result that would impede the free flow of business and investment capital. Or alternatively, differences in countries’ sourcing approaches can lead to non-taxation -- no country taxing the particular income, which may encourage tax motivated transactions.

This Article addresses both of these problems by offering an approach for sourcing income that has the potential for being adopted by countries on a multilateral basis. The Article develops an equity-based standard for sourcing that would allow for the derivation of source rules for various types of income. The core idea underlying the proposed sourcing standard is the benefits principle, which calls for the sourcing of income on the basis of related government benefits. To an extent, the proposed approach is somewhat consistent with source rules currently used in the United States and elsewhere. However, unlike the U.S. rules and those of some other countries, the proposed approach would not take into account other policy concerns, with the exception of administrability. Moreover, the suggested approach would divide the income between geographical sources where more than one country provides significant governmental benefits that contribute to the earning of the income, whereas the current rules typically

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8 See infra notes 65-70 and accompanying text.
9 See infra notes 139-46 and accompanying text.
10 See id.
11 See infra notes 51-55, 91-93 and accompanying text.
12 See infra notes 94-97 and accompanying text.
13 See infra notes 103-24 and accompanying text.
assign income to a single geographical source. By basing the source rules on a benefits principle-based standard that allows source to be divided when appropriate, this Article seeks to rationalize and harmonize the provisions used to source income for purposes of taxing cross-border investment and business activities.

This Article differs from prior work in this area in two important respects. First, it offers a multilateral approach for sourcing income, whereas earlier studies of significance have taken a national approach, evaluating for reform the source rules of the United States. Second, unlike other scholarship devoted to the source rules, the Article develops a single standard for sourcing income that promotes equity by dividing the income tax jurisdiction of countries based on the provision of government benefits that relate to the income. Thus, the Article is important in that it develops an equity-based standard for sourcing income that may gain international acceptance.

Part II of the Article briefly describes source rules used in the United States and other countries, reviews the principles underlying the current source rules, and describes the significant problems caused by the current approach. Part III develops a standard for devising source rules, first by identifying the benefits principle and administrability as the appropriate principles for developing the standard for sourcing income. This part then formulates a standard that would devise source rules by evaluating the source of income on the basis of three factors: the destination of the services, property or capital giving rise to income; the location(s) of the activities giving rise to income; and the residence of the person receiving income. Based on this evaluation, the rule for a given type of income may divide the source of the income among multiple locations. Part IV then illustrates the use of this standard by suggesting revised source rules for several types of income. Part V concludes the Article.

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15 This would be analogous to the international acceptance of the of arm’s length principles to allocate income among commonly controlled entities. See, e.g., OECD Model Income Tax Treaty, Article 9 (calling for the use of arm’s length principles to allocate income among associated enterprises).
16 This Article will not address the related subject of sourcing deductions, that is, linking expense deductions to income from different sources. For purposes of both source and residence taxation, it is often necessary to determine the net income from different sources. See, e.g., I.R.C. §§ 871(b), 882 (a), 904(a). This requires that deductions be allocated and apportioned to income from different sources. Under the U.S. rules, deductions are generally matched to gross income based on the factual relationship between the deductions and income. See Treas. Reg. §§ 1.861-8, 8T. There are also special allocation and apportionment rules for interest expense and research and development costs. See Treas. Reg. §§ 1.861-9, 9T, 10T, 17. While determining appropriate rules for sourcing deductions is certainly important in crafting harmonized source rules, this issue will be left for a future endeavor.
II. CURRENT SOURCE RULES: DESCRIPTION, PRINCIPLES AND PROBLEMS

This part proceeds by briefly describing source rules used in the United States and other countries. This is followed by a review of the policies underlying the current source rules, and then a description of the significant problems caused by the current approach.

A. Description of Current Source Rules

The current approach used in the United States and other countries for sourcing income is to provide separate source rules for particular types of income. Thus, there are different rules for several categories of income, such as interest, dividends, service income, rents, royalties and various types of property gains. In addition, while technically not source rules, statutes and treaties have provisions that limit or eliminate countries’ exercise of source taxation. What follows is a brief description of these rules.

1. Interest and Dividends

Interest income is typically sourced based on the residence or place of incorporation of the borrower.\textsuperscript{17} This rule is usually overlaid with exceptions for business-related interest, under which interest that is associated with a business that is conducted outside the borrower’s country of residence or incorporation is sourced according to the actual or presumed location of that business.\textsuperscript{18} Similar to interest, dividends are generally sourced according to the place of incorporation of the corporation paying the dividend,\textsuperscript{19} with exceptions for situations where the corporation derives a significant portion of its income outside its country of incorporation.\textsuperscript{20}

While the source rule for interest would indicate that the borrower’s country of residence would generally have taxing rights over the interest payments, in most cases source taxation is prevented. Many countries have statutes that provide tax exemptions for domestic source interest received by foreign persons.\textsuperscript{21} In addition, income tax treaties between countries usually give the country where the interest recipient resides the exclusive

\textsuperscript{17}See, e.g., I.R.C. § 861(a)(1); OECD Model Income Tax Treaty, Article 11, Paragraph 5; see Ault and Arnold, supra note 5, at 510 (stating that interest is generally sourced where the payer is resident).
\textsuperscript{18}See, e.g., I.R.C. § 861(a)(1)(A), (B), (C); OECD Model Income Tax Treaty, Article 11, Paragraph 5.
\textsuperscript{19}See, e.g., OECD Model Income Tax Treaty, Article 10.
\textsuperscript{20}See, e.g., I.R.C. § 861(a)(2)(B).
\textsuperscript{21}See American Law Institute, Federal Income Tax Project: International Aspects of United States Income Taxation II, Proposals of the American Law Institute on United States Income Tax Treaties 194 (1991) (ALI Project II); see, e.g., I.R.C. §§ 871(h), 881(c) (portfolio interest exemption); I.R.C. §§ 871(i)(2)(A), 881(d) (bank deposit interest exemption).
right to tax interest income.\textsuperscript{22} For dividends, treaties typically reduce source taxation by limiting the source country tax rates on dividends to either fifteen or five percent.\textsuperscript{23}

2. Rents and Royalties

Rental income from the leasing of tangible property is traditionally sourced at the location of the leased property.\textsuperscript{24} Royalty income from licensing intangible property is sourced using a similar, destination-type approach, but there are differences among countries in carrying out this approach. Under U.S. law, the source of royalty income is determined according to the place where the intangible is used.\textsuperscript{25} The place of use is typically the country that is providing the legal protections that relate to the intangible.\textsuperscript{26} In other countries, royalties are often sourced based on the residence of the payer or the country from which payment is made.\textsuperscript{27} Despite the source rules for royalties, income tax treaties typically prevent the source country from taxing royalty income that is received by residents of the other treaty country.\textsuperscript{28}

3. Service Income

A few approaches have emerged for sourcing income from the performance of services. Some countries, including the United States, source service income according to where the services are performed.\textsuperscript{29} Other countries apply a destination approach and focus instead on the country in which the services are utilized.\textsuperscript{30} Some countries use both approaches and determine a domestic source for service income if the services are either preformed or utilized in the particular country.\textsuperscript{31}

4. Property Gains

There are several approaches for sourcing gains from the disposition of property, with the particular approach based on type of property that is

\textsuperscript{22} See, e.g., U.S. Model Income Tax Convention (2006), Article 11, Paragraph 1.
\textsuperscript{23} See, e.g., OECD Model Income Tax Treaty, Article 10, Paragraph 2.
\textsuperscript{24} See, e.g., I.R.C. § 861(a)(4).
\textsuperscript{25} See I.R.C. § 861(a)(4).
\textsuperscript{27} See ALI Project II, supra note 21 at 199; See Ault and Arnold, supra note 1 at 513 (discussing the implicit source rule under the Australian non-resident withholding tax, which effectively treats royalties (as well as interest and dividends) paid by residents as Australian source income).
\textsuperscript{28} See, e.g., OECD Treaty, Article 12, Paragraph 1.
\textsuperscript{29} See, e.g., I.R.C. § 861(a)(3).
\textsuperscript{30} See ALI Project I, supra note 14; ALI Project II, supra note 21, at 7; Ault & Arnold, supra note 5, at 506.
\textsuperscript{31} See ALI Project I, supra note 14, at 57.
involved. For sales of inventory property that is purchased by the taxpayer (as opposed to being produced by the taxpayer), the United States generally sources the income on the basis of where beneficial ownership and risk of loss pass to the buyer – the so-called title passage rule. Other countries appear to focus on the country where the sales activities giving rise to the income takes place. For sales of inventory property that is produced by the taxpayer, the United States generally sources 50 percent of the income to the country that is the situs of the production activities and 50 percent of the income to the country where title to the goods passes to the buyer. Other countries similarly divide the source of the income between production and sales activities, but they may use different methods for determining the amount of income that is attributable to the production and sales activities. Although technically not source rules, statutory provisions prevent the exercise of source taxation over inventory income and other types of business income unless the nonresident is conducting a trade or business in the source country. Similarly, treaties condition the exercise of source taxation over inventory income and other forms of business profits on the existence of a permanent establishment in the source country, which is generally a fixed place of business through which the business is conducted.

The United States generally sources gain on the sale of other types of property based on the residence of the seller. Under this rule, gain from the sale of a financial asset, such as corporate stock, by a foreign person would generally be foreign source. Most other countries also generally source investment gains based on the residence of the seller. However, several countries, contrary to the U.S. rule, do impose a source tax on gains realized by a nonresident on the sale of stock in a resident corporation. Under the U.S. rule, gain on the sale of an intangible would generally be

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32 See I.R.C. § 861(a)(6); Treas. Reg. § 1.861-7(c).
33 See Ault & Arnold, supra note 5, at 456 (discussing the source rule for export sales of inventory used by Japan for purposes of its foreign tax credit limitation, which treats income from such sales as foreign source only if effected through a foreign branch or in other circumstances that subject the income to a foreign tax). The United States uses this approach in treating income as U.S. source where the income is derived by nonresidents from sales of property that are attributable to a U.S. fixed place of business. See I.R.C. § 865(e)(2).
35 See ALI Project II, supra note 21, at 8. In addition, other countries would probably focus on the location of the sales activities as opposed to where title passes in sourcing the sales portion of such income.
36 See, e.g., I.R.C. §§ 871(b), 882(a), 864(b).
37 See, e.g., OECD Model Income Tax Treaty, Article 7.
38 See, e.g., OECD Model Income Tax Treaty, Article 5.
39 See I.R.C. § 865(a).
40 See I.R.C. §§ 865(a), 865(g).
41 See ALI Project II, supra note, at 202.
42 See id.; Andrus, Determining the Source of Income in a Changing World, 75 TAXES 839, 844 (1997); Ault & Arnold, supra note 5, at 497-98, 507.
sourced according to the residence of seller. An exception exists for contingent payment sales, in which case the gain is sourced under the royalty rule discussed above.

B. Principles Underlying the Current Source Rules

It has been pointed out that a comprehensive rationale has never been offered for the source rules that exist in the United States and other countries. Instead, the current rules are a product of balancing a complex of conflicting principles, considerations and claims as they apply to particular income types.

1. Connection to Governmental Benefits/Economic Nexus

An important principle used in formulating source rules is the view that income should be sourced to the country that provides governmental services and protections that are used in deriving the income. In practice, this policy is usually carried out by associating income to a geographic source based on an economic nexus between the income and a particular country. Thus, in determining the source of income from activities, the focus is typically on the country in which income-producing activities occur. Likewise, the source of income derived from property or capital is often determined to be the country where the property or capital is used.

Income may well have an economic nexus to two or more countries. For example, a bank may perform lending activities in one country in connection with a loan made to a borrower who resides in another country; in this case, there would be a conflict between the activities and utilization bases for sourcing income. Or the conflict could involve the activities basis alone, for example, where two selling branches participate in one sales transaction. In most cases, the source rules resolve such conflicts by

43 See I.R.C. § 865(a).
44 See I.R.C. § 865(d)(1); supra notes 25-26 and accompanying text.
45 See ALI Project I, supra note 14 at 18; See Andrew Walker, Exceptions in Search of a Rule: The Source and Taxability of “None of the Above” Income, unpublished paper on file at http://www.law.columbia.edu/center_program/Tax_Policy, 4 (stating that there is no obvious unifying principle that explains the existing U.S. source rules).
46 See ALI Project I, supra note, at 18; Walker, supra note, 45 at 5; cf. Staff of the Joint Committee on Taxation, Description and Analysis of Present-Law Rules Relating to International Taxation, 25 (1999) (stating that various factors determine the source of income for U.S. purposes, including the location or nationality of the payer and recipient, and the location of the activities and assets that generate income).
47 See, e.g., ALI Project I, supra note 14, at 18.
49 See, e.g., ALI Project I, supra note, 14 at 19.
50 See id.
51 See id.
sourcing the income to one of the countries involved.\textsuperscript{52} This is often determined by deciding which country has the stronger source claim,\textsuperscript{53} based either on the country with the aspects of the transaction that have the greatest economic significance\textsuperscript{54} or the country that is providing the most important public benefits related to the derivation of the income.\textsuperscript{55} Sometimes conflicting source claims are resolved by determining whether one of the competing countries is likely to tax the income, a principle that is discussed below.\textsuperscript{56} In some cases, however, source conflicts are resolved by dividing the income between two countries; for example, this approach is used to source inventory income where the inventory is produced in one country and sold in another.\textsuperscript{57}

2. Expectation that another Country Will Be Taxing the Income

Another principle that is sometimes used to source income is whether it is expected that other countries will be taxing the income.\textsuperscript{58} The United States uses this principle in sourcing several types of income for purposes of the foreign tax credit limitation.\textsuperscript{59} The concern underlying this principle is international undertaxation. That is, if income is included in calculating a residence country’s foreign tax credit limitation, but the income is not taxed by another country, the taxpayer would be able to cross-credit excess foreign tax credits on other foreign income against the pre-credit residence country tax on the income, thus resulting in effectively no tax or a reduced tax on the income.\textsuperscript{60} Similarly, if the residence country uses a territorial system, exempting income that is not taxed by another country would mean that no country is taxing the income.

To prevent this, a residence country can use the expected-to-tax principle to treat income as domestic source, thus removing it from either the foreign tax credit limitation or foreign income exemption. When used, this principle may serve as a tiebreaker in determining source where the income has an economic connection to two or more countries, but only one of the countries is expected to tax the income.\textsuperscript{61} Because of a concern that the expected-to-tax principle still allows for substantial cross crediting opportunities, some commentators go further and call for an investigation of whether it is feasible to treat income as foreign source for foreign tax credit

\textsuperscript{52} See, e.g., I.R.C. §§ 861(a)(4), 865(e)(2).
\textsuperscript{53} See ALI Project I, supra note 14, at 19.
\textsuperscript{54} See id. at 45.
\textsuperscript{56} See infra notes 58-63 and accompanying text.
\textsuperscript{57} See supra notes 34-35 and accompanying text.
\textsuperscript{58} See Andrus, supra note, at 843-44; McIntyre, supra note, at 3-68 – 3-69.
\textsuperscript{59} See STAFF OF THE JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986 (1986 Bluebook) 917-918, 933 (sales of personal property; income from space and certain ocean activities) (1987).
\textsuperscript{60} See 1986 Bluebook, supra note 59, at 917-18
\textsuperscript{61} See McIntyre, Tax Rules, supra note 48, at 3-68 – 3-69.
limitation purposes only where a foreign country imposes a significant tax on the income. In this regard, some countries use a subject-to-tax requirement for exempting foreign income under territorial tax systems.

3. National Interests Unrelated to Traditional Tax Policy Goals

A country’s national interests unrelated to traditional tax policy goals may also affect the design of source rules. For example, the United States uses the source rules in order to provide export incentives. In 1986 the United States generally repealed the title passage rule for sourcing personal property gains because it did not want U.S. taxpayers to be able to generate foreign source income on sales that were not likely to be subject to a foreign tax (an application of the expected-to-tax principle discussed above). Such low or non-taxed foreign income could be used to absorb excess foreign tax credits on high-taxed foreign income. However, the United States retained the title passage rule for sales of inventory out of a concern that the repeal of this rule for inventory sales would create difficulties for U.S. businesses competing in international commerce, especially given the substantial U.S. trade deficit at that time. Thus, the United States’ continued use of the title passage rule for inventory sales is a form of export incentive.

In addition, as mentioned above, many countries, including the United States, generally provide tax exemptions for domestic source interest income received by nonresidents. The purpose for the portfolio interest exemption is to allow domestic borrowers unrestricted access to the Eurobond market, where debt securities are generally free of taxes withheld at source and where the issuer would generally be required to pay interest net of any source tax. To the extent that a source withholding tax is imposed, a borrower in the Eurobond market would generally have to gross up the interest payment to cover the tax. The exemptions for interest promote national, non-tax policy objectives by allowing less costly

63 See Shay, Source, supra note 1, at 150; see also section 865(e)(1) (personal property gains of U.S. residents otherwise subject to residence-based sourcing are treated as foreign source where the sale of the personal property is attributable to an office or fixed place of business maintained by the U.S. resident in a foreign country, provided that at least a ten percent income tax is actually paid to a foreign country with respect to the gain).
64 See 1986 Bluebook, supra note 59, at 918.
65 See id.
66 See id.
67 See supra note 21 and accompanying text.
69 See id.
borrowings by domestic persons, as well by encouraging non-residents to lend money to residents of a particular country.\textsuperscript{70}

4. Principles Reflected in Treaties

As noted above, treaties typically limit a countries’ exercise of source taxation by reducing or eliminating the withholding tax on investment income such as interest, dividends and royalties.\textsuperscript{71} An important reason for the reduction of withholding taxes on investment income is to avoid excessive taxation by the source country.\textsuperscript{72} Gross basis withholding taxes that take no account of expenses associated with the income can result in a very high rate of tax on the net income from transaction. The quintessential example is interest income derived by a financial institutional upon relending funds that are borrowed from others; in this situation, a significant gross basis tax may be confiscatory in that it could exceed the amount of net income from the transaction.\textsuperscript{73}

Another, apparent reason for treaty provisions that reduce or eliminate source taxation on investment income is the notion that the source country’s claim to tax such income may be considered to be relatively weak.\textsuperscript{74} The fact that the general elimination of the source tax on interest applies not only to financial institutions but also to other interest recipients suggests that another principle is at work besides preventing excessive source taxation.\textsuperscript{75} Likewise, the treaty rate on dividends, typically fifteen percent, seems lower than necessary to address concerns of a high rate of source tax on net income, given the degree of associated expenses usually incurred in connection with portfolio investments.\textsuperscript{76}

\textsuperscript{70} See ALI Project II, supra note 21, at 195 (stating that the U.S. tax exemptions for interest apparently reflect a policy judgment that it is critical to stimulate or preserve the willingness of non-residents to lend to U.S. borrowers); Yoram Keinan, The Case For Residency-Based Taxation of Financial Transactions in Developing Countries, 9 F.L.A. TAX REV. 1, 26 (“The portfolio-interest exception is perhaps the purest example of enlightened self-interest and realism in attracting foreign capital.” (quoting from Dan R. Mastromarco & Lawrence A. Hunter, The U.S. Anti-Savings Directive, 2002 TNT 247-28)).

\textsuperscript{71} See supra notes 22-23, 28 and accompanying text.

\textsuperscript{72} See ALI Project II, supra note 21, at 9.

\textsuperscript{73} See id.

\textsuperscript{74} See id. at 194 (referring to this as a possible basis for the general treaty elimination of source taxation of interest income); Michael J. Graetz & Itai Grinberg, Taxation International Portfolio Income, 56 TAX L. REV. 537, 569 (2003) (stating that the source country’s claim to tax portfolio income is more attenuated than its claim to tax business income, and that the claims of the residence country seem to deserve priority in the internation allocation of tax jurisdiction over portfolio income; pointing out that primary allocation of taxing rights over portfolio income reflects this priority).

\textsuperscript{75} See ALI Project II, supra note 21, at 194.

\textsuperscript{76} But see id. at 184 (stating that object of treaty provisions that limit the source country rate on dividends seems to be keep the rate low enough so that at least in a broad range of cases the source tax will not exceed the net basis tax that would be imposed in the residence country).
5. Administrability

Administrability is an important consideration in devising source rules. Although more than one country may be connected to the derivation of income, the current source rules usually determine a single source apparently because of a concern that a multi-source approach would be overly complex. Source rules also attempt to avoid detailed factual inquiries. In this regard, both the title passage rule and the 50-50 source rules used by the United States in a few contexts allow for bright line determinations of source. Simplicity is especially desirable for the source rules that are used to determine withholding obligations, such as those for interest, dividends and royalties.

C. Problems with the Current Source Rules

The current approach for sourcing income suffers from two fundamental and related problems. First, the source rules lack coherence in that they fail to advance a consistent normative tax policy. In particular, the rules fail to reflect the consistent application of the key principle appropriate for allocating nations’ primary taxing rights – namely, the benefits principle. And second, because of a lack of coherence, there may be considerable variation in the source rules used worldwide, thus increasing the likelihood of double taxation and non-taxation.

1. Lack of Coherence

The current sources rules employed in the United States and elsewhere fail to advance a consistent normative tax policy. This leads to different

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77 See ALI Project I, supra note 14, at 19; McIntyre, Tax Rules, supra note 48, at 3-66; infra note and accompanying text.


79 See supra note and accompanying text.

80 See I.R.C. §§ 863(c), 863(e); Treas. Reg. § 1.863-3.

81 See McIntyre, Tax Rules, supra note 48, at 3-66.

82 See Shay, Source, supra note 1, at 83-84 (stating that “[b]ecause no clear economic or equitable principles guide the formulation of rules to divide income and expense by geographic origin, the construction of these rules has been a significantly arbitrary exercise.”) and n.3 (stating that “the claimed rationale for most source rules has a substantial element of arbitrariness”); Ruth Mason, Tax Expenditures and Global Labor Mobility, 84 N.Y.U. L. REV. 1540, 1591 (2009) (stating that the source rules have long been criticized for their arbitrariness); Ilan Benshalom, The New Poor at Our Gates: Global Justice Implications for International Trade and Tax Law, 85 N.Y. U. L. REV. 1, 76 (2010) (arguing that “the notorious complexity of the source rules is due primarily to a lack of normative comprehension as to what they are expected to achieve”); cf. Arthur J. Cockfield, The Rise of the OECD as Informal “World Tax Organization” Through National Responses to E-Commerce Challenges, 9 YALE J. L. & TECH. 59, 98 (2006) (referring to observations that international tax policy suffers from a degree of arbitrariness because of a lack of agreement on guiding principles).
sourcing approaches for economically similar types of income. For example, dividends are generally sourced based on the country of incorporation of the corporation paying the dividend. In contrast, as a result of the expected-to-tax principle, stock gains are generally sourced under the U.S. rules according to the residence of the seller. Yet, in substance the two items are quite similar given that stock gains represent a market capitalization of future earnings. The different source consequences on the sale or license of a patent in the example above are also a result of basing source rules on different principles. Similarly, the source tax exemption that generally applies to interest, which is to allow domestic borrowers unrestricted access to the Eurobond market, is inconsistent with the general source taxation of other types of investment income, such as dividends and royalties.

More fundamentally, the rules fail to reflect the consistent application of the key principle appropriate for allocating nations’ primary taxing rights – namely, the benefits principle. As developed more fully in the next part, the connection to governmental benefits should be the guidepost for designing source of income rules, because the source rules define the scope of source taxation and source taxation is justified by governmental benefits provided to a nonresident by the host country. In this regard, equity supports host country taxation of nonresidents who benefit from host country governmental services so that the costs of these services are not borne solely by residents of that country.

While the economic nexus principle can function to a degree as a surrogate for focusing on governmental benefits, the general binary nature of the source rules results in a failure to appropriately allocate primary tax jurisdiction in accordance with the provision of government benefits. As discussed above, the current source rules often assign all of the income to a

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83 See Shay, Source, supra note 1, at n. 3 (providing an example of the often capricious nature of the source rules that involves the title passage rule for sales of inventory); cf Willard B. Taylor & Diana L. Wollman, Why Can’t We All Just Get Along: Finding Consistent Solutions to the Treatment of Derivatives and Other Problems, 53 TAX L.AW. 95 (1999) (pointing out the differences in the source rules applying to several types of derivative financial instruments and the lack of a seeming purpose for such; suggesting that there could be a single rule for sourcing derivative gains and losses).
84 See supra notes 19-20 and accompanying text.
85 See supra notes 58-63 and accompanying text.
86 See supra notes 39-40 and accompanying text. It should be noted that the expected to tax principle is problematic in some cases, in that a determination that other countries are not imposing a source tax on a particular type of income may not always be correct. See Andrus, supra note 42, at 844 (pointing out that the United States’ application of residence based sourcing of gains from the disposition of foreign corporate stock pursuant to the expected to tax principle can result in double taxation because a significant number of countries do tax nonresidents on such gains).
87 See Shay, Source, supra note 1, at 122.
88 See supra notes 21, 67-70 and accompanying text.
89 See supra notes 19-20, 25-27 and accompanying text.
90 See infra Part III.B.1.
91 See infra notes 143-46 and accompanying text.
single geographic source even though relevant economic activities occur in more than one country.\textsuperscript{92} Although administrative considerations counsel against a sourcing approach that would take into account all countries that might have some connection to the income,\textsuperscript{93} one certainly questions the soundness of the current approach that usually ignores all but one of the connected countries. Moreover, the decision to choose a particular country as the most important either in terms of economic contribution or provision of public benefits often is arbitrary.\textsuperscript{94} For example, where an intangible is produced in one country and licensed for use in another country, is it so clear that the latter country is the most important in the derivation of the income?\textsuperscript{95} And when compared to a similar situation involving services performed in one country that are utilized in another country, the U.S. source rules appear inconsistent, given that the source of the service income typically will be in the country in which the services are performed.\textsuperscript{96} (As mentioned above, some countries use a destination approach for sourcing service income.\textsuperscript{97})

The arbitrary and inconsistent results of single source rules are exacerbated by the need to characterize transactions.\textsuperscript{98} Characterization is particularly necessary and often problematic in the case of transactions involving intangibles and electronic commerce, where the income from a given transaction may take the form of royalties, compensation or property gains based on the specific facts and circumstances.\textsuperscript{99} And because the single source rules produce very different results depending on the type of income involved,\textsuperscript{100} a great deal turns on how income is characterized. For example, where a U.S. resident develops an invention in the United States, obtains a foreign patent on the invention, and then sells the foreign patent for a lump sum amount, all of the gain will be U.S. source;\textsuperscript{101} however, if instead of selling the patent the taxpayer licenses the patent in exchange for a lump sum royalty for a period that is slightly less than the patent’s remaining life, all of the income would be foreign source.\textsuperscript{102} Despite the

\textsuperscript{92}See supra notes 51-55 and accompanying text.
\textsuperscript{93}See supra notes 77-81 and accompanying text.
\textsuperscript{94}See Mason, supra note 82, at 1591 and n. 195 (noting different possible bases for sourcing sales income (where title passes, place of sale, or place of consumption) and interest income (including the residence of the borrower, where the principal is either made available or used, or where interest payments are made).
\textsuperscript{95}Under section 861(a)(4), the royalty income will be sourced where the intangible is being used. See I.R.C. § 861(a)(4).
\textsuperscript{96}See I.R.C. § 861(a)(3).
\textsuperscript{97}See supra notes 30-31 and accompanying text.
\textsuperscript{98}See Mason, supra note 82, at 1591 (referring to disputes about how to classify income).
\textsuperscript{99}See ALI Project I, supra note 14, at 43; Andrus, supra note 42, at 855-56.
\textsuperscript{100}See supra Part II.A.
\textsuperscript{101}See I.R.C. §§ 865(a), 865(g)(1). This assumes that the sale was either not attributable to a foreign office maintained by the U.S. resident or subject to foreign tax of at least ten percent. See I.R.C. § 865(e)(1).
\textsuperscript{102}See I.R.C. §§ 861(a)(4), 862(a)(4).
similarity in the substance of these two alternatives, the source results are quite different.

2. Variation in Source Rules Used Worldwide

Because of a lack of coherence, there may be considerable variation in the source rules used worldwide.\textsuperscript{103} This raises the concern of double taxation -- that two or more countries are taxing the same income, a result that would impede the free flow of business and investment capital.\textsuperscript{104} Or alternatively, differences in countries’ sourcing approaches can lead to non-taxation -- that no country is taxing the particular income, which may encourage inefficient, tax motivated transactions.\textsuperscript{105}

Where more than one country has a connection to an income item (which is often the case), the single source approach requires that the income be sourced to only one of the countries. In this regard, nations may come to a different conclusion as to the appropriate country, thus creating differences in source rules.\textsuperscript{106} For example, some countries source service income based on where the services are performed, while others focus on where the services are utilized\textsuperscript{107} or a mixture of the place of performance, the place of contract and place of payment.\textsuperscript{108} Likewise, countries choose the single source differently with respect to royalty income, with some countries using the location of the payer or place of payment, while other countries focus on where the intangible is being used.\textsuperscript{109} In addition, countries use substantially different approaches in attributing income to domestic

\textsuperscript{103} See Ault & Arnold, supra note 5, at 498-502, 506-09 (discussing differences in countries’ approaches for attributing income to domestic branches, determining the source of employment income, and exercising source taxation over gains derived by nonresidents from disposing of substantial shareholdings in domestic corporations); OECD, \textit{Are the Current Treaty Rules for Taxing Business Profits Appropriate for E-Commerce? Final Report}, 26 (pointing out that even developed countries have different approaches for determining source taxation of business profits); Oleksandr Pastukhov, 36 \textsc{Rutgers Computer \\ & Tech. L. J.} 1, 6-7 (2009) (pointing out that the lack of uniformity among nations in taxing electronic commerce leads to taxing authorities being perplexed over the country that should have taxing rights).

\textsuperscript{104} See McIntyre, \textit{Tax Rules}, supra note 48, at 1-3 – 1-4.

\textsuperscript{105} See id. at 1-4.

\textsuperscript{106} See Michael J. McIntyre, \textit{The Use of Combined Reporting by Nation-States, in The Taxation of Business Profits Under Tax Treaties}, ch. 8 (Arnold, Sasseville, & Zolt, eds.) 263 (2003) (“Because the source of income is not obvious in many cases, the source rules adopted by various countries sometimes conflict.”).

\textsuperscript{107} See supra notes 29-31 and accompanying text.

\textsuperscript{108} See Ault & Arnold, supra note 5, at 506-07 (discussing the Australian approach for sourcing employment income for purposes of exercising source taxation over nonresidents).

\textsuperscript{109} See supra notes 25-27 and accompanying text. While countries generally source interest income based on the residence of the borrower (see supra notes 17-18 and accompanying text), for purposes of its foreign tax credit limitation, Australia sources interest that is not subject to a foreign tax based on the where the funds are made available, which may be the place where the funds are advanced or where the contract was executed. See Ault and Arnold, supra note 5, at 457.
branches of nonresidents for purposes of exercising source taxation.\textsuperscript{110} In this regard, some countries focus on the economic connection between income items and the branch, while other countries use “force of attraction” approaches that attribute domestic source income to the branch regardless of an actual economic connection, with source determined based on an independent set of source rules.\textsuperscript{111} The details of the approaches for sourcing branch income tend to be relatively undeveloped -- for example, the source rules are sometimes from judge-made law that operate on a facts-and-circumstances or similar basis.\textsuperscript{112}

Moreover, even if countries decided their single source rules in the same way, there could still be differences in source results where countries characterized income items differently.\textsuperscript{113} Assume that another country has the same source rules as the United States with respect to service income and royalties, but uses different rules for characterizing transactions as either the performance of services or the licensing of an intangible. Under these circumstances, the United States and the other country would source a given cross-border transaction differently if the United States characterized the transaction as the performance of services while the other country viewed it as the licensing of an intangible.

Not surprisingly, the use of different principles for devising source rules can lead to different source rules. For example, based on the expected-to-tax principle,\textsuperscript{114} the United States generally sources stock gains based on the residence of the seller.\textsuperscript{115} However, several countries impose a source tax on gains realized by a nonresident on the sale of stock in a resident corporation,\textsuperscript{116} presumably on the basis of the economic nexus principle.\textsuperscript{117} This difference in treatment can lead to double taxation where a U.S. resident sells stock in a foreign corporation that results in a source tax in the corporation’s home country.\textsuperscript{118}

In situations where countries use different domestic source rules, bilateral income tax treaties may resolve conflicts in source rules. U.S. treaties typically provide that for the purposes of the U.S. foreign tax credit limitation, income that may be taxed by the other country under the treaty

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\begin{itemize}
  \item \textsuperscript{110} See Ault and Arnold, supra note 5, at 498.
  \item \textsuperscript{111} See id. at 499.
  \item \textsuperscript{112} See id. at 500 (discussing the Australian facts-and-circumstances approach for business income, which appears to source sales income where the contract is made; discussing the Canadian approach under which income is treated as domestic source where it may be allocated in a reasonable manner to a nonresident’s Canadian branch).
  \item \textsuperscript{113} See ALI Project I, supra note 14, at 37, n.46 (noting the problem of conflicting characterizations of transactions by countries); ALI Project II, supra note 21, at 235 (discussing the potential for double taxation or under taxation where countries characterize transactions differently); Andrus, supra note 42, at 856 (same).
  \item \textsuperscript{114} See supra notes 58-63 and accompanying text.
  \item \textsuperscript{115} See supra notes 39-40 and accompanying text.
  \item \textsuperscript{116} See supra note 42 and accompanying text.
  \item \textsuperscript{117} See supra note 47-50 and accompanying text.
  \item \textsuperscript{118} See Andrus, supra note 42, at 844.
\end{itemize}
will be sourced in that country. Sometimes treaties even provide explicit source rules in separate articles. Thus, for example, treaties may prevent double taxation in the situation where a U.S. resident is subject to a source tax on the sale of foreign corporate stock. However, existing treaties fail to comprehensively deal with potential conflicts in domestic source rules. In this regard, treaties often lack specific details with regard to attributing business profits to permanent establishments, and countries may interpret such provisions differently. Moreover, in limiting source taxation and guaranteeing that countries use foreign tax credit or exemption systems, treaties aim to avoid double taxation, and thus do not prevent the non-taxation of cross-border income that results when countries’ varying source rules create underlapping tax jurisdiction. Furthermore, a bilateral treaty-based solution to the problem of double taxation or non-taxation stemming from source rule conflicts is an incomplete solution, because treaties between countries may not always exist.

III. EQUITY-BASED STANDARD FOR DEVISING SOURCE RULES

A. Overview, Basic Assumptions and Preliminary Matters

To address the problems identified above, this part develops a benefits principles-based standard for devising source rules that has the potential to be adopted on a multi-lateral basis. An internationally harmonized approach to sourcing income that is based on the connection to governmental benefits should result in a fair allocation of taxing jurisdiction among nations; this could replace the current patchwork of rules, which often produce incoherent and arbitrary results. And a principled standard that is considered fair by a critical mass of countries could lead to internationally harmonized source rules. In this regard, an important goal

120 See ALI Project II, supra note 21, at 234.
121 See, e.g., United States – Spain Income Tax Convention, Article 13, Paragraph 4; Andrus, supra note 42, at 844.
124 See Andrus, supra note 42, at 844.
125 See id. (concluding that “to address the tax issues created by the changing economy, international consensus must be developed with regard to characterizations issues as well as source rules”).
126 Cf. McIntyre, Tax Rules, supra note 48, at 3-67 – 3-68 (pointing out that each country should receive a reasonable share of the global tax base pursuant to a fair negotiating process).
127 Peggy B. Musgrave, Sovereignty, Entitlement, and Cooperation in International Taxation, 26 Brooklyn J. Int’l L. 1335, 1345 (2001) (Sovereignty) (calling for the adoption of a formula via mutual international agreement that generally is acceptable for fairness reasons in order to achieve international cooperation in the sharing of the tax base); cf. Benshalom, supra note 82 at 79 (stating that effective tax cooperation among nations can be facilitated where it involves an organizing principle that is considered fair); Rifat
is that the allocation of tax jurisdiction via source rules or their equivalent be mutually agreeable,\textsuperscript{128} so that source taxation does not result in either double taxation or non-taxation.\textsuperscript{129}

This part proceeds in two steps: first by establishing the case for using the benefits principle along with administrability as the appropriate principles for designing source rules, and second by formulating a standard for devising source rules that is based on the appropriate principles. Before doing so, a few assumptions and preliminary matters are in order.

First, it is assumed that countries will continue to exercise source taxation, as opposed to abandoning such in favor of exclusive residence taxation. Second, it is assumed that countries will continue to adhere to the “single tax principle” — subjecting cross-border income to one tax — and thus attempt to avoid double taxation and non-taxation by employing either foreign tax credit or territorial systems.\textsuperscript{130} Third, it is assumed that in allocating taxing rights over cross-border business and investment income, countries will continue to use the separate transactions method (source and transfer pricing rules), rather than applying formulary apportionment methods to a taxpayer’s aggregate net income.\textsuperscript{131}

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\textsuperscript{128} See McIntyre, Tax Rules, supra note 48, at 3-67 – 3-68 (stating that a goal of model source rules should be the allocation of taxing jurisdiction in some mutually agreeable manner); cf. Andrus, supra note 42, at 856 (1997) (calling for international consensus on source rules to address sourcing issues created by electronic commerce and other aspects of the changing economy).

\textsuperscript{129} See McIntyre, Tax Rules, supra note 48, at 3-67 – 3-68.

\textsuperscript{130} See Reuven S. Avi-Yonah, International Taxation of Electronic Commerce, 52 Tax L. Rev. 507, 517 (1997) (Electronic Commerce). The single tax principle has been justified on both theoretical and practical grounds. See Reuven S. Avi-Yonah 61 BULL. INT’L TAX’N 130 (2007). With regard to theory, a heavier tax on cross-border income as compared to domestic income would create an inefficient incentive to invest domestically; a lighter tax on cross-border income would create an inefficient incentive to invest abroad. See id. In addition, the non-taxation of cross-border income when compared to the taxation of domestic labor income can violate both horizontal and vertical equity. See id. From a practical perspective, double taxation of cross-border income would tend to stifle international investment, while non-taxation of such income can lead to the avoidance of domestic taxation by investing internationally, thereby eroding the national tax base. See id.

\textsuperscript{131} Recently, several notable commentators on international taxation have proposed using formulary apportionment to allocate tax jurisdiction over the income of related multi-national corporations. See, e.g., Reuven S. Avi-Yonah, Kimberly A. Clausing, & Michael C. Durst, Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split, 9 FLA. TAX REV. 497 (2009). While it is conceivable, it is not likely that formulary apportionment will replace the current system in the foreseeable future. See James J. Tobin, Barbara M. Angus, & David J. Canale, Preserving and Protecting the Arm’s-Length Standard, INT’L TAX MON. (July 19, 2010) (asserting that the arm’s-length standard should continue to be at the center of the international tax system); see also Susan C. Morse, Revisiting Global Formulary Apportionment, 29 VA. TAX REV. 593 (2010) (questioning the benefits of the unilateral U.S. adoption of a destination sales-based formulary apportionment method for dividing global jurisdiction to tax corporate income).
The harmonized source rules developed under the sourcing standard should be the same for countries’ taxation of both in-bound transactions by nonresidents and out-bound transactions by residents.\footnote{Cf. ALI Project I supra note 14, at 348-49 (stating that “presumptively at least, ‘inbound’ and ‘outbound’ source rules should be the same”); PETER A. HARRIS, CORPORATE/SHAREHOLDER INCOME TAXATION AND ALLOCATING TAXING RIGHTS BETWEEN COUNTRIES, 445-446 (1996) (stating that the only reference point in evaluating whether countries appropriately tax international income “is the symmetry of their own tax system”). Some commentators disagree with this, but they are approaching the issue of sourcing from the perspective of enhancing the welfare of U.S. individuals. See Shay, Source, supra note 1, at 81. As mentioned above, the objective of this Article is to develop a sourcing standard that can be adopted multi-laterally, which thus should refrain from taking into account particular countries’ national interests.} Where countries use uniform source rules, but the rules for in-bound and out-bound transactions differ, either double taxation or non-taxation will result.\footnote{See Andrus, supra note 42, at 843 (source rules that do not treat U.S. and foreign taxpayers the same will inevitably lead to double taxation or non-taxation).} For example, assume that all countries adopted a rule that sourced service income based on the location of the recipient of the services for in-bound transactions and on the place of performing services for out-bound transactions. A Country A resident performs services in Country A for a company that is located in Country B. Under the in-bound source rule, the Country A resident would have Country B source income that is subject to tax in Country B because the recipient of the services was located there. However, under the out-bound source rule, Country A would treat the income as domestic source for purposes of calculating its resident’s allowable foreign tax credit (assuming it uses a foreign tax credit system that includes a limitation based on the amount of foreign source income), because the services were performed in Country A. Consequently, the Country A resident may be prohibited from receiving a foreign tax credit against her Country A tax liability for the Country B tax, thus potentially resulting in double taxation. If the source rules were reversed, it could be that neither country would be taxing the income.

Finally, the standard should be used to devise source rules that form the basis for countries’ exercise of taxing jurisdiction.\footnote{Nevertheless, as under current law, certain countries, generally referred to as tax havens, may impose little or no tax on income over which they have jurisdiction to tax. Consequently, it is assumed that countries may continue to employ mechanisms designed to prevent their residents from avoiding current taxes on certain income that is allocated to tax haven corporations, such as the anti-deferral regimes used in the United States (subpart F (see I.R.C. §§ 951-965) and the PFIC rules (see I.R.C. §§ 1291-1298). In addition, with the proposed sourcing approach, countries also may want to exercise residual tax jurisdiction over foreign source portion of income derived by nonresidents from domestic activities. See infra note 273 and accompanying text.} Thus, income that is treated as domestic source with respect to a particular country would be
subject to tax in the hands of a nonresident of that country;\textsuperscript{135} unlike current U.S. law,\textsuperscript{136} operative tax provisions will not prevent the taxation of income that is treated as domestic source. Likewise, income that is treated as foreign source would be nontaxable to a nonresident.\textsuperscript{137} Similarly, it is contemplated that since there will be multi-lateral agreement on source via harmonized domestic rules, treaties would not generally alter the taxing rights of countries, although treaties may still affect to some degree the tax rates that apply to particular types of income.\textsuperscript{138}

\textbf{B. Appropriate Principles for Sourcing Income}

\textbf{1. The Benefits Principle}

As discussed earlier,\textsuperscript{139} the source rules are used to determine the contours of countries' exercise of source taxation, that is, the taxation by a host country over nonresidents. Source rules also affect the scope of countries' exercise of residence taxation -- the taxation by a country of its residents. This effect, however, is derivative of source taxation. Countries that mitigate double taxation through foreign tax credit systems cede primary tax jurisdiction with respect to their residents over income that is viewed as properly subject to source taxation by host countries. Countries that use territorial systems that exempt foreign source income cede all tax jurisdiction over such income. Because the source rules define the scope of source taxation, the principles that form the basis for source taxation should be used in formulating source rules.

It is widely accepted that source taxation is grounded on the benefits principle: a host country should have the right to tax a nonresident on income that benefits from host country government services, with the tax serving as a charge, of sorts, for these benefits.\textsuperscript{140} A nonresident with

\textsuperscript{135} Cf. ALI Project Part I, supra note 14, at 115 (recommending that U.S. source income generally be subject to either U.S. net basis or gross basis taxation, although providing exceptions for certain items, including portfolio interest).

\textsuperscript{136} See, e.g., I.R.C. § 871(c) (portfolio interest exemption)

\textsuperscript{137} Under current U.S. law, it is possible for a foreign person to be taxable on foreign source income. See I.R.C. §§ 864(c)(4), 882(a).

\textsuperscript{138} This may be warranted in order to ameliorate the excessive burdens of gross basis taxes where a taxpayer is likely to incur significant expenses in earning income – for example, interest income earned by a nonresident bank. See supra note and accompanying text. Of course, this could also be done through harmonized domestic legislation, but there may be reasons why countries may find the treaty process more appropriate for such provisions. See ALI Project II, supra note 21, at 12-13 (stating that a source country may not want to forgo taxing income that is received by a resident of a tax haven country).

\textsuperscript{139} See supra notes 3-6 and accompanying text.

\textsuperscript{140} See ALI Project I, supra note 14, at 12; Lokken, supra note 55 at 239; Shay, Source, supra note 1, at 90; Peggy B. Musgrave, Interjurisdictional Equity in Company Taxation: Principles and Applications to the European Union, in Taxation Capital Income in the European Union 46, 52-53 (Sjibren Cnossen ed., 2000), reprinted in Michael J. Graetz, Foundations of International Income Taxation 6 (2003); Avi-Yonah, Electronic Commerce, supra note 130 at 521; Gruetz & Grinberg, supra note 74, at 569; Michael S. Kirsch, The
investments or business activities in the host country benefits from numerous government activities, including those that give rise to infrastructure (physical, economic and legal), public safety, national security, and a skilled workforce. Consequently, a key principle in determining whether an item of income should be sourced to a particular country is whether that country provides the taxpayer with governmental benefits that relate to the income.

Closely aligned with the benefits principle basis for sourcing is the view that income should be sourced according to the location of the economic activities that give rise to the income. The economic nexus basis for sourcing is best understood as a surrogate for the benefits principle – that is, the location of economic activities is where the taxpayer receives government benefits that justify a source tax. Indeed, authorities referring to the economic nexus basis for sourcing income usually also refer to the place of legal protections as a basis for sourcing, thus suggesting that it is the connection to government benefits that underlies the focus on economic activities. Importantly, economic nexus is an incomplete surrogate for the benefits principle in that by focusing on the location of economic activities, it neglects the benefits principle.

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141 See Shay, Source, supra note 1, at 90; Mason, supra note 82, at 1553-54. For a more detailed discussion of these public benefits, see infra notes and accompanying text.

142 Cf. OECD, supra note 103, at n.20 (noting that the benefits principle, which provides a justification for source taxation, “can also be put forward as a principle for determining the source of business profits”).

143 See, e.g., President Reagan’s Tax Proposals to the Congress for Fairness, Growth and Simplicity, 21 WEEKLY COMP. PRES. DOC. 707 (May 29, 1985); ALI Project I, supra note 14, at 19; McIntyre, Tax Rules supra note 48, at 3-67 – 6-68.

144 See Dean, supra note 140, at 162 & n.164 (indicating that the benefits principle underlies the recognized right of a country to tax income derived from economic activity occurring within its borders).

145 See President Reagan’s Tax Proposals to the Congress for Fairness, Growth and Simplicity, 21 WEEKLY COMP. PRES. DOC. 707 (May 29, 1985).
economic activities conducted by taxpayer, it ignores government benefits provided by the taxpayer’s country of residence that relate to the earning and enjoyment of income by the taxpayer. 146

Source taxation may also be justified by the right of a host country to exact a charge for economic rents, or super-normal returns, realized by nonresidents through the use of a country’s resources. 147 This basis for source taxation, however, should properly be viewed as merely a supplement to the benefits principle basis, as it would only permit a host country to tax super-normal returns. In both theory and practice, it is widely acknowledged that source taxation extends to all income that bears a sufficient economic connection to the host country, not just super-normal returns. 148

At its core, the benefits principle underlying source taxation is an equitable principle. Nonresidents who earn income that profits from a country’s government activities should be subject to source taxation on such income; otherwise, the burden for these government activities that benefit nonresidents would be borne by residents of that country alone. 149 Thus, an equitable sharing of the cost of government activities between nonresidents and residents is at the root of source taxation. The equity basis underlying source taxation can be described as a form of inter-individual equity, because it requires the fair treatment of taxpayers – residents and nonresidents – who receive governmental benefits from a particular country.

The equity basis for source taxation may be complicated by the fact that some residents of a given country will be investing or doing business in other countries. Thus, it may be contended that one country’s failure to tax a nonresident for the receipt of governmental benefits can be “offset” by the failure of the nonresident’s country to tax the other country’s residents when they receive host country governmental benefits. One response is that taxpayers with purely domestic business and investment activities would

146 Cf. Dean, supra note 140, at n.162 (stating that the benefits principle also describes the relationship between a country and its residences, citing to PEGGIE BREWER RICHMAN, TAXATION OF FOREIGN INVESTMENT INCOME: AN ECONOMIC ANALYSIS 23 (1963), for the proposition that a country has the right to tax the income and wealth of its residents based on the protection and services provided by the country). These residence country benefits are more fully described below. See infra notes 238-41 and accompanying text.

147 See OECD, supra note at 12; Robert A. Green, The Future of Sourced Based Taxation of the Income of Multinational Enterprises, 79 CORNELL L. REV. 18, 30 (1993); Kane, supra note 140, at 904-05.

148 See Green, supra note 147, at 30 (stating that this argument does not justify source-based corporate income taxes).

149 See Shay, Source, supra note 1, at 96-97 (“Domestic fairness requires that the costs of the U.S. government be borne both by (1) residents on the basis of ability to pay, and (2) nonresidents on the basis of an appropriate charge for the privilege of exploiting the U.S. market. To the extent that abandonment of source taxation relieves nonresidents of their charge, the tax burden belonging to nonresidents inevitably will shift to U.S. residents. A failure of nonresidents to contribute to the costs of government, would therefore, diminish, not enhance, domestic tax fairness.”).
not benefit from another country’s lack of source taxation: such taxpayers would bear the cost of home country governmental benefits received by nonresidents but would not take advantage of tax-free governmental benefits provided by other countries. Nonetheless, a further contention may be that resident taxpayers with purely domestic activities would not suffer from their home country’s lack of source taxation over nonresidents because other home country residents with foreign income that is free of source taxation would then bear a greater residence country tax burden. This is because without the imposition of source taxation, there would be no need for a home country to provide its residents with foreign tax credits or foreign income exclusions. Thus, home country residents with foreign income would be taxed by their home country effectively as surrogates for the nonresidents receiving governmental benefits from the particular country. However, this argument assumes equal capital flows between countries, which would never be the case. If a given country’s amount of nonresident investment or business activity exceeds the amount of foreign investment or business activity conducted by its residents, i.e., is a net capital importer, then its residents with purely domestic activities would not experience a sufficient tax offset for its country’s failure to exercise source taxation over nonresidents.

Notions of perceived equity bolster the equity basis for source taxation. Recently, some leading commentators on international taxation have put forth what they term as a new principle for structuring source taxation -- the parity principle. In applying this principle to U.S. source taxation, they assert that the U.S. income tax should treat businesses owned by foreign taxpayers no more favorably than comparably situated U.S.-owned businesses. The basis for the parity principle is that residence taxation will lose legitimacy and efficacy if residents perceive that they are being more heavily taxed than nonresidents with equal amounts of income from the residence country, thus, this principle rests on perceptional equity concerns (along with real equity concerns). In applying the parity principle in examining a few source rules, the commentators refer to the access to the U.S. market, which they see as a product of government activities, as well as U.S. legal protections, indicating that the benefits principle is at the core of their parity principle. Consequently, their work suggests that both real and perceptional equity concerns support the benefits-principle basis for source taxation.

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150 See Shay, Source, supra note 1, at 110-11.
151 See id. at 111.
152 See id.
153 Other scholars have pointed out the importance of perceptional equity. See, e.g., Noel B. Cunningham & Deborah H. Schenk, The Case for a Capital Gains Preference, 48 Tax L. Rev. 319, 368-69 (1993).
154 See Shay, Source, supra note 1, at 91-92, 142-43.
2. Effect of the Ability to Pay Principle

In contrast to source taxation, residence taxation rests on a different equity basis than source taxation, this being the notion of a taxpayer’s ability to pay.\textsuperscript{155} Under residence taxation, the tax burden is allocated among taxpayers in a manner that reflects their relative abilities to pay.\textsuperscript{156} Because a taxpayer’s worldwide income is usually considered the proper gauge for measuring a taxpayer’s ability to pay, and because the ability to pay principle suggests that tax rates should be progressive, residence taxation is generally implemented by imposing a progressive tax on a taxpayer’s worldwide income.\textsuperscript{157}

Although it may seem as though source taxation and residence taxation are quite distinct, this is not the case. First, source taxation, while founded on the benefits principle, can be viewed as having ability-to-pay attributes.\textsuperscript{158} The source tax, like the residence tax, is determined by applying tax rates to a nonresident’s domestic source income. Thus, no effort is made to approximate the value of the benefits received by the nonresident from the host country’s government activities that relate to the nonresident’s income, no doubt because it would be impossible to do so with any degree of accuracy.\textsuperscript{159} Instead, the amount of tax that is imposed on a nonresident’s domestic source income appears to reflect the host country’s determination of a fair allocation of the tax burden based on the relative abilities to pay of all taxpayers, with nonresidents judged only on the basis of their domestic source income.\textsuperscript{160} This view is buttressed by the fact that the rates that apply to a nonresident’s domestic source business income are often progressive in nature.\textsuperscript{161} Thus, while the benefits principle forms the basis for, and defines the scope of, source taxation, the ability to pay principle appears to provide some role, at least in practice, in determining the amount of tax that is imposed on a nonresident’s domestic source income.\textsuperscript{162}

\textsuperscript{155} See Fleming, Peroni & Shay, \textit{Fairness in International Taxation: The Ability-to-Pay Case for Taxing Worldwide Income}, 5 FLA. TAX REV. 299, 306-308 (2001) (\textit{Fairness}). Besides equity, other considerations that are important in residence taxation include economic efficiency and administrability. See id. at 306-08, n.14.

\textsuperscript{156} See Green, supra note 147, at 29.

\textsuperscript{157} See id.

\textsuperscript{158} See Lokken, supra note 55, at 239-40.

\textsuperscript{159} See Mason, supra note 82, at 1585 (stating that it would be impossible to determine precisely the amount of government benefits received by taxpayers); Barker, supra note 140, at 370 (stating that there is no way to measure directly the benefit received; instead one should develop a tax base that reflects the benefit received).

\textsuperscript{160} See Lokken, supra note 55, at 239-40.

\textsuperscript{161} See I.R.C. §§ 871(b), 882(a).

\textsuperscript{162} See Lokken, supra note 55, at 239-40. Whether this is correct as a normative matter is another issue. Some commentators are of the view that ability to pay considerations should not be used in connection to source taxation. Their reason is that ability to pay should be measured with reference to a taxpayer’s total income and not just that income over which a country exercises taxing jurisdiction. See Shay, Source, supra note 1, at 94-95. Nevertheless, these commentators endorse the determination of a nonresident’s source tax
In addition, and of significance in determining principles for sourcing income, source taxation and residence taxation are related in that source taxation frustrates to an extent the ability to pay principle underlying residence taxation. It is standard practice, as well as an assumption of this Article, that with source taxation, countries will relieve international double taxation either by allowing their residents a foreign tax credit or exempting certain foreign income from residence taxation. Where a foreign tax credit is allowed, the residence tax is reduced by the amount of the credit, whereas from the strict standpoint of measuring ability to pay, there should only be a deduction for foreign taxes, as is the case with other expenses of earning income. And where a residence country employs an exemption system to relieve double taxation, the residence country ignores completely the exempt foreign income in measuring the resident’s ability to pay. Consequently, source taxation effectively diminishes the ability of a residence country to equitably allocate the costs of government activities among its residents on their respective abilities to pay.

Based on this reason, some commentators call for an end to source taxation in favor of exclusive residence taxation. Other commentators advocate for a modified source taxation approach under which passive income would be subject to exclusive residence taxation, but active income would continue to be subject to source taxation. Those supporting the modified source taxation approach justify the passive/active income distinction by pointing to the fact that international passive income is often earned by individuals, for whom ability to pay taxation is geared, whereas international active income tends to be earned by corporations, for which the ability to pay principle is less relevant. Because these proposals call for a reduction (or even elimination) of source taxation, they would obviously greatly affect the formulation of source rules.

The appropriateness of eliminating or reducing source taxation should be decided on the basis of the equitable principles involved. Source taxation promotes an equitable sharing of the costs of government among residents and nonresidents. Residence taxation advances the equitable allocation of the costs of government among residents based on their relative abilities to

liability by imposing graduated tax rates on a nonresident’s domestic source, because it is a reasonable and practical measure of the host country government benefits received and it treats nonresidents in a nondiscriminatory manner versus residents. See id. at 95, 104.

163 See supra note 130 and accompanying text.
164 See Fleming, Fairness, supra note 155, at 328; Ault & Bradford, supra note 1, at 41.
165 See Shay, Source, supra note 1, at 97. Some commentators appear to take the position that source taxation is objectionable under the ability-to-pay criterion not necessarily because it interferes with residence taxation, but because source taxation is itself a poor way to measure ability to pay as it only taxes a portion of a taxpayer’s worldwide income and sometimes uses gross basis withholding taxes. See Graetz and Grinberg, supra note 74, at 570; Green, supra note 147, at 29.
166 See Green, supra note 147, at 29.
168 See id. at 1310-17.
pay. Because source taxation frustrates residence taxation to an extent, the issue is which approach strikes the appropriate balance between these two competing types of equity.

Exclusive residence taxation simply goes too far in favor of ability-to-pay equity, by ignoring completely the benefits provided to nonresidents by the host country. In addition, because exclusive residence taxation would result in more tax revenue for developed countries and less for developing countries, the latter would likely refuse to cooperate in such a system. In any event, this Article assumes that countries will continue to exercise source taxation.

While an approach that eliminates source taxation of passive income at least strikes a balance between the equitable principles involved, is it an appropriate one? Equitable determinations are fraught with value judgments, and the same is true in deciding between competing notions of equity. There appears to be no correct answer here. The remainder of the Article assumes that countries will generally agree that the equitable notions underlying the benefits principle are more important than those supporting ability-to-pay taxation where these equitable notions conflict, and that the benefits principle should generally dictate the scope of source taxation for both passive and active income. However, under the proposed sourcing standard (which is discussed in the next section), it would be possible to take ability-to-pay equity into account to some extent in determining the source of income; this can be done by increasing the portion of income that is sourced to the country of residence due to ability-to-pay equity considerations.

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169 See Michael J. Graetz, Foundations of International Income Taxation 67-68 (2003); cf. Avi-Yonah, Simplification, supra note 167 at 1311 (the ability-to-pay argument for exclusive residence taxation does not explain why the home country should have the only claim to tax cross-border income, and that based on economic allegiance, both countries should have taxing rights).

170 See Avi-Yonah, Simplification, supra note 167 at 1313-14.

171 See supra note 130 and accompanying text.

172 Indeed, some would assert that for purposes of the ability-to-pay criterion, a resident of a country who has income from foreign sources is not similarly situated to a resident with income only from domestic sources. See Ault & Bradford, supra note 1, at 41 (referring to these assertions).

173 See infra Part III.C.

174 Cf. Julie Roin, Competition and Evasion: Another Perspective on International Tax Competition, 89 GEO. L. J. 543, 588-89 (2001) (in arguing for a system where the United States exempts foreign income from taxation, contending that the United States may be justified in imposing some tax on such income because of the government benefits provided by the United States to U.S. corporations with respect to such income, along with the notion that “U.S. corporations may be expected to contribute to the redistributitional social benefits decided by the nation’s electorate”).

175 See infra note 296 and accompanying text.
3. Administrability

Another principle that should guide the development of a sourcing standard is administrability. \(^{176}\) It is important for source rules to operate in a clear fashion and refrain from requiring difficult factual determinations on a case-by-case basis. \(^{177}\) Both taxpayers and tax administrators need clarity and minimal uncertainty in performing their respective compliance and enforcement tasks. This is particularly so where the source of income determines whether a payer of an item is required to withhold in order to collect tax on an in-bound transaction. \(^{178}\)

To this end, the sourcing standard, and the rules devised there under, should avoid overly refined approaches aimed at absolute precision. In particular, while the sourcing standard (discussed in the next section) will call for the division of an item of income among different sources where appropriate, \(^{179}\) this will generally be done using a bright line approach in order to provide clear and predictable source rules. \(^{180}\) Such an approach is further supported by the equity basis that underlies the benefits principle, which, as noted above, is somewhat imprecise given the value judgments involved. \(^{181}\)

An aspect of administrability is that a source tax must be enforceable. \(^{182}\) It would make little sense in designating income as domestic source for purposes of a country’s exercise of source taxation over nonresidents if the tax cannot be enforced because the nonresidents are not physically present in the host country and collection of the tax through withholding would not be feasible. Accordingly, enforcement should be an important consideration under the standard for devising source rules. \(^{183}\)

4. Inappropriate Principles in Developing the Sourcing Standard

The preceding subsections have determined that connection to government benefits and administrability are principles that should guide the development of a standard for sourcing income. This subsection demonstrates why other principles should not be used in developing the

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\(^{176}\) See ALI Project I, supra note 14, at 19; President Reagan’s Tax Proposals to the Congress for Fairness, Growth and Simplicity, 21 WEEKLY COMP. PRES. DOC. 707 (May 29, 1985); Michael J. McIntyre, Tax Rules, supra note 48, at 3-66 – 3-67.

\(^{177}\) See President Reagan’s Tax Proposals to the Congress for Fairness, Growth and Simplicity, 21 WEEKLY COMP. PRES. DOC. 707 (May 29, 1985); Michael J. McIntyre, supra note 48, at 3-66; Andrus, supra note 42, at 842.

\(^{178}\) See Michael J. McIntyre, Tax Rules, supra note 48, at 3-66; cf. ALI Project I, supra note 14, at 36 (referring to withholding complications as a reason for not dividing the source of rental income where a taxpayer had produced the leased property).

\(^{179}\) See infra notes 256-59 and accompanying text.

\(^{180}\) Cf. Andrus, supra note 42, at 842 (noting the administrative benefits of source rules that rely on line drawing).

\(^{181}\) See supra notes 149, 172 and accompanying text.

\(^{182}\) See Shay, Source, supra note 1, at 115.

\(^{183}\) See Walker, supra note 45, at 6, 30.
sourcing standard, because they either do not appropriately relate to sourcing income or are not suitable for crafting source rules intended for multi-lateral adoption.\footnote{In this regard, the principles underlying treaty provisions that reduce or eliminate source taxation on investment income can be viewed as either consistent or supplemental to an approach for sourcing income that focuses on the countries that provide the taxpayer with public benefits relating to the income. To the extent that these treaty provisions reflect the view that the source country’s claim to tax investment income is relatively weak (see supra notes 74-76 and accompanying text), they seem to be consistent with the benefits principle; nevertheless, an evaluation of the related public benefits under the standard proposed in this Article may lead to different allocations of tax jurisdiction than that currently provided in treaties. To the extent that the treaty limitations on taxing investment income aim to prevent excessive source taxation, this principle can co-exist with harmonized source rules founded primarily on the benefits principles, by allowing for treaties to continue reducing the source tax rate on certain income where appropriate to achieve this objective. See supra notes 71-73 and accompanying text.\footnote{See Michael J. Graetz, Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies, 54 TAX L. REV. 261, 270-71 (2001) (Inadequate Principles).}}

\textit{a. Capital Export Neutrality and Capital Import Neutrality}

Capital export neutrality (CEN) and capital import neutrality (CIN) should be examined for their potential for providing principles for sourcing. While these are the key neutrality policies generally thought to govern the structure of cross-border taxation,\footnote{See OECD, supra note 103, at 13 (concluding that the policies of CEN or CIN do not depend in practice on whether a country should have source taxation rights over particular income); Shay, \textit{Source, supra} note 1, at 108-10 (stating that CEN and CIN apply without regard to the division of tax revenue between source and residence countries; concluding that the efficiency criterion offer little help in the design of source taxation).} they apparently have little to offer in developing the sourcing standard.\footnote{See supra note 185, at 270.}

CEN is satisfied when a resident pays the same total of resident country and foreign taxes regardless of whether the income is earned within or without the country of residence.\footnote{See id. at 18.} In this situation, a resident’s decision to invest in the residence country or abroad is unaffected by the tax consequences in the residence and foreign countries.\footnote{See id.} Instead, the decision is dictated by pre-tax returns.\footnote{See Graetz, \textit{Inadequate Principles, supra} note 185, at 270.} Because the location of investments is not affected by the income taxes, economists generally view CEN as essential for worldwide economic efficiency.\footnote{See Shay, \textit{Source, supra} note 1, at 108.}

Whether CEN is achieved does not depend on the method used for dividing tax jurisdiction among countries. For example, CEN would be satisfied if all countries used residence taxation exclusively.\footnote{See Shay, \textit{Source, supra} note 1, at 108.}
Alternatively, CEN would exist with source taxation, provided that residence countries taxed domestic and foreign income the same and allowed for an unlimited and refundable foreign tax credit.\textsuperscript{192} (It should be noted that apparently no country allows for an unlimited foreign tax credit\textsuperscript{193}). On the other hand, CEN is not satisfied where a residence country uses a territorial system that exempts foreign income (assuming that foreign tax rate differs from the rate applied by the residence country on domestic source income), and this would be true regardless how income is sourced for these purposes. Thus, with source taxation, whether or not CEN is satisfied depends primarily on methods used by resident countries for mitigating double taxation.\textsuperscript{194} Nevertheless, CEN does support measures to reduce opportunities for cross crediting, so that taxpayers will not have a tax incentive to invest in activities generating low-taxed foreign income as opposed to domestic income.\textsuperscript{195} And, as discussed above,\textsuperscript{196} a way of combating cross-crediting is to treat income as foreign source only where a foreign country is expected to tax the income. However, as pointed out below,\textsuperscript{197} this expected-to-tax principle is not relevant in designing source rules intended for multi-lateral adoption by countries.

CIN exists when the total tax that is paid on income earned in a country is determined without regard to the residence of the taxpayer.\textsuperscript{198} Thus, CIN requires that all firms operating in a particular country be taxed at the same rate, no matter whether the firms are domestically or foreign owned.\textsuperscript{199} Where CIN holds, the worldwide allocation of savings is efficient because all savers receive the same after-tax returns.\textsuperscript{200}

Upon initial examination, it would seem that similar to CEN, CIN is concerned only with the overall structure of international taxation. Thus, it is often stated that CIN would exist where countries employed territorial tax regimes that exempted foreign source income.\textsuperscript{201} Under such a structure, only the source country would be taxing income from activities or investments within a given country, thus resulting in the same level of taxation for all taxpayers with income from that country.

On closer inspection, however, CIN may have something to say about the design of source rules. For CIN to exist, source countries and residence countries must apply the same source rules in determining the income to tax and exempt, respectively. Moreover, even with the uniform source rules, CIN arguably may be violated if certain source rules were used. For example, assume that all countries sourced sales income according to the
location of the sales activity rather than the destination of the items sold. Under this rule, sales by remote sellers with sales activities in their countries of residence would be treated as domestic source for purposes of residence country taxation and exempt income for purposes of source taxation. Further assume that Country A imposes a 40 percent tax, Country B imposes a 30 percent tax, and Country C imposes a 20 percent tax. In these circumstances, a resident of Country C who is selling goods remotely into Country A would be taxed at 20 percent (the Country C rate), whereas a Country B resident performing the same activity would be taxed at 30 percent (the Country B rate). Thus, CIN may be viewed as violated because the two sellers are not subject to the same tax on income that is earned through activities in Country A, the activities consisting of accessing the Country A market.\textsuperscript{202} If so, then CIN would dictate that sales income should be sourced based on the destination of the goods. On the other hand, it can be claimed that CIN is not violated in this example because the relevant activities are conducted in the residence countries. Under this view, CIN would support place of sales activity source rule. Perhaps CIN calls for a sourcing principle that looks to the situs of economic activities, but it is unclear how this is to be determined in certain situations; in this regard, the benefits principle appears to provide firmer guidance. Moreover, commentators have asserted that CIN has little or no relevance to the taxation of portfolio income, because taxing such income has no effect on the abilities of companies from different nations to compete against one another in a particular country.\textsuperscript{203}

Furthermore, even if CIN did offer a principle for designing source rules, CIN is not the generally accepted neutrality standard,\textsuperscript{204} and consequently does not seem to be an appropriate guide for crafting source rules intended for multi-lateral adopting by countries. Economists generally favor CEN over CIN because distortions in the investment locations are considered to be more costly than distortions in the savings allocation\textsuperscript{205} (and it is

\textsuperscript{202} See infra note 233-37 and accompanying text for a discussion of this basis for sourcing income.

\textsuperscript{203} Graetz & Grinberg, supra note 74, at 558-59. Consequently, while the existence of CIN would appear to depend on the design of source rules, given the apparent uncertainty in applying CIN to situations involving income derived from activities occurring in more than one country, CIN does not appear to provide a firm principle for sourcing income.

\textsuperscript{204} See Jane G. Gravelle, Reform of U.S. International Taxation: Alternatives, CONGRESSIONAL RESEARCH SERVICE 7 (December 17, 2010) (concluding that “capital import ‘neutrality’ is not neutral at all”).

\textsuperscript{205} See Graetz, Inadequate Principles, supra note 185, at 272. Moreover, as a practical matter, CIN is often rejected as an objective compared to CEN and national neutrality, given that many national policies of individual countries affect the return to savings. See James R. Hines, Jr., Reconsidering the Taxation of Foreign Income, 62 TAX L. REV. 269, 273-74 (2009). Nevertheless, economists may still advocate territorial taxation based on a “second best” efficiency argument, as well as asserted simplicity and revenue raising benefits. See Gravelle, supra note 204, at 13-14 (referring to proposals advancing these arguments, but not subscribing to such views).
practically impossible to achieve CEN and CIN simultaneously). Consequently, it is unlikely that countries would generally agree to adhere to CIN, which would be necessary for them to want to use it as a principle for designing source rules. For these reasons, CIN should not inform the development of the sourcing standard.

b. **Expectation that another Country Will Be Taxing the Income**

As mentioned previously, another principle that is sometimes used to source income is whether it is expected that other countries will be taxing the income. The concern underlying this principle is international undertaxation. That is, if income is included in calculating a residence country’s foreign tax credit limitation, but the income is not taxed by another country, the taxpayer would be able to cross-credit excess foreign tax credits on other foreign income against the pre-credit residence country tax on the income, thus resulting in effectively no or a reduced overall tax on the income. Similarly, if the residence country uses a territorial system, exempting income that is not taxed by another country would mean that no country is taxing the income.

The expected-to-tax principle is simply not relevant to the design of source rules in light of the following objectives of this Article – that the sourcing standard should produce source rules that are the same for countries’ taxation of both in-bound transactions by nonresidents and out-bound transactions by residents, and that the source rules form the basis for countries’ exercise of taxing jurisdiction. With the same source rules being applied by countries for inbound and outbound transactions, the concern that underlies the expected-to-tax principle should not be present: income that is treated as foreign source for purposes of a taxpayer’s home country foreign tax credit will be treated as domestic source and thereby be taxable by the host country. Consequently, the expected-to-tax principle should be discarded.

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206 To do so would require uniform income tax bases and tax rates for all countries, or a worldwide government. *See id.*

207 *See supra* notes 58-63 and accompanying text.


209 *See supra* note 59-60 and accompanying text.

210 Of course, even with the general adoption of the sourcing scheme proposed by this article, there will always be outlier countries. However, assuming that they are in the distinct minority, then the expected-to-tax principle should be satisfied automatically in the vast majority of cases (because the vast majority of countries will be using consistent rules) and thus need not be a principle for formulating source rules. If the proposed sourcing scheme is not generally adopted, then it should not be used because of the high degree of double taxation and non-taxation that is likely to result. *See infra* notes 317-20 and accompanying text.

211 *See supra* note 86 for problems under current law with source rules based on this principle.
Finally, the national interests of particular countries should not be considered as relevant factors in developing the sourcing standard. In this regard, some prominent commentators assert that U.S. national interests should dictate the structure of U.S. international income tax rules. Fostering national interests may be a proper consideration in contexts where it is not critical whether countries use harmonized approaches for taxing international income. For example, it would appear that no great harm results where some countries tax their residents on the basis of worldwide income subject to the allowance of foreign tax credits, while other countries employ exemptions systems under which certain foreign income is excluded from home country taxation. Consequently, in deciding among these overall structures for taxing international income, countries may appropriately take into account national concerns such as the economic well-being of their own residents. However, where source rules vary among countries, there is the potential for double or under taxation. For this reason, this Article seeks to develop rules that are suitable for international acceptance, and universal agreement will likely not be reached on source rules that are designed to serve the national interests of one or more nations.

Accordingly, source rules suitable for multi-lateral adoption should avoid features aimed at promoting national interests, such as the title passage rule for inventory sales and the portfolio interest exemption. It

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212 See Graetz, *Inadequate Principles*, supra note 185, at 277-82 (framing the inquiry as what international income tax rules will enhance the economic well-being of U.S. citizens and residents); Graetz & Grinberg, *supra* note 74, at 538 (asking what income tax policy for taxing foreign portfolio investments serves the United States’ interest); Shay, *Source*, *supra* note 1, at 108 (in evaluating the structure of U.S. source taxation, asserting that “the primary obligation of U.S. tax policy is to improve the well-being … of U.S. individuals).  

213 See Musgrave, *Sovereignty*, *supra* note 127, at 1344 (calling for cooperative rules among nations for the division of the tax base and tax rates); OECD, *supra* note 103, at 25 (stressing the need for universal agreement of rules for allocating taxing rights over business profits in order to prevent double taxation or non-taxation).  

214 Cf. Musgrave, *Sovereignty*, *supra* note 127, at 1348 (noting that the national interests of countries may conflict with each other).  

215 See *supra* note and accompanying text. In this regard, commentators assert that the foreign tax credit and the source rules used for purposes of limiting the credit should be focused on mitigating the double taxation of foreign income and “should not be designed to subsidize foreign investment, favor or disfavor particular types of investment, or serve nonrevenue raising foreign policy objectives.” See Shay, *Source*, *supra* note 1, at 149. Commentators have used tax expenditure analysis to demonstrate that the title passage rule as applied to U.S. export sales is an inappropriate and ineffective subsidy for such sales activities; these commentators accordingly recommend that the title passage rule for export sales be repealed, and that the source of income from export sales be determined using an approach that more clearly reflects the location of the underlying economic activities. See J. Clifton Fleming & Robert J. Peroni, *Reinvigorating Tax Expenditure Analysis and Its International Dimension*, 27 VA. TAX REV. 437, 551-61 (2008).
may be contended that such deviations from the benefits principle whereby countries give up tax revenue\(^{217}\) in order to promote national interests are benign from the standpoint of achieving universal agreement: countries not employing such features may simply not care because the effect would be undertaxation borne by another country as opposed to potential double taxation a country’s residents. However, other countries may object because such measures may harm their own national interests – for example, the title passage rule may provide a U.S. exporter with a competitive advantage vis a vis companies operating in the importing country. Similarly, while the portfolio interest exemption stimulates the provision of foreign capital,\(^{218}\) capital importing countries, in particular developing nations, stand to lose tax revenue to capital exporting countries (i.e., developed nations) from source tax exemptions for interest and other types of portfolio income.\(^{219}\) And developing nations usually struggle between their tax revenue and foreign capital needs.\(^{220}\) Thus, countries not

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\(^{216}\) Other commentators also have proposed repealing the portfolio interest exemption, albeit for reasons that differ from those advanced in this Article. See Reuven S. Avi-Yonah, *Memo to Congress: It’s Time to Repeal the U.S. Portfolio Interest Exemption*, 17 TAX NOTES INT’L 1817 (1998) (proposing that Congress repeal the portfolio interest exemption and instead enact a high withholding tax on interest and other deductible payments to nonresidents that would be completely refundable upon proof that the income has been reported to tax authorities in the beneficial owner’s country of residence; basing this proposal on the assertion that the factors that led to the enactment of the portfolio interest exemption no longer exist, and that the exemption has led to the situation where most cross-border portfolio income is not being taxed any jurisdiction, which is unacceptable from an efficiency or equity perspective); Michael J. McIntyre, *Guidelines for Taxing International Capital Flows: The Legal Perspective* (Guidelines) 46 NAT’L TAX J. 315, 318 (1993) (recommending that countries harmonize their withholding taxes on capital income at some positive rate and that the United States should take the first step towards this end by imposing a low-rate withholding tax on all interest payments; basing this proposal on the need to mitigate competitive pressures that undermine countries’ imposition of income taxes and to raise revenue).

\(^{217}\) With the title passage rule, the United States is surrendering some residence taxation; with the portfolio interest exemptions, countries are surrendering some source taxation.


\(^{219}\) See Michael J. Graetz & Michael M. O’Hear, *The “Original Intent” of U.S. International Taxation*, 46 DUKE L. J. 1021, 1033-34 (“capital-exporting and capital importing nations have conflicting financial interests: capital importers have the most to gain from taxation at source, capital exporters from taxation of residents”).

\(^{220}\) See Keinan, *supra* note 70, at 66; Reuven S. Avi-Yonah, *Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State*, 113 HARV. L. REV. 1573, 1639-48 (2000) (*Globalization*). In this regard, commentators have warned “the resulting fiscal sacrifice [by developing countries from source tax exemptions] is likely to exceed by far the potential benefits resulting from new investment capital. See Lee A. Sheppard, *News Analysis: Revenge of the Source Countries, Part III: Source as Fiction*, 40 TAX NOTES Int’l 219 (Oct. 17, 2005) (quoting from a report given by Angel Schindel and Adolfo Atchabahian at the September 12-16, 2005 International Fiscal Association World Congress in Buenos Aires, Argentina). Consequently, there is a growing awareness that for developing countries the sensible approach is to withhold tax on payments of portfolio
favoring source exemptions for portfolio income may well object if the sourcing standard permits such exemptions, because these countries would then be at a competitive disadvantage in attracting foreign capital if they were to impose a source tax on portfolio income. Moreover, permitting deviations from the benefits principle sets a precedent whereby countries may feel justified in varying their source rules where it suits their national interests, and such measures may indeed result in instances of double taxation, thereby frustrating the goals of a universal sourcing standard.

C. Standard for Sourcing Income

The previous section has determined that the sourcing standard should be developed according to the following two principles: (i) sourcing income based on the countries that provide the taxpayer with public benefits that relate to the income and (ii) administrability. This section uses these principles to develop a standard that can be used to derive particular source rules. As a first step in developing the standard, it is important to describe in some detail the types of public benefits that countries provide.

1. Categorizing and Describing Governmental Benefits that Relate to Income

Taxpayers receive numerous governmental benefits that relate to their earning and enjoyment of income. The locations where such governmental benefits are provided can be grouped into three categories: the situs of the activities giving rise to income; the destination of the services, property or capital giving rise to income; and the residence of the person receiving income. Each of these is examined below.

a. Countries Where Taxpayer Conducts Activities

Numerous public benefits arise from government services that are provided in countries where taxpayers conduct income-producing activities. Included among these public benefits are physical infrastructure (e.g., roads and telecommunications), economic infrastructure (e.g., banking systems), legal infrastructure (e.g., court systems and regulatory agencies), public income to foreign investors. See id.; Cockfield, supra note 82, at 99 (pointing out that many developing nations prefer the provisions contained in the United Nations model tax treaty, which enhance source taxation); but cf. Keinan, supra note 70, at 66 (contending that although residency taxation of financial transaction income would shift revenue from developing countries to developed countries in the short run, it would benefit developing countries in the long run).

221 With only some countries taxing portfolio income, it can be expected that most of the tax would be shifted to the borrower in the form of higher interest payments. See McIntyre, Guidelines, supra note 216, at 318.

222 For example, a country that wants to curb imports may enact a source rule that results in more domestic source income than that prescribed by multi-lateral sourcing standard.
safety, national security, and a skilled workforce.\textsuperscript{223} These products of government activities are either essential for, or contribute greatly to, the capacity of taxpayers to carry on activities in the particular country. As discussed in the previous section,\textsuperscript{224} the receipt of these government benefits justifies a source tax, and thus the location of these benefits should serve as a basis for sourcing income. Indeed, several of the current source rules determine the source of income based on the location of the economic activities giving rise to the income, which can be viewed as a surrogate for the location of the public benefits provided; these include the rules for sourcing service income\textsuperscript{225} and manufacturing income.\textsuperscript{226}

\subsection*{b. Countries in Which Taxpayer Provides Property, Capital or Services}

Where a taxpayer provides property, capital or services into a country, the country of destination is providing the taxpayer with government benefits that relate to the earning of income. This is most easily understood in the form of legal protections provided by a destination country to a taxpayer in connection with royalties received for licensing patents, copyrights or other intangibles for use in that country.\textsuperscript{227} In this regard, the source rules typically source royalty income based on the location of the legal protections.\textsuperscript{228} Destination countries provide other public benefits to taxpayers as well. For example, when a taxpayer is providing capital to a corporation, both the country (or countries) where the corporation conducts activities as well as the country under whose laws the corporation is formed are providing benefits that contribute to the taxpayer’s ability to receive dividend income and stock gains; the former country provides benefits in support of the corporation’s activities and the latter country provides the legal infrastructure that protects and regulates the taxpayer’s investment in the corporation.\textsuperscript{229} Current U.S. law recognizes both types of public benefits in sourcing dividend income, with dividends generally sourced according to the corporation’s country of incorporation, but with exceptions that look to the place of substantial business activity conducted by the company.\textsuperscript{230} Similarly, a taxpayer who loans money indirectly profits from the public benefits received by the borrower in connection with the borrower’s income-producing activities, which provide the borrower with

\textsuperscript{223} See Shay, Source, supra note 1, at 90.

\textsuperscript{224} See supra Part III.B.1.

\textsuperscript{225} See I.R.C. § 861(a)(3); supra note 29 and accompanying text.

\textsuperscript{226} See Treas. Reg. § 1.863-3; supra note 34 and accompanying text.

\textsuperscript{227} See ALI Project I, supra note 14, at 45; See Shay, Source, supra note 1, at 143; Lokken, supra note 55, at 240-41.

\textsuperscript{228} See I.R.C. § 861(a)(4); supra notes 25-26 and accompanying text.

\textsuperscript{229} See ALI Project I, supra note 14, at 63.

\textsuperscript{230} See I.R.C. §§ 861(a)(2), 871(i)(2); supra notes 19-20 and accompanying text.
funds to pay interest to the taxpayer. The current U.S. source rule is generally in accord with this view, as it sources interest income based on the residence (in the case of non-corporate borrowers) or country of incorporation (in the case of corporate borrowers) of the debtor, unless the debtor has substantial business activities, or a banking branch outside its country of residence or incorporation.

In addition, the country of destination provides significant public benefits by performing the government services essential for establishing a market for a taxpayer’s goods and services. The market in any country could not exist without the necessary physical, economic and legal infrastructure, and this is largely a result of government functions. And by accessing a country’s market through the sale of goods and services, a taxpayer is benefiting from these government activities, thus justifying a source tax to some degree on the income earned. While current U.S. law does not appear to recognize market access as a basis for sourcing income, several leading commentators advocate that the United States should tax nonresidents as a charge for exploiting the U.S. market, and other notable analysts view market access as a legitimate basis for exercising source taxation in general.

231 Cf. ALI Project I, supra note 14, at 63 (stating that the general principle under the current source rules for interest appears to be that the interest is sourced in the country that is reasonably presumed to be the place where the borrower derives the income or wealth that funds the interest payments).

232 See I.R.C. §§ 861(a)(1), 861(c); supra notes 17-18 and accompanying text.

233 See Shay, Source, supra note 1, at 91; Avi-Yonah, Electronic Commerce, supra note 130, at 540; cf. ALI Project I, supra note 14, at 20 (stating that it might be appropriate to source income from the sale of inventory in the country in which the purchaser is located, because this is the country that has provided the market for the goods sold).

234 See Shay, Source, supra note 1, at 91; cf. OECD, supra note 103, at 14 (some members of the Technical Advisory Group studying the taxation of electronic commerce concluding that source taxation of a supplier not physically present in a market country is justified because the business profits derive partly from the use of the country’s infrastructure, such as “means of transportation (such as roads), public safety, a legal system that ensure the protection of property rights and a financial infrastructure”).

235 An exception to this may be the source rule for international communications income that is earned by U.S. persons, which treats fifty percent of such income as foreign source, possibly because the U.S. person is viewed as having accessed a foreign country’s market by transmitting communications or date to that country. See I.R.C. 863(e). While not based on the market access rationale, the title passage rule that applies under U.S. law for inventory sales can produce a source designation that is consistent with a market access approach. For example, where inventory is sold into a foreign country with title passing to the buyer in that country, the income will be foreign source. Of course, sales into the foreign country can also generate U.S. income if title to the goods passes in the United States. In any event, simply selling inventory into a country is not likely to result in a source tax in the absence of some other business activity in that country (and possibly a fixed place of business if a treaty applies). See, e.g., I.R.C. §§ 871(b), 882(a), 864(b); See, e.g., OECD Treaty, Articles 5.7.

236 See Shay, Source, supra note 1, at 91.

237 See Avi-Yonah, Electronic Commerce, supra note 130, at 540; cf. Graetz, Inadequate Principles, supra note 185, at 299 (stating that countries that supply only a market for goods and services may have a basis for exercising source taxation). In this regard, the
c. Country Where Taxpayer Resides

The taxpayer’s country of residence provides public benefits that relate to the taxpayer’s earning and enjoyment of income. Specifically, the residence country contributes to the ability of a taxpayer to acquire and protect the wealth arising from income by providing a legal system that governs rights and obligations. These public benefits include the creation of a court system and the regulation of financial markets and commercial activity. Moreover, through military protection and agencies that are responsible for relationships with other nations, a country is providing services that protect its residents’ financial interests in other countries.

For income that is consumed by individuals, the residence country provides important government benefits to the individual that relates to consumption; one would be unable to spend and consume income within a given country in the absence of the government services that support physical, legal and economic infrastructure as well as public safety.

To an extent, current law appears to recognize the benefits provided by the residence country in assigning jurisdiction to tax. For example, although the U.S. rules generally source interest income according to the residence of the borrower, most interest paid by U.S. persons to nonresidents is exempt from U.S. tax under the portfolio interest exemption. While the stated reason for this exemption is to allow U.S.
borrowers the opportunity to participate in the Eurobond market,\textsuperscript{244} the notion that the resident country has a greater right to tax such interest may also play a role.\textsuperscript{245} More generally, treaties usually assign the right to tax interest and royalties to the residence country,\textsuperscript{246} and significantly reduce the rate of source taxation on dividends.\textsuperscript{247} Again, although the prevention of excessive source taxation is an important reason for these treaty provisions,\textsuperscript{248} they also seem to reflect a determination that the residence country has the greater taxing rights over these types of income,\textsuperscript{249} or that at least tax jurisdiction should be shared between the residence and source countries.

2. Unifying the Activities, Destination and Residence Approaches for Sourcing Income

\textit{a. The Benefits Principle and the Propriety of Split Sourcing}

As discussed above, several countries may be providing governmental benefits to a taxpayer that relate to the taxpayer's income, with these countries grouped into three categories – location of activities, destination of property, capital or services, and country of residence. In many situations, more than one country may provide benefits in different categories. For example, a taxpayer who resides in one country may receive dividends from a corporation that is incorporated and does business in another country. In this situation, there are governmental benefits relating to the income provided by both the residence country (where the taxpayer resides) and the destination country (where the corporation is incorporated and does business, which is the destination of the taxpayer's invested capital). In fact, for a given item of income, countries in all three categories may provide benefits. For example, a taxpayer who resides in one country may develop an intangible in another country and license the intangible for use in a third country. Here, the taxpayer is receiving public benefits from the residence country, the activities country (where the intangible is developed), and the destination country (where the intangible is being used). Current law addresses such situations by sourcing all of the income to one of the countries involved.\textsuperscript{250} Thus, in the first situation, all of the

\begin{itemize}
\item \textsuperscript{244} See supra notes 67-70 and accompanying text.
\item \textsuperscript{245} See supra note 21 at 194 (providing as a possible explanation for the portfolio interest exemption that source country’s claim to tax interest received by a nonresident may be considered to be weak); Graetz & Grinberg, supra note 74, at 569 (stating that the source country’s claim to tax portfolio income is more attenuated than its claim to tax business income, and that the claims of the residence country seem to deserve priority in the inter-nation allocation of tax jurisdiction over portfolio income; pointing out that primary allocation of taxing rights over portfolio income reflects this priority).
\item \textsuperscript{246} See supra notes 22, 28 and accompanying text.
\item \textsuperscript{247} See supra note 23 and accompanying text.
\item \textsuperscript{248} See supra notes 71-73 and accompanying text.
\item \textsuperscript{249} See supra note 245.
\item \textsuperscript{250} See supra notes 19-20, 25-27 and accompanying text.
\end{itemize}
dividends are sourced to the country of destination despite the public benefits that are also provided in the residence country.\textsuperscript{251} And in the second situation, all of the royalties are sourced to the destination country even though all three countries are benefitting the taxpayer.\textsuperscript{252}

The current approach apparently is to choose the country to which the income primarily relates.\textsuperscript{253} However, this can sometime lead to arbitrary determinations;\textsuperscript{254} it is not always clear which of the countries is the greatest contributor to the income in question. More fundamentally, the current “single source” approach is inappropriate given that often more than one country is providing significant public benefits. Furthermore, an approach that seeks to determine the primary country that is providing public benefits can lead to disagreements among nations,\textsuperscript{255} and thus does not appear suitable for multi-lateral adoption.

Instead, a unified approach is called for, one that recognizes those countries that provide significant public benefits that relate to the income. Accordingly, this Article proposes that multi-lateral source rules be devised pursuant to a standard that evaluates income for sourcing on the basis of three factors: the destination of the services, property or capital giving rise to income; the location(s) of the activities giving rise to income; and the residence of the person receiving income.\textsuperscript{256} Each of these countries has the

\textsuperscript{251} See, e.g., I.R.C. § 861(a)(2).
\textsuperscript{252} See, e.g., I.R.C. § 861(a)(4).
\textsuperscript{253} See Lokken, supra note 55, at 242-43; ALI Project I, supra note 14, at.
\textsuperscript{254} See Mason, supra note 82, at 1591.
\textsuperscript{255} See supra notes 106-12 and accompanying text.
\textsuperscript{256} Cf. Azam, supra note 127, at (proposing that source rules for taxing electronic commerce be developed by taking into account the locations of producers, consumers and other physical facilities and components that contribute to e-commerce income, so that the tax pie can be divided fairly among countries). These factors, and the bases for them, are conceptually consistent with the idea of economic allegiance for determining the tax jurisdiction of countries that was developed by four prominent economists in their seminal report for the League of Nations. See League of Nations, Economic and Financial Commission, Report on Double Taxation Submitted to the Financial Committee by Professors Bruins, Einaudi, Seligman, and Sir Josiah Stamp, League of Nations Document no. E.F.S.73F.19 (Geneva: League of Nations, 1923). In determining the meaning of economic allegiance, the report identified four fundamental considerations: (i) the acquisition of wealth, (ii) the location of wealth, (iii) the enforceability of the rights to wealth, and (iv) the consumption of wealth. See id. at 22-23. Corresponding to these considerations are four points that are significant in determining the proper place of taxation: (i) the place of origin of wealth, (ii) the situs of wealth, (iii) the place of enforcement of the rights to wealth, and (iv) residence or domicile. See id. at 23. The report concludes that of the four, the place of wealth origin and residence or domicile of the taxpayer are the most important, with the other two factors mostly significant in reinforcing the tax claims of the country of origin or domicile. See id. at 25. In examining the origin of wealth with respect to the human relations that help create wealth, the report discusses the places where activities such as management occur as well as “the selling end, that is, the place where agents for selling ply their calling and where the actual markets are to be found.” See id. at 24. And in applying the economic allegiance criteria to real estate mortgages, the report views the place of wealth origin as where the land is located, apparently embracing an approach that determines origin in this context based on the destination of the loaned capital. See id. at 34-35; but cf. id. at 36 (in evaluating the origin
potential for contributing significantly to the earning of income, as demonstrated above and as reflected in the current source rules. Under this standard, a given item of income may have its source divided among multiple locations. Thus, in the second example above, a portion of the royalty income would be sourced to the residence country, the activities country and the destination country. Subsection 3, below, discusses the specifics of assigning income portions.

b. Defending the Residence Country Source Portion

For the most part, commentators appear to view a split-sourcing approach as appropriate from the standpoint of the benefits principle. The major concerns with such an approach are administrative and of income on corporate shares, the report favors the place where the owners of the corporation, i.e., the shareholders, reside, as opposed to the place where the corporation earns the dividends, especially because determining the location of the underlying corporate earnings would be complicated where the corporation has production, sales or a chief office in more than one country. Thus, similar to the factors identified in this Article, the League of Nations report focuses on where the taxpayer resides and where wealth is produced, with the latter apparently taking into account both the activities giving rise to income along with the destination of the products or capital in some cases.

257 See supra notes 223-24, 227, 229, 231, 233-34, 238-41 and accompanying text.
258 See supra notes 225-26, 228, 230, 232, 242-47 and accompanying text; cf. Avi-Yonah, Globalization, supra note 220, at 1586 (pointing out that three types of jurisdictions may, under current rules, impose a tax on cross-border sales of goods or provision of services: both the supply and demand jurisdictions may impose a source tax, and the residence jurisdiction may impose residual tax that is not taxed by the supply or demand jurisdictions).
259 Cf. Kevin A. Bell, Indian Official Says Source Country Should Have Greater Taxing Rights, INT’L TAX MON. (February 26, 2008) (Indian official quoted as stating that the source country and residence country should each have the right to tax one half of certain income that originates in India).
260 See, e.g., ALI Project I, supra note 14, at 35-36, 48 (stating that it seems anomalous to assign all of the rental income from leasing tangible property produced by the taxpayer to the country of use; noting that conceptually royalty payments received on the license of intangible property developed by the taxpayer represent income generated by both the creation and exploitation of the intangible); Lokken, supra note 55 at 242 (acknowledging that with regard to royalty income received from the license of intangible property developed by the taxpayer, both the country that was the situs of development activities and the country where the intangible is used provide important services and protections); Christians, supra note 78, at 20-21 (stating that a highly analytical approach for determining the source of service income might attribute the income to one or more jurisdictions, each of the contacts with which provides an economically defensible basis for determining source).
261 See, e.g., ALI Project I, supra note 14, at 36, 48 (pointing out administrative difficulties of splitting the source of rental income received from leasing tangible property produced by the taxpayer; pointing out administrative difficulties of splitting the source of royalty income received from licensing intangible property developed by the taxpayer); Lokken, supra note 55, at 242-43 (pointing out administrative difficulties of splitting the source of royalty income received from licensing intangible property developed by the taxpayer); cf. Christians, supra note 78, at 21 (stating that the U.S. source rule for service income, which
coordination among countries, which are addressed in the next subsection. However, some leading commentators would probably take issue with sourcing a portion of income to the country of residence. With regard to U.S. source taxation, they assert that where a nonresident is doing business in the United States (or possibly accessing that U.S. market), the public benefits provided by the United States to the nonresident are quite similar to the public benefits provided to residents, thus justifying a source tax that is equivalent to that imposed on U.S. residents. These commentators also are concerned that U.S. residents would perceive a lower tax for nonresidents as inequitable, and thus damage the legitimacy and efficacy of the residence tax. The commentators specifically disagree with other analysts, who argue that nonresidents should pay a lower tax than residents on income earned in a particular country because the nonresidents are receiving fewer public benefits from that country.

This criticism is not warranted. First and foremost, assigning a portion of income to the residence country is in accord with the benefits principle. Because a resident benefits from home country government activities with respect to income that is either accumulated or consumed, the residence country should have a primary right to tax at least a portion of

looks to the place where services are performed, is probably based primarily on administrative considerations).

262 See, e.g., ALI Project I, supra note 14, at 37, 48 (stating that no case has been found in which a country divides the source of rental income between the place where the leased property was developed and the place where it is being used; noting that few if any countries divide the source of royalty income between the place where the licensed property was developed and the place where it is being used).

263 See Shay, Source, supra note 1, at 90-91; cf. Lokken, supra note 55, at 239 (asserting that consumer benefits received by individuals are not related to the issue of source of income).

264 See Shay, Source, supra note 1, at 110-11.

265 See id. at 90-91.

266 See Harris, supra note 132, at 457 (the rate of tax on nonresidents with domestic income should be less than that on residents with domestic income, “because nonresidents deriving domestic income receive less government services than residents deriving such income, i.e. they are not in receipt of residence or consumption services from the domestic government”); VanderWolk, Benefits Theory, supra note 241, at 1469 (arguing that the taxation of foreign-source business income should be divided more or less equally between the residence country and the source country because of the government services provided by each country); Jefferson VanderWolk, BULLETIN FOR INTERNATIONAL FISCAL DOCUMENTATION 173, (April 2000) (proposing an approach under which the tax rate on the local-source income of nonresidents is lower than the rate on residents’ income, because nonresidents receive less government benefits than residents – nonresidents “receive only production services, not consumption services”); cf. Julie Roin, supra note 174, at 591 (stating that “a case can be made for imposing a lower tax on the U.S. income of foreign corporations than on the U.S. income of domestic corporations,” because foreign corporations are receiving less benefits from the United States as compared to domestic corporations); Avi-Yonah, Against Taxing Citizens, supra note 238, at 7 (in arguing against the United States taxing nonresidents citizens on their worldwide income, pointing out that nonresident citizens do not receive certain significant benefits that are received by U.S. residents or only receive them in a substantially weaker form).

267 Several commentators agree with this proposition. See supra note 266.
income that is derived from activities or market access that occurs outside of that country. This in turn should reduce the income over which the countries of activities and destination should have a right to tax. To support this proposition, consider the case of an individual who resides in Country A but who derives all of her income from Country B, which has a tax rate that exceeds the Country A tax rate, thus precluding any residual tax by Country A even if it employed a foreign tax credit system as opposed to an exemption system. The individual consumes all of her income in Country A, and uses the banking and financial system of Country A to protect the wealth that accumulates from the income. Furthermore, the government activities of Country A, through its military and state department, protect her property rights in Country B. If the individual’s income was sourced only on the basis of activities and destination, she would pay no tax to Country A, despite the public benefits that she receives from Country A. To prevent this, at least a portion of the taxpayer’s income should be assigned to Country A for primary taxation purposes in order for the taxpayer to shoulder some of the burden of Country A government costs from which the taxpayer clearly benefits.

As far as the perceived inequity of a country taxing nonresidents less heavily than residents (which would occur where a portion of the income is sourced to the residence country), residents may well not feel that they are being unfairly treated given that nonresidents are receiving fewer benefits – in particular, a lack of public benefits relating to personal consumption. Indeed, an argument can be made that if nonresidents are subject to the same taxes as residents despite receiving less public benefits from the host country, the nonresidents may be the ones who feel that they are being treated unfairly. This could result in less compliance by nonresidents as well as steps taken to reduce their exposure to source taxation – for example, by avoiding a presence in the host country and instead carrying out host country activities remotely.

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268 See VanderWolk, Benefits Theory, supra note 241, at 1469 (arguing that the taxation of foreign-source business income should be divided more or less equally between the residence country and the source country, because of the government services provided by each country); Harris, supra note 132, at 462-63 (proposing that residents deriving foreign income should be taxed by the residence country on their worldwide taxable income at the full residence income tax rate, “but should receive a tax credit with respect to their foreign income at the source income tax rate,” with the source tax rate being lower than the residence tax rate; this will result in residents with foreign income contributing to the cost of the government services that they receive, i.e., consumption services); Roin, supra note 174 at 588-89 (in arguing for a system where the United States exempts foreign income from taxation, contending that the government benefits provided by the United States to U.S. corporations with respect to foreign income “may be substantial enough to justify some home country tax” on such income).

269 See Roin, supra note 174, at 591 (“Exactly the same factors that justify the imposition of an add-on tax imposed with respect to the foreign income of a U.S. corporation, then, justify a corresponding downward adjustment in the rate of corporate tax payable on the domestic income of foreign corporations.”).

The difference in benefits provided to residents and nonresidents may also mitigate or eliminate any concerns that nonresidents would have an advantage in competing with residents in the particular country. A lower source tax on nonresidents would only present this concern where the difference in tax burden is not being made up by tax liability in the residence country on the portion of the income sourced to it. With substantially harmonized source rules (the end-product of this Article’s endeavor), there would likely be a lack of a significant residence tax only where the residence country is not providing important benefits to its individuals and corporations, such as stable legal protections.271 In this regard, investors in a tax haven corporation would likely have a higher degree of legal risk than investors in a corporation from a developed country. Given this tradeoff, nonresidents may well not have a competitive advantage over residents even if the nonresidents faced lower overall tax liability.272 Nevertheless, countries could always remove any perceived advantage by subjecting the residence country source portion of income to a form of residual source taxation -- that is, a host country could impose a tax on the entire portion of a nonresident’s income that is derived from activities in the host country, subject to a credit for any residence country taxes that are imposed on the portion of the income that is sourced to the residence country.273

An additional reason for assigning a portion of income to the residence country is to have a reasonable allocation of tax jurisdiction that can be agreed to by nations on a multi-lateral basis. Under the destination component of the proposed standard, where a taxpayer earns income by accessing a country’s market, a portion of the income should be assigned to that country even without the taxpayer’s actual presence in the country, which is not the case under current law.274 Similarly, the proposed standard will assign taxing rights over a portion of interest and royalty income to the destination country, thereby altering the typical rights of residence countries to tax such income in its entirety.275 These features of the standard thus expand the reach of source taxation. Allowing residence countries a primary right to tax a portion of income is an appropriate and fair

271 Cf. Roin, supra note 174, at 589 (differences in the tax rates imposed by countries often reflect differences in the level of government benefits provided).
272 Cf. id. at 588-91 (contending that the proposed structure, which generally exempts U.S. corporations’ foreign income but considers the imposition of an add-on tax on such, and considers taxing foreign corporations on U.S. income at a lower rate than that applied to the U.S. income of U.S. corporations, adheres rather closely to capital export neutrality, with neutrality “expanded to include governmental benefits”).
273 This would be similar to the tax imposed under section 877, under which a nonresident alien who is treated as having expatriated to avoid U.S. tax is subject to U.S. tax on U.S. source income, as expanded under the provision, but with a credit for foreign taxes on income that taxable solely as a result of section 877. See I.R.C. § 877(a), (b), (d).
274 See supra notes 36-38 and accompanying text.
275 See supra notes 21-22, 28 and accompanying text.
counterbalance to these features, and a measure that is more likely to bring about international accord on a sourcing standard.276

c. Less Stress on Characterization

In addition to doing a better job of effectuating the benefits principle, the proposed standard would also reduce or possibly eliminate the current stress that is placed on characterizing income items for purposes of applying source rules. As mentioned previously, under the current source rules, a great deal turns on how income is characterized.277 This is because the current single source rules result in very different results depending on the type of income involved. For example, royalties received on a license of a patent are sourced where the patent derives its legal protection,278 whereas gain on the sale of a patent is usually sourced where the seller resides.279 Characterization is particularly problematic in the case of transactions involving intangibles and electronic commerce, where the income from a given transaction may take the form of royalties, compensation or property gains based on the specific facts and circumstances.280

276 Notwithstanding the conceptual basis for residence-based sourcing, there may be a concern over determining the residence of corporations, which of course is necessary in deciding where to source the residence-based portion of income earned by corporations. Cf. Andrus, supra note 42, at 848 (pointing out that residence-based source rules will place tremendous pressure on the residence definition). Under U.S. law, corporate residency is based on the country of incorporation. See I.R.C. § 7701(a)(4), (5). As a consequence, a publicly traded corporation can avoid being subject to U.S. tax on its worldwide income, as well as being subject to subpart F on foreign income, simply by being incorporated outside the United States. See Shay, Task Force, supra note 26, at 746-47. This concern has prompted some commentators to advocate tests for determining corporate residency that focus on what are arguably more meaningful factors than the place of incorporation. See id. at 749-755 (evaluating alternative tests and concluding that the place of incorporation should be retained). Recently, bills have been proposed in Congress that would enact a new section 7701(p), which would treat any large or publicly-traded foreign-organized corporation as a domestic corporation for U.S. tax purposes if the management and control of the corporation occurs primarily in the United States. See “International Tax Competitiveness Act of 2011,” introduced as H.R. 62 in the 112th Congress; “International Tax Competitiveness Act of 2010,” introduced as H.R. 5328 in the 111th Congress; “Stop Tax Haven Abuse Act,” introduced as S. 506 and H.R. 1265 in the 111th Congress; see also New York State Bar Association, Report on the Management and Control Provision of the “International Tax Competitiveness Act of 2011” (January 31, 2011) (providing comments on this legislative proposal). While determining corporate residency is important in crafting harmonized source rules that use residence-based sourcing, this issue will need to be left for a future endeavor. For now it may be useful to point out that a basis for sourcing a portion of income to the residence country, that being the legal protections provided by that country, may support a corporate residency test that looks to the country of incorporation. If it is appropriate to focus on factors beyond the place of incorporation, several alternative tests have, been suggested for determining corporate residency for purposes of residence taxation. See Shay, Task Force, supra note 26, at 749-55.

277 See supra notes 98-102 and accompanying text.

278 See I.R.C. § 861(a)(4).

279 See I.R.C. § 865(a).

280 See ALI Project I, supra note 14, at 43; Andrus, supra note 42, at 855-56.
As a consequence, the current approach often leads to a great deal of uncertainty, as well as the potential for double taxation or non-taxation because countries may be characterizing an item differently (even if they used similar source rules). More fundamentally, the current rules are flawed in that they produce different source results for transactions that are economically similar. This in turn creates planning opportunities for taxpayers, with the attendant concerns of manipulation, compliance and enforcement. To restate an illustration provided earlier, where a U.S. resident develops an invention in the United States, obtains a foreign patent on the invention, and then sells the foreign patent, all of the gain will be U.S. source; however, if instead of selling the patent the taxpayer licenses the patent in exchange for a lump sum royalty for a period that is slightly less than the patent’s remaining life, all of the income would be foreign source. Despite the similarity in the substance of these two alternatives, the source results are quite different.

Under the proposed standard, there would be similar source results regardless of how a transaction is characterized. Because the sourcing standard calls for rules that would divide the source of income among the countries of activities, destination, and residence, economically similar transactions would have the same or similar source results. Specifically, in the case of an intangible developed by the taxpayer, the standard would support a rule that allocates the source of royalty income among the country where the intangible was developed, the country where the intangible is being used, and country where the taxpayer resides. The same rule should be appropriate for gain from the sale of an intangible developed by the taxpayer. Consequently, the different source results in the example above would no longer obtain.

Because the sourcing standard recognizes the public benefits of the different countries involved, and the location of these benefits relates to the economic substance of a transaction, rules developed pursuant to the standard should produce similar sourcing results for transactions with similar economic substance. This would reduce the uncertainty and potential for taxpayer manipulation that plagues current law. It would also avoid the need for harmonized characterization rules for nations, which would be necessary if multi-lateral source rules continued to use a single source approach with different rules based on the type of income involved. Although there are single source rule options for reducing uncertainty and manipulation, such as residence-based or destination-based sourcing for all service and intangible income, these approaches would be distortive.

281 See supra note 113 and accompanying text.
282 See supra notes 101-02 and accompanying text.
283 See I.R.C. §§ 865(a), 865(g)(1).
285 See infra notes 351-53 and accompanying text.
286 See infra notes 354-57 and accompanying text.
287 See Andrus, supra note 42, at 856.
288 See ALI Project I, supra note 14, at.
in light of the benefits principle and may well not be acceptable internationally.\textsuperscript{289}

3. Addressing Administrative and Coordination Concerns

\textit{a. An Allocation Scheme that Avoids Administrative Difficulties}

Commentators who agree that the current source rules are arbitrary because they typically choose the primary country that provides related public benefits, while ignoring other countries that are also providing benefits, view the current approach as necessary.\textsuperscript{290} That is, while in a given situation there may be connections to several different countries, an approach that attempted to attribute income to each of the countries involved would be overly complex and unadministrable.\textsuperscript{291}

While taking into account all benefit-providing nations would be unworkable, the proposed standard eschews such an approach in favor of one that limits the source inquiry to the countries that are likely to provide significant public benefits that relate to the income in question. Thus, certain less significant connections, such as the residence of the payer or the place where payment is made, are ignored because it is administratively impossible to allocate income to every country with some connection to the transaction.

In applying the standard to devise rules, certain lines should be drawn to promote administrability. For example, service income should be sourced without regard to where the taxpayer was educated or developed her skills. Although the development of human capital is related to earning compensation income and could fall within the activity component,\textsuperscript{292} taking this into account is too difficult administratively; moreover, human capital development would likely occur at the place where services are performed,\textsuperscript{293} and under the standard a portion of the income will be sourced there in any event. In the same vein, source rules devised pursuant to the standard should use reasonably certain indicia for the place of activities or destination. For example, in determining the destination of goods or services, the rules should use well-developed factors such as the “use, consumption, or disposition” concept that is currently used under U.S. law.\textsuperscript{294} Similarly, it would be advisable for the location of taxpayer activities to be limited to those jurisdictions where taxpayers engage in \textit{significant} activities involving manufacturing, sales, development, or services that relate to the income in question.

\textsuperscript{289} See Andrus, supra note 42 at 856.
\textsuperscript{290} See, e.g., Christians, supra note 78, at 20-21.
\textsuperscript{291} See id. at 20.
\textsuperscript{292} Cf. Shay, Source, supra note 1, at 140 (arguing that country where a service provider’s extensive human capital was developed would seem to have a claim to tax a portion of the service income).
\textsuperscript{293} See Graetz & Grinberg, supra note 74, at 569.
\textsuperscript{294} See Treas. Reg. § 1.864-6(b)(3)(ii).
The most important administrative issue with the proposed sourcing standard is determining the portions of income that should be assigned to the different components. That is, once it is decided that an item of income should be divided among the standard’s components, what method should be used to make the allocation? For many situations, there would not be a precise basis for making allocations. For example, it would be nearly impossible to value the public benefits provided by the residence country in order to determine an appropriate allocation for the residence country component. Likewise, where income is allocated to the destination country because a taxpayer has accessed that country’s market by selling goods or services into the country, the value of the public benefits provided by the destination country appears to be indeterminable. In some cases, arm’s length pricing principles may provide a basis for making allocations, but these principles would only be helpful in assigning income to economic activities. Thus, the arm’s length method would not be able to determine the portion of portfolio income that should be allocated to a residence country, or the appropriate allocation of income between the country of sales activities and the country of destination. Yet, some allocation is appropriate in light of the public benefits provided at the different locations.

To address these difficulties, allocations among the sourcing components generally should be made using fixed percentages that are mutually agreed to by countries. An inexact allocation using fixed percentages is the only practical approach for split sourcing where it is not possible to determine with any degree of precision the value of government benefits provided by countries. And such an approach is superior to no allocation at all because it at least recognizes that more than one country is providing significant government benefits that relate to the income. As an illustration of this approach, countries may decide that service income should be allocated by assigning one third of the income to each of the countries where the services

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295 In this regard, several leading commentators have expressed their opposition to an approach that would partially exempt international income from the tax bases of the source and residence countries based on the view that international income receives fewer governmental benefits than income earned within a taxing country by its residents. See Fleming, supra note 155, at 334-37. The commentators object to this approach in part because the approximate cost of the government benefits provided by the countries involved is not capable of being measured. See id. at 337.

296 The determination of these percentages should generally be made based on a rough evaluation of the amount of public benefits provided by the residence, activities and destination countries. However, as mentioned previously, it may be appropriate also to take into account equity considerations underlying ability-to-pay taxation in determining the portion of the income that is sourced to the country of residence. See supra notes 173-75 and accompanying text.

297 Moreover, the benefits principle’s equity basis for sourcing is somewhat imprecise given the value judgments involved. See supra notes 149, 172 and accompanying text.
are performed, where the services are used or consumed, and where the taxpayer resides. 298

The use of fixed percentage allocations to source income has support under current law. For income that is attributable to transportation that either begins or ends in the United States, the current U.S. rules treat 50 percent of the gross income as U.S. source and 50 percent as foreign source. 299 The U.S. rules also use a 50-50 method to source international communications income that is earned by U.S. persons. 300 Similarly, income from the manufacture and sale of inventory is generally sourced by allocating 50 percent of income to the place of manufacturing and 50 percent of the income to the place of sales. 301 Furthermore, the apportionment formulas used by U.S. states provide analogous support for using fixed percentages in sourcing income. These formulas typically apportion income among states by using fixed percentage factors – for example, an equally weighted three-factor formula that takes into account the location of sales, payroll costs and assets. 302 Recently, some commentators have proposed using similar formula apportionment schemes in lieu of transfer pricing to allocate income among affiliated corporations. 303 These measures reflect a judgment that where more precise allocations are unavailable or too difficult, a reasonable allocation of tax jurisdiction based on fixed percentages is superior to no allocation whatsoever.

As alluded to above, it would be appropriate to use arm’s length pricing principles to allocate income within the activity component. For example, in lieu of the 50-50 method generally used under U.S. law to allocate income between manufacturing activities and sales activities, it would be advisable to base such allocations on the arm’s length method. 304 This would allow for a determination that takes into account the economic income attributable to these activities, which should serve as a reasonable proxy for the government benefits provided at these locations. The use of arm’s length principles to allocate income among a taxpayer’s activities would also promote the neutral treatment of activities conducted through branches and subsidiaries, given the use of the arm’s length method to allocate income where activities are conducted through affiliated

298 Cf. Bell, supra note 259 (Indian official quoted as stating that giving the residence and source countries the rights to tax one half of certain income that originates in India “would be an amicable resolution of the problem”).
299 See I.R.C. § 863(c).
300 See I.R.C. § 863(e).
303 See, e.g., Avi-Yonah, Clausing, & Durst, supra note 131.
304 See ALI Project I, supra note 14, at 29-33 (recommending that the source of income from the production and sale of tangible personal property be determined by apportioning the income between the countries of production activities and sales activities using arm’s length principles).
corporations. For the same reasons, it would be appropriate to use arm’s length principles to allocate income within the activity component in other situations, such as in the case of global dealing operations involving financial products. The use of arm’s length principles in these and other similar situations is consistent with the functional separate entity method that is authorized by the OECD model treaty as well as by some recent U.S. treaties.

In theory, arm’s length principles can also be used in certain situations to allocate income between the activities component and the destination component of the sourcing standard. For example, where a bank incorporated in Country A makes a loan to a resident of Country B, with all of the loan activities done at a branch located in Country C, it may be possible to divide the interest income received by the bank between the activities and destination components by determining an arm’s length charge for the banking services performed by the Country C branch. This may provide an economically justifiable way of determining the portion of the interest that represents compensation for the banking services and the portion that represents compensation for the use of money. (A portion would still need to be assigned to Country A, the residence country). However, a problem with using arm’s length principles to make this allocation is that since the interest would be received over time, it would be necessary to apportion each payment of interest between the banking services element and use of money element, which would require the use of present value concepts to achieve a degree of accuracy. Moreover, given the uncertainty in determining an arm’s length charge for the banking services at the Country C branch, using this method would severely complicate the application of a withholding tax on the interest in Country A, although procedures could be created that would allow the bank to claim a refund for over-withholding by demonstrating the amount of interest that is properly assignable to the Country C banking branch.

Even more troublesome would be using arm’s length principles to allocate royalty income between a taxpayer’s development activities in one country and the use of the intangible in another country. In theory, such income could be economically divided by determining the value of the intangible and then using this value to allocate the royalties between the portion that represents a return of the value of the intellectual property and the portion that represents a return on the intellectual property. However,

306 Proposed Treasury regulations are in accord with this approach. See Prop. Reg. § 1.482-8.
308 Cf. ALI Project I, supra note 14, at 36 (discussing similar administrative problems with an approach that would use arm’s length principles to divide the source of income from the production and lease of tangible property).
309 See ALI Project I, supra note 14, at 48.
in addition to the problems discussed above, there is a great deal of uncertainty in valuing intangibles.\footnote{See id. at 49; See Lokken, supra note 55, at 243.} Moreover, even after determining the value of the intangible, in the case of contingent royalties there would be the added difficulties of determining the extent to which the royalties represent a return of this value, given that the time period that the intangible would be productive can only be roughly estimated and the annual royalties will typically vary over the life of the intangible.\footnote{See Lokken, supra note 55, at 243.} Because of these problems, the American Law Institute decided to forgo any allocation to the place of development activities, and instead source royalties in their entirety to the location where the intangible is used.\footnote{See ALI Project I, supra note 14, at 48-49. A leading commentator on international taxation also came to the same conclusion. See Lokken, supra note 55, at 242-43.} Without delving into the details, other commentators, however, appear to suggest that an allocation between the locations where an intangible is developed and used should at least be considered.\footnote{See Shay, Source, supra note 1, at 143.}

Because of these difficulties, fixed percentages should be used to allocate income between the activities and destination components, with the particular percentages determined by international agreement. The same approach should be used for other activities-destination allocations. The use of arm’s length principles for this purpose is too difficult administratively, but an allocation is warranted in light of the government benefits received in each location. Thus, as stated previously, where other methods are not available, a reasonable, fixed percentage allocation is superior to no allocation at all. And the fact that the percentages would need to be agreed upon internationally should ensure that they are reasonable.

\textit{b. Market Access and Enforcement Concerns}

Where a nonresident generates income by accessing the market of another country, a portion of the income should in principle be sourced to this country under the destination component of the sourcing standard due to the governmental benefits provided to the taxpayer by the country whose market is penetrated.\footnote{See supra notes 233-37 and accompanying text.} Thus, where a wholesaler who resides in one country sells goods from a branch in that country to an independent retailer located in another country, the destination country should have the right to tax the wholesaler on a portion of the income on the sale. And it should be feasible for the destination country to collect the tax by requiring the retailer to withhold. However, if the sale by the nonresident seller were directly to consumers in the destination country through electronic commerce or other remote selling techniques, the collection of the tax would be more problematic, given that consumers may not be reliable withholding
agents. While there may be ways to create an enforcement structure for these situations, the important point is that in devising source rules, the allocation of income under destination component may be dependent on addressing enforcement concerns for taxing electronic commerce and other types of remote selling.

c. The Need for International Agreement

Critical to the success of this Article’s endeavor is that there be substantial international agreement on the sourcing standard and the rules developed there under. In the absence of such agreement, there would likely be an unacceptable amount of double taxation and undertaxation. This is because the proposed split sourcing approach is inconsistent with the current single source approaches that are typically used by countries. Thus, if some countries use the proposed standard to devise source rules, but many other countries did not, there would be great amount of inconsistency in the source rules used by nations – probably considerably more so than under current law.

This Article recommends that the United States should take the lead in advocating the international acceptance of the proposed sourcing standard. The key would be having the support of the OECD, which could then work to turn the sourcing standard into source rules that can be adopted by at least a substantial majority of countries.

International agreement may well be attainable. In particular, it is certainly possible that countries could agree to share tax jurisdiction by agreeing to the fixed percentages that would generally be used to allocate income among the activities, destination and residence countries. The fact that countries entering into tax treaties typically use the identical provisions to reduce or eliminate source taxation on passive income demonstrates that

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315 See Kirsch, Services, supra note 140, at 48.
316 See infra note 344.
317 Cf. OECD, supra note 103, at 25 (stressing the need for universal agreement of rules for allocating taxing rights over business profits in order to prevent double taxation or non-taxation).
318 Cf. Fleming, Fairness, supra note 155, at 339 (pointing out that the unilateral adoption of an approach that fractionally apportioned international income between the source and residence countries would result in double taxation probably being over or under mitigated in most cases).
319 This would be similar to the United States having taken the lead in promoting the international adoption of the arm’s length method for allocating income among commonly controlled corporations. See Barbara Angus, Tom Neubig, Eric Solomon, and Mark Weinberger, The U.S. International Tax System At a Crossroads, TAX NOTES 45, 64 (April 5, 2010).
320 Cf. Reuven S. Avi-Yonah & Ilan Benshalom, Formulary Apportionment – Myths and Prospects: Promoting Better International Tax Policy by Utilizing the Misunderstood and Under-Theorized Formulary Alternative, unpublished article available at http://ssrn.com/abstract=1693105 (claiming that for a hybrid arm’s-length/formulary apportionment regime to be operative, it would be sufficient if a critical mass of countries that includes some major developed and emerging economies adopts such a regime).
such agreement is possible.\textsuperscript{321} And beyond the split-sourcing aspect of the standard, the proposed approach is not at all radical: rather than introducing a new basis for allocating tax jurisdiction, the standard unifies into a split-sourcing approach the concepts that are currently used separately in single source rules.\textsuperscript{322}

IV. \textbf{USING THE STANDARD TO DEVISE SOURCE RULES}

This part uses the standard developed in the preceding part to suggest source rules for several types of income. The objective here is not to propose a comprehensive and detailed set of source rules that should be adopted on a multi-lateral basis. Instead, it is to illustrate how the standard can be used to formulate certain source rules in order to provide a foundation for future efforts in this area.

To recap, under the sourcing standard, the source of income should be evaluated on the basis of three factors: the destination of the services, property, or capital giving rise to income; the location(s) of the activities giving rise to income; and the residence of the person receiving income; based on this evaluation, a given item of income may have its source divided among multiple locations. Below this standard is applied to suggest source rules for the following types of income: interest, dividends and stock gains, service income, income from intangibles, and inventory income.

A. \textit{Interest}

In using the standard to devise source rules for interest income, there should be separate treatment for interest received by passive investors and interest received by active lenders, such as banks and other financial businesses. For passive investors, the source of interest income should be divided between the residence country of the interest recipient and the destination country of the funds that are loaned. Because a passive investor will have performed minimal activities in making the loan, none of the interest should be sourced under the activities component of the standard. The division of the interest income between the residence and destination countries should be based on a fixed percentage that is agreed to internationally.

There are several possibilities for determining the destination of the loaned funds, considering the public benefits that relate to the interest income. One option would be to source the destination component according to the residence of the borrower. This is based on the view that the borrower’s country of residence is presumably where the borrower derives the income or wealth that fund the interest payments, and that the public benefits provided by this country thus indirectly benefit the interest

\textsuperscript{321} See \textit{supra} notes 22-23, 28 and accompanying text.

\textsuperscript{322} See \textit{supra} Part III.C.2.
recipient.\textsuperscript{323} A more refined approach in this regard would be to focus on specific factors that indicate the location of the borrower’s economic activities; for this purpose, the relevant activities could be those of the borrower in general\textsuperscript{324} or those that relate to funding the particular interest payments.\textsuperscript{325} A third option would be to combine the first two options: the destination of the loaned funds would presumptively be the residence of the borrower unless there are clear indicia that the borrower was conducting relevant economic activities at another location. This third option appears the most appropriate as it strikes a reasonable balance between the benefits principle and administrability. It is also similar to the approach under current U.S. law,\textsuperscript{326} except that the U.S. rule applies to source the entire amount of interest, as opposed to just the destination component.

Where the interest recipient is a bank or other financial entity, the source results should be the same as above except that a portion of the interest income would also be assigned to the country (or countries) where the taxpayer conducts significant activities that relate to the lending transaction. As discussed previously, the portion sourced to the activities component should be based on a fixed percentage agreed to internationally. This portion may be further apportioned between two or more countries where significant activities related to the transaction occur at multiple countries; such apportionment could be done either based on the ratio of arm’s length charges for the lending activities at the different locations or by using fixed percentages.

B. Income from Corporate Stock

1. Dividends

Dividend income should be sourced in a manner that is similar to the sourcing of interest income. That is, for passive investors a portion of the dividends should be allocated to the shareholder’s residence country and a portion should be allocated to the destination country of the invested capital, with the portions determined on the basis of a fixed percentage. As with interest received by passive investors, none of the dividend income should be sourced based on the activities component of the standard; this is

\textsuperscript{323} Cf. ALI Project I, supra note 14, at 67-68 (stating that general principle underlying the source rules for interest appears to be that interest should be sourced in the country that is reasonably presumed to be the place where the borrower derives the income or wealth from which the interest is paid; stating that a fair presumption is that in most cases the borrower’s country of residence or domicile is where the borrower’s economic interests are centered).

\textsuperscript{324} Cf. id. at 68 (pointing out that in certain circumstances, current U.S. law disregards the borrower’s residence or domicile and sources interest based on the geographic composition of the borrower’s income).

\textsuperscript{325} Cf. id. at 69-70 (recommending an approach for sourcing interest that in part focuses on the location of real estate or a business that the interest relates to).

\textsuperscript{326} See I.R.C. § 861(a)(1)(A), (B), (C).
because the shareholder’s activities in connection with earning the dividends are likely to be minimal.

Similar to sourcing interest income, there are several options in determining the destination country of the shareholder’s invested capital. One possibility would be to look to the country of incorporation based on the view that this country is providing the shareholder with public benefits through its legal system that protects and regulates the shareholder’s investment in the corporation.\textsuperscript{327} Alternatively, the destination country could be considered the country or countries where the corporation is engaged in significant business activities.\textsuperscript{328} This is because such countries provide public benefits that relate to the corporate earnings that in turn are the economic source of the dividends;\textsuperscript{329} in other words, the countries where the corporation conducts activities provide indirect public benefits to the shareholders. A third option would be to take into account both the corporation’s incorporation country and activities countries by apportioning the destination portion of the dividend among these countries; if this is done, a fixed percentage should be used for this purpose. If all or a portion of the destination portion of the dividend is sourced according to the location of the corporation’s business activities, it would be advisable to base this determination on the composition by source of the corporation’s income.\textsuperscript{330}

Determining the source of dividend income on the income composition of a corporation raises difficulties and complications in imposing a source tax that is collected through withholding.\textsuperscript{331} For this reason,\textsuperscript{332} in lieu of a secondary dividend tax, the United States and a some other countries exact a second level of tax on the domestic earnings of foreign corporations by imposing a branch profits tax on such corporations.\textsuperscript{333} Assuming that the destination portion of dividends will not be sourced exclusively on the basis of the corporation’s country of incorporation, countries should continue to

\textsuperscript{327} Cf. ALI Project I, supra note 14, at 62-63 (stating that the traditional rule, which sources dividends to the country of the distributing corporation’s domicile, gives controlling weight to the fact that the distributing corporation derives its legal capacity from its country of domicile).

\textsuperscript{328} Cf. id. at 63 (referring to this approach as alternative way of sourcing dividends).

\textsuperscript{329} See id.

\textsuperscript{330} To illustrate, if the third option were used, a fixed percentage of the destination portion of the dividend would be assigned to both the corporation’s country of incorporation and the country (or countries) where the corporation conducts economic activities; where the corporation has activities in more than one country, the latter portion would be further apportioned according to the percentages of corporate income derived from each country.

\textsuperscript{331} See 1986 Bluebook, supra note 59, at 1036-37; ALI Project I, supra note 14 at 141; Fred B. Brown, Reforming the Branch Profits Tax to Achieve Neutrality, 25 VA. TAX REV. 1219, 1225 (2006) (Branch Profits Tax).

\textsuperscript{332} See 1986 Bluebook, supra note 59, at 1037; Brown, Branch Profits Tax, supra note 331, at 1225.

\textsuperscript{333} See, e.g., I.R.C. § 884; See Ault & Arnold, supra note 5, at 516-17.
have the option of using a branch profits tax as a surrogate for taxing a portion of dividends.\textsuperscript{334}

Where the dividend recipient is a securities dealer or otherwise purchasing corporate stock in the conduct of an active business, it is appropriate to modify the source results by assigning a portion of the dividend to the country (or countries) where the taxpayer conducts significant activities that relate to the acquisition of the stock. If this is done, the portion sourced to the activities component should be based on a fixed percentage agreed to internationally. This portion may be further apportioned between two or more countries where significant activities related to the transaction occur at multiple countries; such apportionment could be done either based on the ratio of arm’s length charges for the activities at the different locations or by using fixed percentages.

2. Stock Gains

The gain on the sale of stock should be sourced in the same way as dividend income. Economically, a stock gain is essentially a market capitalization of a corporation’s future earnings.\textsuperscript{335} Consequently, the same reasons that support the rights of the residence and destination countries to tax portions of the dividend should apply with equal force to stock gains.\textsuperscript{336} In particular, the country or countries where the corporation is incorporated and/or doing business are providing the selling shareholder with important public benefits that contribute to the value of the stock investment, both directly through legal protection and indirectly through benefits provided to the corporation. While current law usually sources stock gains exclusively to the taxpayer’s country of residence,\textsuperscript{337} this treatment appears to be mainly due to perceived administrative and enforcement concerns of imposing a source tax on such gains.\textsuperscript{338} As have been pointed out by other commentators, these concerns can be addressed by applying withholding procedures similar to those that apply under U.S. law for taxing foreign persons on sales of stock in U.S. real property holding corporations.\textsuperscript{339}

C. Service Income

Income received for performing services should be sourced by dividing the income among the country where the service provider resides, the

\textsuperscript{334} In this regard, there may need to be modifications to the source rule to account for the fact that a corporation’s country of incorporation may be permitting the corporation a foreign tax credit for branch profit taxes paid to other countries.

\textsuperscript{335} \textit{See} Shay, \textit{Source}, \textit{supra} note 1, at 122.

\textsuperscript{336} \textit{Cf. id.} (stating that if the market access rationale supports a source tax on dividends, it should also support source tax on stock gains).

\textsuperscript{337} \textit{See} I.R.C. § 865(a), (f); \textit{supra} notes 39-41 and accompanying text.

\textsuperscript{338} \textit{See} Shay, \textit{Source}, \textit{supra} note 1, at 122.

\textsuperscript{339} \textit{See} Cynthia Blum, \textit{How the United States Should Tax Foreign Shareholders}, 7 VA. TAX REV. 583, 643-51 (1988); Shay, \textit{Source}, \textit{supra} note 1 at 145.
country where the services are performed, and the country where the services are either used or consumed. Fixed percentages should be used for making these allocations. Under this rule, where services are performed in one country for use or consumption in another country, both countries, in addition to the service provider’s country of residence, would have the primary right to tax a portion of the income. While current U.S. law focuses exclusively on where the services are performed, some countries use a destination approach for sourcing service income, and a few commentators view market access as a justification for imposing a source tax on services performed remotely. Indeed, a recent article emphasizes that the continued reliance on a service provider’s physical presence in sourcing service income will become increasingly untenable with the prevalence of remote services in the modern economy. While not inconsistent with these views, this Article calls for an approach that divides the source of service income in recognition of the public benefits provided at each of the relevant locations.

An important caveat to the suggested rule for sourcing service income is the ability of the destination country to enforce a source tax on services performed remotely. While withholding by the service recipient should be feasible where the recipient is a business, difficulties will be encountered where services are rendered remotely to a broad range of individual consumers, such as in the case of electronic commerce. Enforcement mechanisms must be developed before the implementation of a rule that sources a portion of service income to the destination of remotely performed consumer services. In this regard, commentators have suggested possible enforcement structures for taxing electronic commerce.

340 See supra notes 29-31 and accompanying text.
341 See Avi-Yonah, Electronic Commerce, supra note 130, at 537-40; Kirsch, Services, supra note 140, at 45-47, 60. In a similar vein, another commentator has proposed a market state approach to the sourcing of service receipts for dividing the business income of multistate enterprises under UDITPA for state corporate income tax purposes. See John A. Swain, Reforming the State Corporate Income Tax: A Market State Approach to the Sourcing of Service Receipts, 83 TUL. L. REV. 285, 346-53 (2008).
342 See Kirsch, Services, supra note 140, at 64.
343 See id. at 48.
344 See Shay, Source, supra note 1, at 145-46 (stating that because electronic commerce involves “credit or debit charges, or electronic cash payment facilities, it may be possible to rely on these payors in some fashion to structure a viable enforcement mechanism in the future”); Avi-Yonah, Electronic Commerce, supra note 130, at 537-38 (proposing a gross withholding tax that would be imposed “by the Demand Jurisdiction unilaterally by forbidding merchants from selling goods to its residents unless procedures for the withholding tax are in place”).

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D. Income from Intangibles

1. Royalties

In using the standard to devise a source rule for royalties, it is important to distinguish between situations where the taxpayer purchased the intangible that is licensed and where the taxpayer developed the licensed intangible. In the former situation, the source of royalty income should be divided between the licensor’s country of residence and the country where the intangible is used. This assumes that the taxpayer is not engaged in an active business of licensing intangibles, and thus none of the royalty income should be sourced based on the activities component of the standard because the taxpayer’s activities would seem to be relatively insignificant to the economics of the transaction.\(^{345}\) If the transaction had been in the active contact of a licensing business, it should be appropriate to allocate a portion of the royalties to the country or countries where the licensing activities take place.\(^{346}\) As in other situations, the division of the royalty income should be based on fixed percentages.

The place of use should typically be the country that provides the legal protections that relate to the intangible.\(^{347}\) This country should have the right to tax a portion of the royalties because through its laws and legal system, the destination country provides the taxpayer with the public benefits that permit the earning of the royalty income.\(^{348}\) The destination country also provides the taxpayer with indirect benefits that relate to the royalty income, by providing public benefits to the taxpayer’s licensor that contribute to the licensor’s ability to earn income that is typically shared with the licensor via contingent royalty payments.\(^{349}\) As under current law, complications would arise in determining the place of use where the intangible provides protection in more than one country.\(^{350}\)

Where the taxpayer developed the licensed intangible, the source of the royalty income should be divided among the taxpayer’s country of residence, the country (or countries) where the development activities took place.

\(^{345}\) See ALI Project I, supra note 14, at 45; Lokken, supra note 55, at 240.

\(^{346}\) Current U.S. law provides some support for sourcing a portion of royalties to the place where a taxpayer performs significant licensing activities in connection with an active business. Under section 864(c), foreign source royalties received by a foreign person are subject to U.S. net basis tax where the royalties are derived in the active conduct of a U.S. business and attributable to the foreign person’s U.S. office. See I.R.C. § 864(c)(4)(A), (B), (5). Of course, under this provision, the United States has tax jurisdiction over entire amount of the royalties, not just a portion.

\(^{347}\) See Shay, Task Force, supra note 26, at 773.

\(^{348}\) See ALI Project I, supra note 14, at 45; Lokken, supra note 55, at 240-41.

\(^{349}\) See ALI Project I, supra note 14, at 45

\(^{350}\) See id. at 50-52; Lokken, supra note 55, at 277-86.
place, and the country where the intangible is used; again, fixed percentages should be used to divide the income.\textsuperscript{351}

As discussed previously,\textsuperscript{352} the country or countries where the development activities occur provide significant public benefits in support of such activities and thus should have the right to tax a portion of the royalty income. And using a fixed percentage to assign a portion of the royalties to the development country should remove the administrative concerns regarding such allocations voiced by commentators.\textsuperscript{353} While this allocation approach is imprecise, it is superior to ignoring the development country in assigning source, in light of the public benefits provided there. Where the taxpayer conducts significant development activities in two or more countries, it would be advisable to further apportion the portion of the royalties assigned to development activities; this should probably be done using fixed percentages because of difficulties in valuing the relative contributions of different development activities.

2. Intangible Gains

Gain on the sale of an intangible should be sourced in the same manner as royalties.\textsuperscript{354} Thus, for purchased intangibles, the source of the gain should be divided between the taxpayer’s country of residence and the country where the intangible will be used; for developed intangibles, the source of the gain should be divided among the taxpayer’s country of residence, the country (or countries) where the development activities took place, and the country where the intangible will be used.\textsuperscript{355} Again, fixed percentages should be used to divide the income.

The same reasons that support this approach for royalties also apply with respect to intangible gains. A taxpayer who realizes gain on the sale of an intangible receives public benefits from the country from which the intangible derives its legal protection; without this protection, which is a product of the laws and legal system of the country providing it, the

\textsuperscript{351} This assumes that the licensing transaction is not in connection with an active business. If it were, it would be appropriate to source a portion of the royalties to the location of the licensing activities. See supra note 346 and accompanying text.

\textsuperscript{352} See supra note 223 and accompanying text.

\textsuperscript{353} In this regard, commentators have recognized the conceptual basis for dividing the source of such royalty income between the country of development and country of use, but declined to do so mainly for administrative reasons. See ALI Project I, supra note 14, at 48; Lokken, supra note 55, at 242-43.

\textsuperscript{354} Other commentators have also proposed using the same rule to source both royalties and intangible gains. See ALI Project I, supra note 14, at 47-50; Lokken, supra note 55, at 244. Unlike the proposal here, these commentators would use the place of use rule to source both items. See id. Under current U.S. law, intangible gains are sourced the same as royalties only where the gains are contingent on the productivity, use or disposition of the intangible. See I.R.C. § 865(d)(1).

\textsuperscript{355} This assumes that the sales transaction is not in connection with an active business. If it were, it would be appropriate to source a portion of the gain to the location of the sales activities.

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intangible would lack value and the gain would not be realized. And where the taxpayer has developed the intangible, whether the intangible is licensed or sold, the country or countries where the development activities take place provides important public benefits that relate to the taxpayer’s ability to earn the income. An additional reason for applying the same source rule for royalties and intangible gains is that this approach will avoid the difficult issue of determining whether a transfer of an intangible should be characterized as a license or a sale. Indeed, with the proposed rule for service income, the same or similar source rules would apply to royalties, intangible gains, and service income, putting considerably less stress on property/service characterization issues.

E. Income from the Sale of Inventory

In using the standard to devise a source rule for income from the sale of inventory, it is important to distinguish between situations where the taxpayer purchased the inventory and where the taxpayer produced the inventory. For purchased inventory, the source of the inventory income should be divided among the taxpayer’s country of residence, the country or countries where significant sales activities take place, and the country in which the inventory is used or consumed. Fixed percentages should be used to divide the income. The portion assigned to the location of sales activities should be further apportioned between two or more countries where significant sales activities related to the transaction occur at multiple countries; such apportionment should probably be done based on the ratio of arm’s length charges for the activities at the different locations, although the use of fixed percentages may be an acceptable alternative. This source rule recognizes the related public benefits provided to the taxpayer by each of the residence, activities, and destination countries.

356 See Lokken, supra note 55, at 244 (in proposing that intangible gains should be sourced based on where the intangible will be used, pointing out the importance of the services and protections provided by the country in which the intangible is exploited).

357 See id. (in considering but ultimately rejecting an approach that would divide intangible gain between the country of use and the country of development, noting that the services and protections provided by the country that is the location of development activities can be viewed as significant factors in creating the intangible).

358 See ALI Project I, supra note 14, at 47.

359 Cf. id. at 53-57 (discussing these difficulties). In this regard, the Treasury has issued regulations that attempt to address these characterization issues in the context of transactions involving computer programs. See Treas. Reg. § 1.861-18.

360 This can occur where one branch is performing a wholesaling function and another is performing a retail selling function; it can also occur where the taxpayer is either a wholesaler or a retailer, but different functions are performed at different branches — for example, storage and shipping at one branch with solicitation and negotiation at another branch.

361 In this regard, the American Law Institute found that it may be appropriate for inventory income to be sourced in either the activities country or the destination country in light of the related public benefits provided by each of these countries. See ALI Project I, supra note 14, at 20. Ultimately, the ALI settled on a recommended rule that focuses primarily
Where the taxpayer produced the inventory, the source of the inventory income should be divided among the taxpayer’s country of residence, the country (or countries) where the production activities take place, the country or countries where significant sales activities take place, and the country in which the inventory is used or consumed. In this situation, portions of the inventory income would be assigned to two different activities -- production and sales. Fixed percentages should be used to allocate the inventory income among the three categories of countries: that is, a certain percentage of the income should be assigned to the residence country, a certain percentage of the income should be assigned to the destination country, and a certain percentage of the income should be assigned to the countries where production and sales activities occur. It would then be necessary to further divide the portion of the income assigned to production and sales activities. As mentioned previously, it would be advisable to do so based on the ratio of arm’s length charges for the production and sales activities.

As previously discussed, the destination country should have the right to tax a portion of the inventory income because the taxpayer accesses this country’s market by selling goods to consumers and businesses located therein. Since a country’s market is in large part a product of government activities, the destination country is providing the taxpayer with important public benefits that justify source taxation. And this holds true even when the taxpayer has no physical presence in the destination country. Nevertheless, it may be difficult for the destination country to enforce a source tax where goods are sold remotely to individual consumers, such as in the case of electronic commerce. Consequently, as with remote services, applying the destination component of the source rule to remote sales of consumer goods would need to be conditioned on the creation of adequate mechanisms for enforcing a source tax.

V. CONCLUSION

The current source of income rules used in the United States and other countries are crucial to the functioning of the international tax rules, in that they essentially establish the contours of tax jurisdiction that is exercised by countries. However, the current approach for sourcing income suffers from a lack of coherence and international conformity. This Article addresses both of these problems by offering an equity-based approach for sourcing income that has the potential for being adopted by countries on a
multilateral basis. By basing the source rules on an benefits principle-based standard that allows source to be divided when appropriate, this Article seeks to rationalize and harmonize the provisions used to source income for purposes of taxing cross-border investment and business activities.