Implications of the Tax Reform Proposals for Fraud – or – How to Shift to a Consumption Tax Without Helping the Cheaters

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or
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by Kalyani Robbins

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Introduction

One need only spend a few minutes searching the Internet to be overwhelmed by the intensity of the tax reform debate. In addition to the discussions among scholars and specialists, there are more grassroots movements than one could possibly count. Some of them seem credible, often pushing for one of the proposals already being considered by Congress, and others do nothing but scream so loudly against the IRS that you can almost hear them through cyberspace. Organizations with names like Americans for Fair Taxation,1 Americans for Tax Reform,2 Citizens for an Alternative Tax System,3 Citizens for Tax Justice,4 and the Great American Taxpayer's Revolution5 litter the Web, calling for a better way, but only rarely explaining in much detail just what that way should be. The one thing everyone does seem to agree on, scholars and angry citizens alike, is that the time has come to "shift" from the question of whether to alter our current tax system to the question of how to alter it."6 Given the strength of this mandate, it is worth taking a moment to consider the ramifications of reform for tax cheating.

The vast majority of the proposals on the table today are simply different implementation mechanisms of the same basic idea: a change in the tax base from income to consumption. The purpose of this article is to consider the implications some of these proposals have for the enforcement of tax compliance (prevention of cheating). For this reason, it will only briefly address the impetus for a consumption tax and the policy considerations behind it in part I.7 The first part will also give short descriptions of the proposals that will be considered in this article: the National Retail Sales Tax, the Savings-Exempt Income Tax, and the Value Added Tax (VAT). In part II, I will analyze each of these proposals with regard to the feasibility of evasion. Finally, the article concludes that with regard to the prevention of tax-cheating, the VAT is the most efficient of these proposals. In light of the fact that in most other respects they are effectively the same (they all tax the same base at what would become the same amount after determining revenue needs, and effectively operate to encourage saving and boost the economy through investment), I would endorse a VAT to discourage cheating and to take the burden of compliance out of the hands of the average citizen.

I. Taxing Consumption

What reason is there, that he which laboureth much, and sparing the fruits of his labor, consumeth little, should be charged more, than he that living idly, gotteth little, and spendeth all he gets: Seeing that one

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7This discussion, if thorough, would be its own law review article.
hath no more protection from the commonwealth than the other?  

Fairness to those who are capable of delayed gratification is only one of the many reasons that people in the United States are beginning to seriously consider a move toward a consumption tax (though it is key to distinguishing between excessive consumption and poverty conditions that cause people to spend all of what they earn — this can be taken into account through progressive rates and standard deductions). Another important consideration is that just about every consumption tax proposal, even the fairly complex VAT, is significantly easier to report and collect than our current income tax, and would therefore save time and money and increase productivity. Perhaps most importantly from a policy perspective, taxing consumption encourages saving. Under our current system, which rewards immediate spending, the U.S. has fallen behind almost every developed country in percent saved per year. Not only will increased savings benefit future generations directly, but it will also provide funds today that can be invested in business and boost the economy, which is good for all generations.

One consumption-based tax reform proposal is the National Retail Sales Tax. This is exactly what it sounds like. Instead of taxing income at all, a tax at least 15-20 percent (some argue much more would be necessary) would be levied on all retail purchases. "In order to tax only final consumption, however, purchases by businesses [would] be tax-exempt." Only retail businesses would be responsible for reporting and paying the taxes they had collected, and they would be reimbursed for the added effort. These taxpayers would remit the federal tax money to the states, as they already do with state sales tax in most states. The states in turn would send it to the federal government, less a 1 percent fee for their trouble. In total, far fewer individuals and entities would be involved than with an income tax, which would reduce the aggregate cost of compliance. Regressivity would be avoided through across the board refunds in an amount determined to be representative of the cost of basic needs.

Another way to tax only consumption and leave investment income alone is the Savings-Exempt Income Tax. Under this system, taxes would still be collected from individuals, eliminating some of the efficiency benefits available with the sales tax. It would, however, still provide the previously discussed policy benefit of encouraging saving by deducting the amount newly saved in a given year from total income, effectively taxing only that which is spent. This method can also be more reliable than a sales tax by accurately determining the figure expended on all consumption, not just the spending that fits into the retail sales (or other easily tracked transfers such as those of homes and automobiles) model. Progressivity would be attained through very large standard deductions, and in some proposals, graduated rates. Naturally, to make this system feasible, the tax rates would still have to be higher on average than they are now to make up for the smaller tax base.

While a move to sales tax would make it much more difficult for individuals to cheat, and eliminate the problems of false deductions and unreported income, it would also create a host of new opportunities for cheating.

Finally, there is the method used in many other countries, known as the Value Added Tax (VAT). The VAT is a bit more complicated than the other two systems discussed herein, but is essentially a multi-level sales tax, charged to providers rather than buyers (which basic economic theory tells us is effectively the same thing). Goods and services generally go through several stages (and pass through several sets of hands) before reaching the final purchaser. A VAT does not involve charging the tax directly to the consumer, though he or she will pay for it through higher prices. Rather, it is a tax on the difference in value between the goods purchased for each stage of production, and the thing produced at that stage. A company would be taxed on its gross revenues less the amount it spends on supplies (but not wages). This figure represents the value that a given company has added to those goods as they move along the chain of production, hence the name of the tax. In effect, the value of the final retail product is taxed, with each business that contributed to its final value paying in proportion to the portion of that value it contributed.

Thomas Hobbes, Leviathan 184 (Dutton ed. 1914).

See Joseph Bankman & Thomas Griffith, "Is the Debate Between an Income Tax and a Consumption Tax a Debate About Risk? Does It Matter?" 47 Tax L. Rev. 377, 386 (1992) ("The consumption tax has also been supported on the grounds that it will be easier to administer.").

See Laurence J. Kotlikoff, "Should We Tax Consumption, and If So, How?" (last modified Mar. 14, 1996) http://www.mijic.org/Policy/jobs_capital/jc1995.2/a06.html ("Our nation's net national saving rate is running at less than 3 percent per year — less than one-third the rate observed in the 1950s and 1960s. It is also among the lowest of the developed countries. For example, we are routinely saving at less than one-third the rate of Japan and less than one-half the rate of Germany.").

See Bankman & Griffith, supra note 9, at 385 (Advocates of efforts to increase savings are concerned about leaving "an adequate stock of wealth for future generations.").

See Kotlikoff, supra note 10 (despite that domestic investment can be financed by foreigners, it nonetheless seems to correlate over time with the national savings rate).


For example, the Nunn-Domenici proposal (which combines this method with a VAT) provides for progressive income tax rates.
Because a VAT taxes consumers by increasing the prices of the goods they purchase, it does not lend itself well to progressivity. All consumers would have to pay the same higher prices for what they buy, regardless of their income levels. Although politically difficult, there are some ways to deal with this problem. One would be to tax different production chains at different levels, depending on whether the goods produced are deemed necessities or luxuries. This determination, however, is highly subjective. Another way would be to give monthly checks to low-income individuals in an amount that reflects the tax they are likely to be paying on their necessities. Finally, we could give people with lower incomes special discount cards to use when making purchases. The retailers would then submit copies of the receipts from these discounts to the government for reimbursement (or even just deduct it from the tax they pay, perhaps). Regardless of the method used, if any, there would still be one benefit that we do not have under our current tax system: the wealthy would no longer be able to avoid paying their share of taxes through manipulation of the provisions in the tax code. This may offset the problems with making a VAT progressive.

II. Possible Evasion Tactics for Each Proposal

A. National Retail Sales Tax. While a move to sales tax would make it much more difficult for individuals to cheat, and eliminate entirely the problems of false deductions and unreported income, it would also create a host of new opportunities for cheating. To realize this, one needs only look at the common phenomenon, under existing law, of businesses under-reporting their sales to evade taxes. This would continue and possibly increase, as the rewards of such tactics would be higher when the taxes they pay are no longer diminished by including individual income taxes in the overall revenue pool. In other words, all tax dollars will pass through retailers' hands. This sort of cheating is one of the easiest to get away with, as there is no other source of information for the government to cross-reference with the retailer's reporting. At least with an income tax, if an individual does not report income, it is likely that the employer did. In contrast, with a sales tax the consumers would exit the store and have at that point completed their role in the process. We would depend almost entirely (and for the entire tax revenue) on the retailers to accurately report their sales and submit the tax dollars to the states. Add to that the complexity of policy-related differential taxation levels for different sorts of goods, and the fact that some goods are sold both to final consumers and to other businesses, and proper compliance becomes even more difficult, even for the honest.

A sales tax can also be evaded on the individual level. First, people could seek out "under the table" sales, much like they do now with employment. This would save them from paying the (most likely quite large) sales tax, and there would be an incentive for sellers to participate in order to make more sales and perhaps charge a little bit more (but still less than the price would have been after the tax). Second, consumers can avoid paying what they feel to be an excessive sales tax by purchasing higher ticket items through the international market. Finally, people could create phony businesses through which to make their purchases, which would then be exempt from the sales tax.

While no alteration of the method of taxation could ever keep some people from wanting to cheat on their taxes, the beauty of a VAT is that it makes it virtually impossible to do so.

Of course, some of these dangers could be avoided through electronic means. Several proposals involve requiring that all purchases be made with "personal smart cards," allowing the government to collect sales directly from the consumer, at the point of sale. One such proposal involves a special card that also contains data on the consumer's income level, allowing for a progressive sales tax rate. Because the card would be capable of immediate funds transfer, the government would be able to collect the tax electronically on the same in-store device which would collect the payment. This suggestion, however, would do nothing to prevent some people from illegally selling goods for cash to evade the tax. Another proposal involves something more like a typical ATM card, to be used for most purchases, but with continued legal use of cash for small expenditures. The government would review the consumer's checking account at the end of each month, and directly withdraw tax on the total ATM amount (card purchases plus cash withdrawals). This method does not suggest a way to deal with credit card purchases, though. Under either of these methods, most of the evasion techniques discussed above would be impossible.

The fatal flaw in these electronic methods is that they are overwhelmingly Orwellian. The government would no longer merely track a person's employment history, investments, and those purchases he chose to claim as itemized deductions (which already leaves some people feeling as though their privacy has been violated, especially during an audit). Big Brother would observe everywhere one went and everything one purchased. There would truly be no privacy left at all with regard to an individual's lifestyle choices. Ironically, privacy is one of the many reasons some people have supported a national sales tax in the first

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17See Arguments for a Consumption Tax (visited Mar. 28, 1998) http://www.ruf.rice.edu/~philip/tax_policy.html ("The international market provides consumers the opportunity to evade the consumption tax.").


19See Kotlikoff, supra note 10.
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This level of invasion is untenable, and besides, it is unlikely that any workable electronic system could even be in place within a reasonable number of years.

Finally, in addition to the strong likelihood of cheating under the National Retail Sales Tax, the distribution of this cheating poses a greater risk to fairness and to total revenue than under other possible taxation regimes. First, because the states will be collecting and enforcing the tax, it is likely that it will be enforced differently in different parts of the country. While there would be a uniform federal requirement of compliance, "[o]ne state's collection efforts or interpretation of the federal law might be more aggressive than that of another state." This could result in unfair variations in effective (post-cheating) taxation levels in different states, which would not correlate to their representation in Congress. The second problem is the sheer volume of tax dollars that could be lost. When only one single stage of production is taxed (as opposed to a VAT), if just one party (the retailer) cheats, the entire tax is lost, rather than merely a portion of it.

B. Savings-Exempt Income Tax. Under a Savings-Exempt Income Tax we would be faced with approximately the same potential for fraud as under the current system, but with a few changes. The problem of unreported income would remain the same, and assuming we kept some of the currently available deductions, taxpayers would continue to lie about those, but there would also be an entirely new problem. With an unlimited new deduction (saved/invested money) comes incentive to claim more of it than one really has. This could be done by selling previously held assets (the proceeds of which would not be reported as income) and purchasing new ones (i.e. deductible "new savings/investments"), or simply spending the proceeds (but not paying the consumption tax on that spending, as it does not vanish from that year's income). Even if this could somehow be avoided by determining the exact amount and whereabouts of everyone's assets before each tax year began (which would be exhausting), we would still have the general problems of income tax evasion.

C. Value Added Tax. While no alteration of the method of taxation could ever keep some people from wanting to cheat on their taxes, the beauty of a VAT is that it makes it virtually impossible to do so. There would be no income reporting, and no separable tax charge on retail purchases. In fact, although the con-

sumers would be effectively paying the tax through its reflection in prices, they would seemingly pay no tax at all, and therefore have no way to withhold payment. Because the actual taxing responsibility would be divided among the various manufacturers involved in any product, a VAT is essentially self-enforcing. Each producer will want to report the amount spent on goods bought from the company one step behind it in the chain, in order to subtract that amount from the proceeds of its later sale of the goods to the next link in the chain, who will report that amount for the same reason. In other words, each link in the chain of production has incentive to police the one that comes before it. For a company in the middle of the chain, there is practically no way to cheat.

Every production chain, however, has an end. As discussed in part II.A, there is nobody to police the retail seller. The customers make their purchases and leave, and without invasive methods, there is no way to cross-reference them. The VAT, however, provides two safeguards at the retail level that do not exist under the sales tax model. First, the penultimate transaction has been recorded, so there is a record of the quantity of (let's say) widgets the retailer bought. If the retailer sells all of those widgets (as evidenced by its purchasing more of them), it will be expected to report gross revenues somewhere in the neighborhood of their market value, or at least in an amount sufficient to turn a net profit after the subtraction of likely other, non-deductible overhead expenses. Second, not only can the retailer only slightly underpay its taxes because of these records, but that figure will be negligible in light of its diminished total tax responsibility (relative to a sales tax). Because the retailer pays only one small portion of the total tax, and can only cheat on a very tiny part of that, and because there are no other potential cheaters in the system, a VAT is nearly cheat-proof. The only way for meaningful fraud to take place would be to elaborate on the system by adding all of the links in a particular production chain. This would require the consent of any entity involved, which is far too unlikely to address with any real concern.

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20 See, e.g., Great American Taxpayer's Revolution, The Better Way USA Plan (visited Mar. 16, 1998) http://www.noirs.com/noirs/plan.html (if we abolish the income tax and the IRS, and replace them with a sales tax, "we will get our privacy back.").


22 See id. ("The retail sales tax imposes tax only at a single stage in the production and distribution chain. This increases the opportunity for the evasion of the entire tax when just one party (the retailer) fails to meet its taxing duty.").

23 See Kotlikoff, supra note 10 ("[H]ouseholds could sell [their] assets and purchase new ones, and claim the amount of the new asset purchased as a tax deduction.").

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20 One way to picture this is to imagine that four people decide to purchase a pizza. No one person would be able to avoid paying his share, as the rest of them would then be responsible for it. Each member polices the others' contributions. Because a VAT taxes the total value of the final product, it is in the interests of each manufacturer to ensure that the others pay tax on the full values added at their stages of production.

21 Even if the retailer and its provider wanted to agree on a lesser quantity to be recorded (to enable the retailer to evade taxes on the value added to those products and to allow the provider to report less gross profits), they would run into the same problem of the previous transaction's having been recorded, and so on. The need to undereport would slide all the way up the chain, making it much more risky and difficult.

22 See Deloitte & Touche, supra note 21 ("The complete amount of tax is evaded only when there is some coordination between parties at different stages of the production and distribution chain.").
Conclusion

While there is no such thing as a good tax, the best we can hope for is one that is less painful than the current system, and which can be more evenly applied through the prevention of evasion. Not only would a VAT be less directly burdensome for most citizens, but for the reasons discussed in part II.C, it would nearly eliminate cheating. This would quickly lead to a reduction in the overall tax rate, as we would regain the fortune lost each year to fraud under our current system. This would make almost everyone more content with the tax system, and provide an additional boost to an economy already improved by the increase in savings discussed above. Alexander Pope said “[w]hoever hopes a faultless tax to see, hopes what ne’er was, is not, and ne’er shall be.”27 Truer words may never have been spoken, but a VAT might be the closest we can come to attaining a livable, albeit imperfect, tax.


How to Earn Millions in U.S.-Source Income for Doing Nothing

by Kenneth P. Brewer

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On March 22 Tax Analysts published a field service advice (FSA) that reveals the secret of how to earn substantial U.S.-source income with little or no effort.1 No doubt the IRS reading room was filled with cries of "Viva la Freedom of Information Act!" upon release of this closely guarded piece of information. But, for those of us who are not drawn by the lure of easy money, the FSA also touches on some very interesting tax issues and suggests some fascinating results in regard to the exercise of tax jurisdiction by the United States over income of foreign taxpayers who may have little or no contact with the U.S. but whose activities outside the U.S. have contributed to sales of somebody else’s product inside the U.S.

According to the FSA, the secret to earning money for nothing involves two very simple steps (which, contrary to advance speculation, do not include playing guitar on the MTV). The steps are: first, become a world famous, highly admired athlete; and second, sign an endorsement contract with a consumer products company under which you receive millions of dollars for simply wearing the company’s logo on your sleeve and refraining from using competing products in public. Both of which activities (or inactivities using the Service’s analysis) may occur entirely outside the U.S.2 Under the approach of the FSA, income from your endorsement contract will be classified as royalty income, rather than personal services income, because you won’t really have to do anything to earn it. As a result, if your image (wearing the company’s logo or using its product) is viewed by people who purchase the product in the U.S., you too will earn millions of dollars in U.S.-source income for doing nothing. The bad news, if you are a nonresident alien, like the taxpayer in the FSA, is that your U.S.-source income will be subject to U.S. income taxation even though you did nothing at all in the U.S. to earn it.

1FSA 1999-790 (May 10, 1993), Doc. 1999-2908 (8 original pages), 1999 TNT 55-35. There is no apparent reason why the formula contained in this FSA cannot be adapted to earn substantial amounts of foreign-source income for doing nothing.

2This aspect of the FSA is a shameless rip-off of an old Steve Martin routine in which Mr. Martin reveals how to earn a million dollars tax-free in two easy steps: first, earn a million dollars; and second, don’t report it on your income tax return.
COMMENTARY / VIEWPOINT

While FSAs do not have any precedential authority, this particular one was written in the context of a fairly high-profile case and, as a result, received the attention and consensus of some very well respected, high-level Service personnel. So, if nothing else, it suggests a reasonable likelihood that the Service may come to the same conclusion when faced with the same issues again. Moreover, it highlights an important area of considerable lack of binding precedent and, hence, uncertainty. The approach taken in the FSA poses significant and heretofore unexpected U.S. tax exposure for foreign taxpayers and equally significant and unexpected tax benefits for U.S. taxpayers. The potential reach of the FSA's analysis goes far beyond fact patterns involving famous athletes to virtually any individual or company whose image (e.g., on television or in newspapers or magazines or on the Internet) may contribute to the sale of someone else's products in the U.S.

The FSA suggests some fascinating results in regard to the exercise of tax jurisdiction by the United States over income of foreign taxpayers who may have little or no contact with the U.S.

This article will attempt to explain: (a) the technical legal analysis offered by the Service as support for its conclusion; (b) why that technically sound approach may not be sound from a tax policy standpoint; and (c) how existing U.S. tax law might be interpreted to provide technical support for a different approach that is perhaps more in keeping with reasonable tax policy objectives and, in that regard, may represent a more acceptable rationale for exercising tax jurisdiction.

The Service's Analysis

The FSA was written back in 1993. It involved a nonresident alien athlete who received a fixed fee from a U.S. company for endorsing a product sold throughout the world. In exchange for the fee, the taxpayer agreed to the following: (a) to appear in some commercials that were filmed outside the U.S. and that were shown only outside the U.S.; (b) to appear in some pamphlets that were produced outside the U.S. and distributed for use entirely outside the U.S.; (c) to make some personal appearances to promote the product; (d) to refrain from using any products while in public that compete with those of the U.S. company; and (e) to wear the company's logo on his sleeve during exhibitions. The FSA does not discuss where the exhibitions took place. It is quite likely that some of them took place in the U.S. and some of them took place outside the U.S. But that fact was not relevant under the Service's analysis. Also of note, neither the product nor any of its packaging displayed the taxpayer's name or likeness.

The FSA addressed the question of the source of the taxpayer's income from the endorsement contract. The Service concluded that the taxpayer's activities should be treated as containing a personal service component and a royalty component; that the personal service component should be sourced where the services were performed; and that the royalty component should be sourced where the company realized sales of its product. Since the company had substantial U.S. sales, the Service concluded that a substantial portion of the royalty component of the taxpayer's income should be sourced to the U.S. The FSA's approach in regard to the personal service component is not at all controversial. The balance of the analysis herein will therefore focus on what the Service chose to classify as royalty income.

To delineate between the two basic components of the taxpayer's income, the FSA looked to whether the taxpayer was required to perform any special activity or simply did whatever he would have done had he not been a party to the contract. Along those lines the FSA concluded that the portion of the income attributable to appearing in the commercials and pamphlets and making personal appearances on behalf of the company was income from personal services. In contrast, the FSA reasoned that wearing the company's logo and using the company's product or refraining from using competing products did not require the taxpayer to perform any special activities other than those which he would have performed in any event. Therefore, because the income was connected in some way to the use of the taxpayer's name and likeness and because it was not deemed to result from the performance of any special personal service, the FSA concluded that it was in the nature of royalty income. In that regard, the FSA explains that "...where a person is engaged in an activity and uses that activity as a showcase for a product, the latter phenomenon is a purely passive part of the performance." The underlying, but unstated, rationale may be that the taxpayer is allowing the company to display its advertisement on him, much the way it would on a billboard. Or perhaps the rationale is that the taxpayer has, in effect, licensed the company the right to use his image in connection with the image of the product or logo. The FSA actually cites three cases and a ruling to support its position that the income earned by a taxpayer from promoting a product is in the nature of royalty income.

In sourcing the royalty component of the income, the FSA noted that the taxpayer's exhibitions were televised internationally and, as a result, regardless of where the events took place, people all over the world, including the U.S., saw the taxpayer using the company's product and wearing the company's logo. On that basis the FSA reasoned that the company used the taxpayer's property (i.e., his name and likeness) in the U.S. to promote sales in the U.S. and, therefore, that

1 Annour v. Commissioner, 22 T.C. 181 (1954), Commissioner v. Affiliated Enterprises, 123 F.2d 665 (10th Cir. 1941), and Commissioner v. Wedtech, 337 U.S. 369 (1949),

section 861(a)(4) requires that portion of the resulting royalty income to be treated as having its source in the U.S. The FSA suggested that the portion of the royalty component of the taxpayer's income that is allocable to the U.S. under section 861(a)(4) could be determined by using a fraction, the numerator of which is the company's U.S. sales and the denominator of which is the company's worldwide sales.

It is difficult to dispute the notion that the taxpayer's name and likeness were "used" in the U.S. (in a sense) to promote sales of the company's product and that some of the company's U.S. sales were, in fact, the direct result of U.S. consumers viewing the taxpayer using the company's product and wearing the company's logo while engaged in athletic competition. Thus, it is difficult to dispute that a portion of the payment by the company to the taxpayer was, in some sense, from U.S. sources. It would also be difficult for the taxpayer to make a credible argument that he did not realize or intend that the company's use of his image would generate U.S. sales. Thus, a legitimate argument can be made that since he intended his actions to have effects in the U.S., it is reasonable to expect that the U.S. would have jurisdiction over the income earned from those actions.

Viewed strictly from the perspective of whether the drafters of the FSA were able to craft a legitimate argument for the extension of tax jurisdiction to the income of the nonresident alien in the case in question, the FSA represents a very thoughtful and creative effort. Viewed in the broader context of its implications in other fact patterns, the FSA raises questions as to whether an alternative approach may be more appropriate.

Tax Policy Implications

To illustrate why the approach of the FSA may not be workable from a policy viewpoint, consider the following hypothetical variation on the facts of the FSA. Assume that the company is a foreign company with no office or fixed place of business in the U.S. and that the taxpayer never set foot in the U.S. In that regard, it is relevant to note that the fact that the company in the FSA was a U.S. company and that the cash payment may have physically originated in the U.S. and the fact that some of the athletic competitions may have taken place in the U.S. did not appear to be deemed relevant by the drafters of the FSA in determining the source of income with respect to the payment. Assume further that the product in the hypothetical is manufactured by the company entirely outside the U.S. and is sold to independent U.S. distributors with title passing to the distributors before the products reach U.S. territory.

Under the approach of the FSA, the income of the taxpayer in the hypothetical would be allocated to U.S. sources based on the ratio that the company's U.S. sales bears to its worldwide sales. In that regard the FSA would treat the sales to U.S. distributors as U.S. sales because, under the analysis of Rev. Rul. 68-443, 1968-2 C.B. 304, cited for this point in the FSA, the products were placed in the stream of commerce with a view toward their ultimate consumption in the U.S. Thus, under the analysis of the FSA, the nonresident alien taxpayer who never set foot in the U.S., who had no property in the U.S. or property rights being exploited in the U.S., and whose name and likeness did not even appear on the product or its packaging in the U.S., would nonetheless have U.S.-source income.

The result in the hypothetical is especially curious in light of the fact that the company whose product is being sold in the U.S. wouldn't even have U.S.-source income. One might be tempted to explain that fact away as an aberration caused by the arbitrary application of the title passage rule. But, it is important to note that the source of the company's income in the hypothetical would probably not be affected by any of the many proposals to do away with the title passage rule. Thus, under the hypothetical, we have a U.S. distributor purchasing a product from outside the U.S. from an unrelated foreign manufacturer for resale in the U.S. The U.S. distributor's income is unquestionably from U.S. sources. We also have the foreign manufacturer whose income is not from U.S. sources but is effectively connected with the conduct of a trade or business in the U.S. And finally, we have the nonresident alien taxpayer receiving payments from the foreign manufacturer for wearing a logo on his shirt sleeve outside the U.S. and for using products outside the U.S. As a practical matter, the cost of attempting to assert and enforce tax jurisdiction over the income of the nonresident alien would not seem justified by the potential revenue gain. Moreover, as a technical matter, one might make the argument that such an extraterritorial extension of tax jurisdiction is a violation of international law in that it infringes on the exclusive rights of the countries where the athletic events took place to exercise source-based tax jurisdiction over any income earned by individuals for services performed at those events.

If the taxpayer in the hypothetical is not deemed to be engaged in the conduct of a U.S. trade or business and if, as the FSA does, we characterize his income as a royalty, then the resulting U.S. tax would be imposed under section 871 and the payor of the income would have a withholding obligation under section 1441. It would seem curious that a foreign corporation with no U.S.-source income and no "effectively connected" income might be required to withhold U.S. tax from payments made to a foreigner who also has no U.S. contacts. As curious as that may seem, it is not much more of a stretch than the Service subsequently attempted to make (unsuccessfully) in SDI Netherlands v. Commissioner, 107 T.C. 161, Doc 96-27033 (26 pages), 96 TNT 194-5 (1996), and with which many well respected commentators actually agreed. It would seem even odder that the U.S. distributor might somehow be held accountable to withhold tax from its payments for products to a foreign supplier because the supplier had an obligation to pay royalties to a foreign celebrity.

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Thus, to impose a withholding obligation on either the U.S. distributor or the foreign manufacturer would be questionable from a policy standpoint.

The result in the hypothetical is especially curious in light of the fact that the company whose product is being sold in the U.S. wouldn't even have U.S.-source income.

If no withholding occurs, it might be expecting a little too much for the nonresident alien taxpayer to even recognize its U.S. tax obligation and, if so, to actually take the initiative to file a U.S. nonresident income tax return and remit the tax on his own. Thus, as a practical matter, the approach of the FSA would seem to impose taxes that would be difficult, if not impossible, to collect in many cases. It is relevant to note that the possibility that there may be no withholding would not necessarily stop the IRS from attempting to impose a gross basis tax directly on the nonresident alien recipient of the royalty.7 Apparently, in the particular case under consideration in the FSA, the Service felt that the taxpayer was engaged in the conduct of a U.S. trade or business (perhaps because of his participation in athletic competitions in the U.S. or because of his regular and continuous endorsement activity in the U.S. or a combination of both activities) and that his endorsement income was effectively connected thereto. Thus, the withholding question was apparently not an issue in the FSA.

A few additional examples might serve to illustrate the more far reaching implications of the FSA's approach. Assume we have a nonresident alien individual or a foreign company that owns a yacht that competes in the America's Cup competition off the coast of Australia and that the yacht owner receives a payment from Foster's Beer to display the Foster's name and logo prominently on the yacht's mainsail. Under the approach of the FSA, if the race is televised in the U.S., or covered by newspapers or magazines having U.S. circulation, and if Foster's sells beer in the U.S., it would seem that the yacht owner has U.S.-source income, subject to a 30 percent withholding tax.

Consider, as another example, a foreign company (Forco) that otherwise has no U.S. trade or business or U.S.-source income. Assume further that the Forco sets up a Web site on the Internet and, like many popular Web sites, this one contains links to the Web sites of other foreign companies that do sell products in the U.S. and that pay Forco for the right to have their icon on Forco's Web site. Under the approach of the FSA it would seem that Forco's Web site is used in the U.S. by the other foreign companies and, therefore, that the portion of Forco's gross revenues attributable to the U.S. sales of the other foreign companies is subject to a 30 percent gross basis tax. Moreover, if other foreign countries take that approach, Forco's income may be taxed by multiple countries even though Forco has no people, property, or sales outside of its home country.

Or consider the nonresident alien soccer player who, for a fee, shaves the Nike logo on his head for his appearance in an internationally televised World Cup soccer game held outside the U.S. Under the approach of the FSA, he should file tax returns wherever Nike sells products.

On the outbound side of the equation, consider the U.S. taxpayer that owns the famous sign that the CITGO company leases in Kenmore Square, Boston. Because of its location, that sign is prominently displayed on television broadcasts several times during the course of every Red Sox home game. When the Toronto Blue Jays and the Montreal Expos come to town to play the Red Sox, the image of that CITGO sign is viewed by thousands of fans in Canada who may then fill up with CITGO gasoline the next time their tanks run low. Thus, the image of that sign, just like the image of the athlete in the FSA, is "used" by CITGO in Canada to sell its products there. Under the approach of the FSA, Canada might then have primary jurisdiction to impose a withholding tax on the rent income that CITGO pays to the owner of the sign in Boston. Now presumably Canada would not really attempt to tax the owner of a sign in Boston as a result of somebody buying some gas in Canada. So, under the approach of the FSA, that leaves the owner of the sign with zero-taxed foreign-source income available, for U.S. tax purposes, to top up excess foreign tax credits associated with other high-taxed income that it might have from real foreign activities.

Technical Weaknesses in the FSA's Approach

The technical basis for the FSA's approach rests on two points; one of which was expressly dealt with in the FSA and a second that was implied. For the approach of the FSA to be valid, both of those points must be correct. The first point, and the one that the FSA took pains to provide authority for, is that the income in question is in the nature of a royalty. The second point, which is implied by the FSA's reliance on section 861(a)(4) as the controlling authority on sourcing, is that the royalty was for the use in the United States of intangible property.

As a practical matter, the approach of the FSA would seem to impose taxes that would be difficult, if not impossible, to collect in many cases.

The authorities cited in the FSA to support royalty characterization can be distinguished from the facts of the FSA based on what would seem to be two very important points. First, only one of the cited authorities addressed the question of whether the income was a royalty in the context of determining the geographic source of the income and, second, all of the cited decisions appear to hinge on the fact that the income in question was received in exchange for the right to...
exploit a valuable property right owned by the taxpayer. It does not appear that the taxpayer in the FSA had licenses any property rights.

In the Armour case, a golf club manufacturer contracted for the right to use Tommy Armour’s name on golf clubs. The FSA points out that the contract in Armour also required the taxpayer to provide some consulting services and to play golf only with clubs manufactured by the company. It is important to recognize, though, that the question in controversy in the Armour case was whether the taxpayer’s income was capital gain, from the sale of the rights to use his name, or was ordinary income from a licensing agreement. The court found the transfer of rights to be in the nature of a license, rather than a sale, and therefore that the income was ordinary. The court noted that a component of the taxpayer’s income was attributable to personal services, but found it unnecessary to make any apportionment because the income would be ordinary regardless if characterized as royalties or service fees. Thus, the FSA’s reliance on Armour (to classify as royalties the taxpayer’s income from wearing the logo and refraining from using competing products) would seem to be tenuous at best.

Under the approach of the FSA, Canada might have primary jurisdiction to impose a withholding tax on the rent income that CITGO pays to the owner of the sign in Boston.

The taxpayers in Affiliated Enterprises and Wedgewise, the other cases cited in the FSA, were both paid for the right to exploit intangible property rights; a proprietary idea in the case of Affiliated Enterprises and copyrighted work in the case of Wedgewise. As with Armour, the question in controversy in Affiliated Enterprises did not have to do with geographic source of income. Rather, it had to do with whether the income in question was personal holding company income. And again, all three of these cases dealt with the exploitation of property rights.

The ruling cited in the FSA, Rev. Rul. 81-178, dealt with the question of whether certain payments received by a tax-exempt organization were taxable as unrelated business taxable income. The taxpayer was a professional sports players’ association which received income of two types. The first type of income was for the right of the payors to use the organization’s trademarks and trade names as well as the member/player’s names, likenesses, and facsimile signatures in connection with the distribution, sale, advertising and promotion of merchandise, and services by such payors. The second type of income was for personal appearances by the athletes. The ruling found that both categories were gross income from an unrelated trade or business, but that the first category was excluded from unrelated business taxable income as a royalty. The ruling stated: “To be a royalty, a payment must relate to the use of a valuable right.” The ruling cited several cases for that proposition and then went on to say “…royalties do not include payments for personal services.”

The authorities cited in the FSA to support royalty characterization can be distinguished from the facts of the FSA based on what would seem to be two very important points.

The FSA’s reliance on Rev. Rul. 81-178 seems to be based on the following logic: Rev. Rul. 81-178 provides that royalties do not include payments for personal services; the taxpayer in the FSA did not perform any significant personal services; therefore the taxpayer in the FSA must have earned royalty income. That logic is obviously flawed in that it would classify all income that is not from significant personal service activities (e.g., dividends, interest, capital gains, income from providing investment banking services and, yes, even income from playing guitar on the MTV) as royalty income. It would also treat income from a covenant not to compete as a royalty. Not only is that logic flawed; it also ignores the other point in the ruling and an important aspect of the operative language of section 861(a)(4) to the effect that, to be a royalty, a payment must be for the use of a valuable property right.

The income that the Service classified as a royalty in the FSA was for wearing a logo on the taxpayer’s shirt sleeve and for refraining from using competing products. The taxpayer did not grant the company a property right with respect to his name and likeness. Rather, he agreed to do certain things while taking part in internationally televised athletic events. The taxpayer had no right to prevent an image of him doing those things from showing up on people’s television screens in the U.S. and, hence, he had no such property right that he could convey to the company for use in the U.S.; nor did he have any right to prevent the company from broadcasting his image in the U.S. In fact, it wasn’t the company at all that was broadcasting the taxpayer’s image on television. It was the television network.

Technical Support for a Different Approach

As effortless as the Service may believe that the taxpayer’s income earning activities were, the fact of the matter is that the income he received for wearing the company’s logo and using the company’s product was for doing things or refraining from doing things. The income was not earned in exchange for the transfer of any sort of property right. Therefore, to the extent that the taxpayer’s income related to things he did or refrained from doing at events that took place outside the U.S., the source of his income could just as easily be determined under section 862(a)(3) (dealing with compensation for personal services performed outside the U.S.) as under 861(a)(4) (dealing with royalties for the use of intangible property inside the U.S.). That, in a nutshell, is all the technical support required to justify a different approach that should not give rise to
any of the practical problems described above that are produced by the approach of the FSA.

On the other hand, if one accepts the Service's apparent rationale that the taxpayer's income should not be treated as being from personal services because he was simply performing the function of a billboard, then his income should be sourced in the same way as it would if the taxpayer had rented a billboard to the company. If that had been the case, presumably the Service would have sourced the income by reference to where the billboard was located, not by reference to where the advertiser had its sales. Alternatively, if the Service's rationale is that the taxpayer was, in effect, performing the function of a broadcaster, sending his image into the U.S. via the airwaves, then perhaps the income should be sourced using the rules applicable to international communications. Under section 863(e), international communications income of a nonresident taxpayer is treated as being from sources outside the U.S. However, if the broadcasting analogy is pursued, it is not clear that section 863(e) would apply to the taxpayer in the FSA. Under the broadcast analogy, it would seem more appropriate to view the taxpayer in the FSA as a content provider, rather than as the broadcaster. As a content provider, it is not entirely clear whether his income should be sourced under section 863(e) or under the source rules for services or for royalties. Under section 863(e) or under the source rule for services, as a nonresident, performing his function entirely outside the U.S., it would seem likely that his income would be treated as being from foreign sources. Alternatively, if the content represents a property right that is licensed by the taxpayer for use in the U.S., the resulting income would likely be from U.S. sources. But the problem with applying the broadcast analogy in that fashion is that the taxpayer in the FSA does not appear to have any property rights in the content that was broadcast in the U.S.

Closing Comments

The rules adopted by any given country for determining the source of income under its tax laws are the fundamental guidelines that the country uses to delineate those situations where the country will assert tax jurisdiction over the income of nonresident taxpayers. Traditionally, in defining those boundaries, countries have applied the same type of analysis that they apply in the context of other aspects of jurisdiction (e.g., jurisdiction to impose service of process or criminal sanctions). That is, they look to whether the taxpayer's activities or the taxpayer's property have sufficient contacts with the country to justify the country, under principles of equity, in asserting jurisdiction. In the case of tax law, industrialized countries tend to recognize that a higher threshold level of connections is required to justify asserting jurisdiction than in some other areas of law, such as product liability law or criminal law. In the case of tax law, countries tend to refrain from exercising jurisdiction over the income of a nonresident alien unless the taxpayer's income earning activities or income earning property are inside the country.

It is true that in the FSA the taxpayer's activities produced benefits to the unrelated company within the U.S. But, in the case of his income for wearing the logo and using the product, neither the taxpayer nor any of the taxpayer's property rights entered U.S. territory to produce those benefits. The taxpayer's income was not for the right to use valuable intangible property in the U.S. If the taxpayer had a valuable U.S. property right to grant, that, by definition, would mean that the taxpayer could somehow have legally prevented the company from using that property in the U.S. That was not the case under the facts of the FSA (or at least not under those facts that the drafters of the FSA deemed relevant to the taxation of the income that it classified as a royalty).

Regardless of one's belief in regard to the possible existence of jurisdictional limits under international law, there is a point at which the extension of tax jurisdiction becomes impossible to enforce.

While seldom litigated, there is a point at which the exercise of tax jurisdiction by a country over nonresidents of that country may violate the right of another country to assert source-based tax jurisdiction under international law. Moreover, regardless of one's belief in regard to the possible existence of jurisdictional limits under international law (or in regard to the existence of international law at all), there is a point at which the extension of tax jurisdiction becomes impossible to enforce. Thus, when choosing between two or more technically valid approaches for applying the source rules of the U.S. Internal Revenue Code to the income of nonresident taxpayers, the Service ought to construe the law in a manner that produces results that can be readily, practically, and fairly enforced in the vast majority of cases that it theoretically affects and, also, in a manner that is not virtually certain to produce double taxation in the context of the reasonable exercise of source-based tax jurisdiction by other countries.

Having said all of the above, it is relevant to note that under the alternative approaches suggested in this article, the Service would not be without recourse to impose a tax on a reasonable portion of the taxpayer's income from wearing the company's logo and using its product. That tax could be determined, within the bounds of equity, by treating as U.S.-source income, that portion of the taxpayer's income earned for wearing the logo and using the product at events that took place in the U.S. The apportionment of income to U.S.-sources in that case would be based more properly on where the taxpayer performed the relevant activities, rather than where those activities were televised or where the unrelated company sold its product.