The David R. Tillinghast Lecture - What's Source Got to Do with it - Source Rules and U.S. International Taxation

The David R. Tillinghast Lecture "What's Source Got to Do With It?" Source Rules and U.S. International Taxation

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TABLE OF CONTENTS

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I. Introduction

Arguably, the largest problem in international income taxation is the proper treatment of income that is subject to the legitimate taxing claims of two or more countries.[1] A source country's jurisdiction to tax foreign persons is limited to income earned within the source country's borders. Under current international norms, however, the taxpayer's residence country is required to accommodate the source country's taxing right by employing a foreign tax credit or by exempting foreign source income. Thus, source taxation is at once geographically constrained, but also jurisdictionally superior to residence taxation.

These principles require that international income be divided and accounted for between countries according to criteria that relate income and deductions to geographic locations. To be specific, the consequence of geographically limited source taxation and overlapping, but secondary, residence taxation is that the source of income must be determined so that the right to tax can be assigned.[2] In this sense, the concept of "source" is at the heart of international taxation.

We argue in Section II that the right of source countries to tax foreign persons on their source country income has a robust normative foundation. By contrast, we find that source rules that serve as instruments for implementing source taxing jurisdiction and effecting residence country accommodation of source country taxation are surprisingly lacking in normative content. Thus, if timing of income and expense recognition is the Achilles heel of a purely domestic income tax system, the source of income and expense is an equally weak link in the international tax rules. Because no clear economic or equitable principles guide the formulation of rules to divide income and

[1] In using this formulation, we do not mean to ignore the existence of regimes that exempt foreign income from taxation.

[2] Hugh J. Ault & David F. Bradford, Taxing International Income: An Analysis of the U.S. System and Its Economic Premises, in Taxation in the Global Economy 11, 12-16 (Assaf Razin & Joel Slemrod eds., 1990). It should be clear from the text that we regard source taxation and sourcing rules as constituting a system for allocating income taxing rights between source countries and residence countries, but having little to do with defining income.

expense by geographic origin, the construction of these rules has been a significantly arbitrary exercise.[3]

Why is it important to get source and source taxation rules right? One reason is to protect the U.S. income tax base. Today, sophisticated taxpayer planning exploits weaknesses in the income tax regimes of the United States, as well as other developed countries, by taking advantage of (1) the evolution of economic activity in the developed world toward value-added services and intangible assets,[4] (2) increased flexibility in locating tangible economic functions and intangible assets,[5] (3) technological and communications advances that challenge the ability of countries to impose tax at source,[6] (4) substantial innovations in the structuring of financial assets,[7] and (5) the con-

[3] On examination, the claimed rationale for most source rules has a substantial element of arbitrariness. In particular, definitions of income provide little principled guidance for constructing source rules. See Ault & Bradford, note 2, at 31-32 (observing that the Schanz-Haig-Simons income concept is "not susceptible to characterization as to source at all" but attaches to a taxpayer that consumes and owns assets); see generally Robert A. Green, The Future of Source-Based Taxation of the Income of Multinational Enterprises, 79 Cornell L. Rev. 18 (1993) [hereinafter Future].

As an example of the often capricious nature of source rules, assume that *USCo* sells products it manufactures in the United States to its French distribution affiliate *FCo*. *FCo* markets and sells the product in France. Under U.S. source rules, it is possible to treat one-half of *USCo*'s income from sales to *FCo* as foreign source income if title passes in France, even though *USCo* performs no selling, marketing, or other activity outside the United States. See Reg. § 1.863-3(b); Intel Corp. v. Commissioner, 76 F.3d 976 (9th Cir. 1995) (upholding an earlier version of the regulation). The asserted foreign portion of *USCo*'s income has no meaningful economic connection to France.

[4] For a description of some of the changes posing these challenges, see Charles I. Kingson, Taxing the Future, The David R. Tillinghast Lecture, NYU School of Law (Oct. 3, 1996), in 51 Tax L. Rev. 641 (1996).

[5] See, e.g., Bausch & Lomb Inc. v. Commissioner, 933 F.2d 1084 (2d Cir. 1991); Seagate Technology, Inc. v. Commissioner, 102 T.C. 149 (1994); Sunstrand Corp. v. Commissioner, 96 T.C. 226 (1991).

[6] See generally Joseph L. Andrus, Determining the Source of Income in a Changing World, 75 Taxes 839 (1997); J. Clifton Fleming, Jr., Electronic Commerce and the State and Federal Tax Bases, 2000 BYU L. Rev. 1 (2000); J. Clifton Fleming, Jr., U.S. Taxation of Profits From Internet Software Sales–An Electronic Commerce Case Study, 19 Tax Notes Int'l 675 (Aug. 16, 1999); David R. Tillinghast, Taxation of Electronic Commerce: Federal Income Tax Issues in the Establishment of a Software Operation in a Tax Haven, 4 Fla. Tax Rev. 339 (1999); Treasury Dep't, Selected Tax Policy Implications of Global Electronic Commerce (1996) [hereinafter Treasury Electronic Commerce Report].

The United States only recently has begun to take these technological and communications-related changes into account in formulating its source rules. See IRC § 863(d), (e); Prop. Reg. § 1.863-8, -9 (relating to income from space and ocean activities and international communications, respectively).

[7] See, e.g., Compaq Computer Corp. v. Commissioner, 277 F.3d 778 (5th Cir. 2001); IES Indus., Inc. v. United States, 253 F.3d 350 (8th Cir. 2001); ACM P'ship v. Commissioner, 157 F.3d 231 (3d Cir. 1998).

tinued availability of low-tax countries that sometimes erect enforcement obstacles in the form of confidentiality restrictions.[8]

Although source taxation plays a vital role in the U.S. international income tax regime by protecting the U.S. income tax base, there has not been a systematic reexamination of U.S. source taxation rules since 1966. In that year, the Foreign Investors Tax Act of 1966[9] reduced the "force of attraction," net-basis taxation of foreign investors' U.S. investment income in order to encourage investment of foreign capital in the United States to relieve a chronic balance of payments deficit in the early 1960's.[10] Since that time, however, the balance of payments has ceased to be a concern and the United States has become a net importer of foreign direct as well as portfolio investment.[11] A reexamination of U.S. source taxation rules is long overdue.

A fresh consideration of source rules and source taxation also is timely because international income is an increasingly important element of the U.S. economy. The 2002 Economic Report of the President identifies two directly relevant trends: (1) increased globalization and location of economic activity according to advantageous terms of trade, and (2) a related evolution of U.S. economic activity toward highly mobile value-added services and intangible products (and tangible products with embedded intangible value).[12] Indeed, total trade (measured as imports plus exports) increased from 16% of gross domestic product in 1975 to 26% in 2000.[13]

In our reconsideration of source taxation and the related rules that assign geographic source to items of income and expense, we assume

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[8] For a discussion of transactions in which U.S. publicly traded companies "invert" into foreign parent holding company structures in tax havens, see N.Y. St. Bar Ass'n Tax Sec., Report on Outbound Inversion Transactions, 2002 TNT 105-34, May 31, 2002, available in LEXIS, TNT File.

[9] Pub. L. No. 89-809, 80 Stat. 1539.

[10] See Presidential Task Force on Promoting Increased Foreign Investment in U.S. Corporate Securities and Increased Foreign Financing for U.S. Corporations Operating Abroad, cited in Legislative History of H.R. 13103, 89th Cong., Foreign Investors Tax Act of 1966, reprinted in 1966-2 C.B. 1059; Harvey P. Dale, Effectively Connected Income, 42 Tax L. Rev. 689, 691 (1987); Stanford G. Ross, United States Taxation of Aliens and Foreign Corporations: The Foreign Investors Tax Act of 1966 and Related Developments, 22 Tax L. Rev. 279 (1967).

More recently, Treasury suggested that difficulties in applying source concepts to link an item of income earned "in the world of cyberspace" with a specific geographic location could render source taxation obsolete. Treasury Electronic Commerce Report, note 6, at 19. We do not subscribe to the view that it is not possible to formulate source taxation responses to the developments described in the text accompanying notes 4-8. See discussion in the text at Section IV.D.

[11] Christopher L. Bach, Annual Revision of the U.S. International Accounts, 1993-2001, 82 Survey of Current Business 33, 34-35 (July 2002).

[12] Council of Econ. Advisers, 2002 Economic Report of the President 265-68 (2002).

[13] Id. at 253.

that source taxation will continue to have primacy over residence taxation, except to the extent that treaties provide otherwise, and that international double taxation issues will continue to be addressed through unilateral and bilateral measures. Moreover, we assume that nations will not forgo self-interest in any significant way when they undertake such unilateral and bilateral measures. In short, we believe that reconsideration of source taxation and source rules must be constrained by the premise that nations will continue to approach international taxation issues within a structure that does not depart radically from current international norms. In particular, we see nothing to suggest any reasonable prospect for nations, including particularly the United States, joining in multilateral approaches that deal with sourcing and double taxation of income.

In Section II we set out the theoretical justification for taxing foreign persons who earn both active and passive income by making use of the U.S. physical, legal, and/or economic infrastructure. We evaluate alternative approaches to imposing tax at source on U.S. business activity and conclude that taxation of net business income at the same progressive rates applicable to residents is the best alternative. We also evaluate the role of fairness considerations in source taxation and conclude that they do not bear significantly, except that fairness would not necessarily be enhanced by eliminating taxation at source.

In Section III we summarize the U.S. tax policy objectives regarding international income and develop criteria for U.S. source taxation of foreign persons on income from their U.S. businesses and portfolio investments. U.S. source taxation of nonresidents is important to preserve the perceived legitimacy of residence-based taxation with respect to similar activities carried on by U.S. persons. Specifically, we suggest that a need for "perceived parity" requires a level of effective source taxation comparable to that imposed on residents engaged in the same activity. Moreover, source taxation is important to prevent residents from having an incentive to become nonresidents and earn U.S. income.

As a country whose residents invest abroad, the United States also has strong reasons to resist excessive or discriminatory taxation of nonresidents. We suggest in Section III, however, that the existing treaty concept of nondiscrimination does not adequately recognize the ways in which differential taxation of owners of U.S. business entities should be taken into account in evaluating whether a tax rule results in discrimination in fact.

Finally, in Section III we undertake an extended review of the impact of source taxation's geographical limitations on the administration and enforcement of source tax rules. We observe that withholding at source helps overcome limitations on jurisdiction to enforce. Adoption of the qualified intermediary rules extends the reach of this regime outside the United States to the financial institution dealing directly with the nonresident taxpayer.[14] Notwithstanding these improvements in enforcement mechanisms, we conclude that administration of source taxation would be less burdensome and enforcement less problematic if exceptions from source taxation were adopted only by treaty. We also conclude that enforcement of net-basis taxation at source on a remote seller (of goods, intangibles, or services) without a direct physical presence is extremely difficult in the absence of a treaty.

In Section IV we consider the implications for certain selected U.S. source rules of the criteria developed in Section III. We disclaim, however, any attempt at a comprehensive critique of U.S. source rules. Instead, we provide illustrative examples of our analytical approach by considering the consequences of applying the Section III criteria to the U.S. sourcing rules for services and royalties. We also discuss the implications of residence-based source rules. While we do not evaluate the policy wisdom of exempting income from foreign-owned capital, in the light of changes in the U.S. mechanisms for enforcing source taxation of investment income, we argue that now is an appropriate time to consider whether reciprocal treaty exemptions should replace the current U.S. unilateral exemption of portfolio interest and gains on the sale of large stock holdings.[15] We also suggest consideration of developing mechanisms to tax at source income from U.S. sales of goods and services by remote sellers, subject to relief by treaty.

In Section V, we contrast the source rules used for source taxation with the source rules used for the foreign tax credit limitation. We conclude that the two sets of source rules need not be symmetrical if the differences reflect different objectives.[16]

We conclude that there is a need to reevaluate the current scope of U.S. taxation at source. In the absence of a treaty, the objective of the U.S. source taxation regime should be parity in taxation of U.S.-owned and foreign-owned businesses carried on in the U.S. marketplace and a desired level of taxation on income earned by foreign-owned capital employed in the U.S. marketplace. The structure of U.S. rules for taxing international income should not expose the U.S. tax base (all income of U.S. residents and U.S. income, appropriately

[14] Reg. § 1.1441-1(e)(5).

[15] IRC § 871(h).

[16] Cf. Andrus, note 6, at 843 (discussing variations between rules relating to space-related income and international communications income and noting their disparate effects).

defined, of nonresidents) to erosion. Relief from source taxation should be extended by treaty, not unilaterally, so that the United States can receive reciprocal benefits and can obtain the treaty partner's assistance to assure that the relief does not go to inappropriate persons. We also urge a comprehensive reexamination of U.S. source rules to take account of the purpose for each rule.

II. Is There a Normative Basis for Income Taxation of Nonresidents?

Nonresidents regularly earn income by utilizing the U.S. physical, legal, and/or economic infrastructure. When referring to such income in the tax context, we use the term "U.S. source income." One of this Article's major premises is that the United States justifiably can impose tax on nonresidents' U.S. source income. Although this premise is broadly accepted,[17] it has provoked a measure of both doubt and dissent.[18] Thus, a brief examination of the normative principles underlying taxation of nonresidents is warranted.

[17] See ALI, Federal Income Tax Project, International Aspects of United States Income Taxation, Proposals on United States Taxation of Foreign Persons and of the Foreign Income of United States Persons 6 (1987) [hereinafter ALI International Project]; Restatement (Third) of the Foreign Relations Law of the United States §§ 411-12 (1987) [hereinafter Restatement (Third)]; Hugh J. Ault, Comparative Income Taxation: A Structural Analysis 367 (1997); Charles H. Gustafson, Robert J. Peroni & Richard Crawford Pugh, Taxation of International Transactions 14 (2d ed. 2001); Peter A. Harris, Corporate/Shareholder Income Taxation and Allocating Taxing Rights Between Countries 313 (1996); Roy Rohatgi, Basic International Taxation 132-33, 154 (2002); Julie Roin, Competition and Evasion: Another Perspective on International Tax Competition, 89 Geo. L.J. 543, 590-91 (2001); Klaus Vogel, World-wide vs. Source Taxation of Income–A Review and Reevaluation of Arguments, in Influence of Tax Differentials on International Competitiveness 115, 119 (1990) [hereinafter Tax Differentials].

[18] Treasury Dep't, Blueprints for Basic Tax Reform 99 (1977) [hereinafter Blueprints] (recommending that the United States seek a worldwide system of residence-based taxation); Ault & Bradford, note 2, at 31 ("To the extent that income describes an activity, it is not that of production but that of consumption and wealth accumulation, and its location is presumably the place of residence of the person doing the consuming and accumulating."); Reuven S. Avi-Yonah, The Structure of International Taxation: A Proposal for Simplification, 74 Tex. L. Rev. 1301, 1316, 1352-54 (1996) [hereinafter Simplification] (recommending that source taxation be confined to active business income); Michael J. Graetz, Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies, The David R. Tillinghast Lecture, NYU School of Law (Oct. 26, 2000), in 54 Tax L. Rev. 261, 323, 327-28, 333 (2001) (arguing that the prevailing international norm of giving priority to source country taxation over residence country taxation should apply only to active business income); Green, Future, note 3, at 32 ("[I]t is difficult to find a persuasive underlying justification for the host country's assertion of entitlement to tax the domestic source income earned by foreign persons.") (footnote omitted).

A. *Do Political Realities Make a Normative Inquiry Pointless?*

Some observers will regard a principled analysis of the justification for source taxation as pointless. In their view, domestic politics irresistibly drives source countries to ease their residents' tax burdens by taxing foreign persons who cannot vote, without regard to normative principles. A report by a group of leading economists to the League of Nations noted this perspective as early as 1923 and observed that "[a] survey of the whole field of recent taxation shows how completely the Governments are dominated by the desire to tax the foreigner."[19] In this same vein, and at about the same time, T.S. Adams, a leading figure in the 1920's development of both the worldwide consensus that still governs international income taxation and the U.S. system for implementing that consensus, characterized source taxation of nonresidents' business income as "inevitably so."[20] More recently, commentators have suggested "that force majeure has been as important as any ethical conception of sovereignty in producing a general acceptance of the priority of the 'source' jurisdiction to tax particular transactions."[21]

The fact that source taxation is politically irresistible, however, does not obviate the need to examine whether such a policy has a convincing normative basis. As we discuss below,[22] modern commercial and financial developments threaten the enforceability of taxation at the source and the methods for dealing with these threats have costs for both taxpayers and governments.[23] The strength of the principled justifications for source taxation significantly affects the extent to which these costs should be undertaken.

[19] See Report on Double Taxation, League of Nations Doc. E.F.S.73 F.19, at 40 (1923), reprinted in 4 Staff of Joint Comm. on Tax'n, Legislative History of United States Tax Conventions 4003, 4044 (1962) [hereinafter Tax Conventions].

[20] Thomas S. Adams, International and Interstate Aspects of Double Taxation, 22 Nat'l Tax Ass'n Proc. 193, 197 (1929). He did believe, however, that there was also a normative rationale. See Michael J. Graetz & Michael M. O'Hear, The "Original Intent" of U.S. International Taxation, 46 Duke L.J. 1021, 1036 (1997) (quoting Thomas S. Adams, The Taxation of Business, 11 Nat'l Tax Ass'n Proc. 185, 186 (1917)).

[21] Ault & Bradford, note 2, at 32; see also Charles E. McLure Jr., Source-Based Taxation and Alternatives to the Concept of Permanent Establishment [hereinafter Alternatives], in 2000 World Tax Conference Report 6:1, 6:4 (Can. Tax Found. 2000).

[22] See Section III.E.

[23] See generally authorities cited in note 6.

B. The Benefits Rationale

The usual justification for source taxation as a benefits-based charge levied on nonresidents by the source country[24] has attracted criticism. Some analysts suggest that such a tax should be limited to the value of source-country government benefits provided to nonresidents. They then argue that this reasoning leads to a significantly lower tax than that paid by residents on similar amounts of income because the value of government benefits provided to nonresidents is significantly less than the value of such benefits bestowed on residents.[25]

We disagree with this constrained view of the benefits conferred on the foreign investor and of the valuation of those benefits. Government benefits received by nonresidents who invest or do business in the United States are not limited to such basic services as the road leading to a particular business location and police and fire protection of that site. A nonresident who invests in or carries on a U.S. business profits from U.S. government activities that create and foster general public safety, national security, a fair legal system, a transparent and safe financial infrastructure, a healthy and educated workforce, transportation and communication infrastructure, legal protection of intellectual property licensed or sold in the United States by the nonresident, and redistributive assistance to the poor that contributes to a stable social order.[26] Stated differently, the benefits provided by

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[24] See ALI International Project, note 17, at 18-19, 29, 34, 37-38; Graetz, note 18, at 298, 327; Harris, note 17, at 483, 485; Lawrence Lokken, The Sources of Income From International Uses and Dispositions of Intellectual Property, 36 Tax L. Rev. 235, 239-40 (1981).

[25] Green, Future, note 3, at 32 (source taxation should be limited to costs imposed on the public sector by foreign persons or to a percentage of location-specific economic rents, if any, earned in the source country); Harris, note 17, at 455-58 (source taxation should be limited to the cost of government services provided to nonresidents who earn domestic-source income; the source income tax rate should be "somewhat less" than the tax rate imposed on residents); McLure, Alternatives, note 21, at 6:4 ("A tax justified by the benefit principle would generally only cover the cost of providing public services for corporations, which would be relatively small."); Roin, note 17, at 591 ("A case may be made" for setting the source tax rate lower than the rate imposed on residents); Jefferson VanderWolk, The Deferral Debate and the Benefits Theory, 20 Tax Notes Int'l 1469, 1470 (Mar. 27, 2000) (the source tax rate should be one-half the tax rate imposed on domestic income earned by residents). Although it is not entirely clear, these commentators seem to suggest that foreign investors be charged only the marginal additional government costs resulting from their investment. Even if we agreed with this description of the benefit conferred on the foreign investor, we believe that this pricing is deficient. First, it would not charge a market price for the benefit—namely what the market will bear, subject to limitation by the nondiscrimination principle (discussed in the text at Section III.D). Second, it would fail to satisfy resident taxpayers that the foreign persons are subjected to comparable taxation on their U.S. business activities (discussed in the text at Section III.C).

[26] See Reuven S. Avi-Yonah, International Taxation of Electronic Commerce, 52 Tax L. Rev. 507, 520-21 (1997) [hereinafter Electronic Commerce]. Foreign investors view stabil-

the U.S. government to nonresident earners of U.S. source income are quite similar to government benefits received by U.S. residents, thus justifying a substantial source tax.

C. *Charging for Nonresidents' Exploitation of the U.S. Market*

The preceding conclusion becomes even more compelling when investors think about government benefits in broader terms. To be specific, consider the case of a nonresident who extracts minerals from the source country. The nonresident exploits the source country's resource endowment and, in this circumstance, there is broad international acceptance of the source country's right to levy a substantial source tax.[27]

This analysis also provides a strong basis for imposing a comparable taxing regime on a foreign person who carries on a nonextractive business in the United States. The U.S. physical, legal, and economic infrastructure (the "U.S. market") on which the nonresident depends is largely the result of U.S. government activities mentioned above.[28] If the nonresident mineral exploiter can be taxed for accessing and exploiting a U.S. natural resource deposit, it also is legitimate to tax a nonresident for accessing and exploiting the U.S. market that is, to a great extent, the creature of U.S. government services and programs.[29]

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ity as a characteristic that protects investment yield. Thus, an important attraction of the U.S. market to foreign investors is the stable social order within which the market functions. We thank Martin McMahon, Jr. for calling our attention to this point.

[27] See Graetz, note 18, at 298; McLure, Alternatives, note 21, at 6:4.

[28] See text accompanying notes 25-26.

[29] See Restatement (Third), note 17, § 412; Avi-Yonah, Electronic Commerce, note 26, at 520-21; Graetz, note 18, at 298-99; McLure, Alternatives, note 21, at 6:4, 6:6; Rohatgi, note 17, at 154; Roin, note 17, at 590-91. We argue in Section III.C that this conclusion also is required in order to preserve the legitimacy of U.S. residence taxation by creating a perception of tax parity between nonresidents and residents.

It is virtually impossible to conceive of the Supreme Court holding that the Due Process Clause of the Fifth Amendment would be violated if the U.S. source tax were rationalized as a charge for accessing and exploiting the U.S. market, so long as the taxpayer has some direct contact with the U.S. economy. This conclusion follows generally from the fact that in modern times, the Due Process Clause consistently has been interpreted as imposing only minimal restraints on Congress' exercise of its power to tax income. 1 Boris I. Bittker & Lawrence Lokken, Federal Taxation of Income, Estates and Gifts ¶¶ 1.2.5-1.2.6 (3d ed. 1999); see also Bruce Ackerman, Taxation and the Constitution, 99 Colum. L. Rev. 1, 3 (1999) ("Under the constitutional regime inaugurated by the New Deal, there are no significant limits on the national government's taxing, spending, and regulatory powers where the economy is concerned–other than the requirement that government compensate owners if their property is taken for public purposes."); Daniel N. Shaviro, Psychic Income Revisited: Response to Professors Johnson and Dodge, 45 Tax L. Rev. 707, 711 n.17 (1990) ("[I]t is generally agreed that the [sixteenth] amendment does not significantly constrain how taxable income can be defined by Congress and the courts.").

More particularly, in Quill Corp. v. North Dakota, 504 U.S. 298 (1992), the Supreme Court held that North Dakota did not violate the Due Process Clause of the Fourteenth

Are there limits on how far the United States may go in asserting a U.S. source taxation right based on accessing and exploiting the U.S. market? Clearly, there are. As one example, the value of the U.S. dollar in relation to other currencies is significantly a function of government activities related to the U.S. economy described above[30] as well as U.S. fiscal and monetary policies. Accordingly, any security denominated in dollars, even if issued by a foreigner, derives at least indirectly a portion of its value from U.S. government actions and policies. Thus, a foreign investor's holding of a U.S. dollar-denominated security issued by a foreign entity with no U.S. market activity, as an abstract economic matter, might justify source taxation of the currency-related income from the security. Nevertheless, administrative and jurisdictional considerations preclude assertion of a source-based tax if the foreign issuer has no U.S. contacts and does not access the U.S. market.[31] Indeed, such considerations effectively will prevent the United States from using the market access rationale to tax income that has only a distant relationship to the U.S. economy.

The market access rationale for source taxation relieves the U.S. government from the necessity of quantifying the cost of government benefits conferred on nonresidents who earn U.S. source income. Under this rationale, setting the level of source-based taxation on the U.S. source income of nonresidents is a pricing question controlled by the relation between the demand for access to the U.S. market and the prices (that is, source tax rates) charged by other countries for access to their markets.[32]

Amendment by requiring a mail-order seller to collect and remit use tax on sales to North Dakota residents where the seller was an out-of-state corporation that had no property or personnel in North Dakota but that annually made $1 million in mail-order sales to approximately 3,000 North Dakota customers. The Court stated that:

> In this case, there is no question that Quill has purposefully directed its activities at North Dakota residents, that the magnitude of those contacts is more than sufficient for due process purposes, and that the use tax is related to the benefits Quill receives from access to the State. We therefore agree . . . that the Due Process Clause [of the Fourteenth Amendment] does not bar enforcement of that State's use tax against Quill.

Id. at 308. This language seems to immunize a source tax rationalized as a charge on foreign persons for direct access to the U.S. market from a Fifth Amendment due process attack. (The *Quill* Court ultimately held that the North Dakota use tax, as applied to an out-of-state mail order seller, was an unconstitutional burden on interstate commerce. This point is irrelevant with respect to Congress' power to tax the U.S. source income of nonresidents.) See note 79.

[30] See text accompanying note 26.

[31] See notes 34-35 and accompanying text. We reserve for future consideration the question whether the United States should impose a source tax when a U.S. person or issuer is a party to a derivative transaction.

[32] See generally McLure, Alternatives, note 21, at 6:4, 6:6. The nondiscrimination article in U.S. bilateral income tax treaties, however, generally prevents the United States from taxing nonresidents more heavily than U.S. residents "in the same circumstances." See,

In later sections of this Article, we address the problems of setting the level and structure of the tax on foreign persons' U.S. source income and, in particular, the problem of preventing source taxation from becoming a protectionist device.[33] For normative purposes, however, it is sufficient to conclude that the United States may appropriately burden the U.S. income of nonresidents with a source tax that is comparable to that paid by residents.

D. *Does the Geographical Limit on Taxation of Nonresidents Foreclose a Fairness Justification for Source Taxation?*

The prevailing international norm gives each country jurisdiction to tax nonresidents but only with respect to income derived within or attributable to the taxing country.[34] Stated differently, there is general agreement that geographically limited source taxation is the only principled regime available to a country for taxing the income of foreign persons. In the context of current U.S. tax rules, U.S. income taxation of nonresidents is regarded as normatively restricted to U.S. economic activity giving rise to U.S. source income.[35]

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e.g., U.S. Model Income Tax Convention, Sept. 20, 1996, art. 24(1), 1 Tax Treaties (CCH) ¶ 214.24 [hereinafter U.S. Model Treaty]; see generally Brian J. Arnold, Tax Discrimination Against Aliens, Non-Residents, and Foreign Activities: Canada, Australia, New Zealand, the United Kingdom, and the United States (1991); Kees van Raad, Nondiscrimination in International Tax Law (1986); 2 Klaus Vogel, Harry A. Shannon, III, Richard L. Doernberg & Kees van Raad, United States Income Tax Treaties, Art. 24 Commentary (1996); Sanford H. Goldberg & Peter A. Glicklich, Treaty-Based Nondiscrimination: Now You See It Now You Don't, 1 Fla. Tax Rev. 51 (1992); James G. O'Brien, The Nondiscrimination Article in Tax Treaties, 10 Law & Pol'y Int. Bus. 545 (1978). We argue below that a parity of taxation or comparable taxation rationale should apply to prevent lower taxation of foreign persons. See Section III.C.

33 See text accompanying notes 59-75.

34 See ALI International Project, note 17, at 6-7; Restatement (Third), note 17, § 412; 1 Joseph Isenbergh, International Taxation 1:18 (3d ed. 2002); Rohatgi, note 17, at 132, 154. A significant exception to this norm is U.S. taxation of foreign source income earned by a domestic corporation with foreign shareholders. See J. Clifton Fleming, Jr., Robert J. Peroni & Stephen E. Shay, Fairness in International Taxation: The Ability-to-Pay Case for Taxing Worldwide Income, 5 Fla. Tax Rev. 299, 321-23 (2001). Even if a source country ostensibly observed the norm but attempted to set the source tax rate on a nonresident's source country income by referring to the nonresident's aggregate worldwide income, the source country usually would be unable to ascertain the worldwide income amount. Harris, note 17, at 456-57.

35 See note 17. As a practical matter, of course, a country's power to enforce an income tax on foreign persons is limited to income from economic activity within its borders. Thus, the international norm that confines taxing jurisdiction over foreign persons to domestic source income may be nothing more than an effort to create the appearance of a principled rationale for a rule that is actually an expression of the limits of enforceability. We assume, however, that the international norm has genuine normative content and proceed on the premise that the U.S. decision to tax foreign persons only on their U.S. source income is a correct application of principle.

To some analysts, this geographical limitation inherently conflicts with the fact that source taxation is ostensibly a levy on income. This is because the principal normative justification for income taxation is that it allocates the cost of government among taxpayers on the basis of comparative economic well-being, or ability to pay.[36] The conventional view holds that ability to pay always should be measured in terms of worldwide income, not income restricted to particular geographical sources.[37] A source taxation regime, however, only reaches income earned within the source country. Consequently, such a regime usually does not take the taxpayer's full income into account and, according to the prevailing orthodoxy, cannot be grounded on an ability-to-pay principle.[38] For some analysts, this fact makes source-based income taxation illegitimate.[39]

An unconventional response is to argue that fairness in the taxation of international income involves two separate issues: (1) determining the extent of the taxing country's jurisdiction and (2) allocating the tax burden among those who earn income subject to that jurisdiction. This argument then asserts that the ability-to-pay principle is relevant only to the second issue, both as to source taxation and residence taxation. Because residence countries have taxing jurisdiction with respect to the worldwide incomes of their residents,[40] an ability-to-pay allocation of the tax burden among residents must make reference to worldwide incomes. As previously noted, however, a country may tax nonresidents only on income derived from sources within that country. But under the present line of argument, this limitation only describes the source country's taxing jurisdiction and does not address how the source tax burden should be allocated among nonresidents. The answer, according to this argument, is that a source country should tax nonresidents in terms of their respective abilities to pay and that for source tax purposes, a nonresident's ability to pay should be measured in terms of the income over which the source country has taxing jurisdiction–that is, income derived by nonresidents from sources within that country.[41]

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[36] See Ault & Bradford, note 2, at 27; Fleming, Peroni & Shay, note 34, at 306-08; see also Erik M. Jensen, The Taxing Power, the Sixteenth Amendment, and the Meaning of "Incomes," 33 Ariz. St. L.J. 1057, 1107-28 (2001) (purpose of Sixteenth Amendment was to link tax burdens to ability to pay).

[37] See Fleming, Peroni & Shay, note 34, at 311-12.

[38] Id. at 307 n.13.

[39] Blueprints, note 18, at 98-99; Green, Future, note 3, at 29-32.

[40] See generally Fleming, Peroni & Shay, note 34. Of course, some countries have abandoned their residence-based taxing jurisdiction and adopted territorial regimes that are limited to source taxation of both residents and nonresidents.

[41] Professor Deborah Geier suggested this line of argument to us.

An example will be useful. Assume that in a given year, nonresident individual A has \$100,000 of U.S. source net income and \$100,000 of foreign source net losses. Under the conventional view, A's ability to pay is zero but under the preceding argument, A's ability to pay (as determined by U.S. taxing jurisdiction) is \$100,000 and A should bear a U.S. source tax calibrated to that level of taxpaying capacity. If, in the alternative, A had \$100,000 of foreign source income along with her \$100,000 of U.S. source income, A's ability to pay U.S. source tax under the preceding argument would be only \$100,000 (not \$200,000).

Thus, this approach does not regard the geographical limitation on source tax jurisdiction as leading to the conclusion that source taxation cannot be based on ability to pay. To the contrary, this argument contends that a tax on the U.S. source income of nonresidents can be and should be structured so that it is an ability-to-pay tax with reference to the taxpayer's U.S. source income.

We could agree if we accepted the premise that ability to pay is measured with reference to income over which a country has taxing jurisdiction. We decline to do so, however. Ability to pay suggests a taxpayer's total realized amounts[42] available for consumption, saving, and paying taxes. Calculation of these amounts can be made only on the basis of worldwide income.[43] Thus, we conclude that the justification for source taxation cannot be ability to pay but instead must be a charge for access to the source country market.[44]

We are, however, in agreement with the end result of the preceding argument, which leads to the conclusions that a nonresident who has a large U.S. source income should pay a relatively large U.S. source tax even if she has fully offsetting foreign source losses and, conversely, that a nonresident who has a small U.S. source income should pay a relatively small U.S. source tax even if she has a huge foreign source income. We endorse these conclusions, both because we believe that the amount of a nonresident's U.S. source income is a reasonable and practical measure of the value of the nonresident's access to the U.S. market and because of a nondiscrimination principle, developed below,[45] that arises from U.S. self-interest in nondiscriminatory taxation of its own residents.

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[42] We accept the fact that practical considerations require income tax systems to deal primarily with realized income even though a theoretically pure income tax, based on ability to pay, would include unrealized gains in the tax base and allow a deduction for unrealized losses (at least with respect to business and investment assets).

[43] Blueprints, note 18, at 98-99; Ault & Bradford, note 2, at 27 ("the source of income has no bearing on its validity as a measure of ability to pay").

[44] An ability-to-pay tax presents theoretical difficulties when the taxpayer is an entity not subject to pass-through taxation. Fleming, Peroni & Shay, note 34, at 318-23. Source taxation rationalized as a market access charge eliminates these difficulties.

[45] See Section III.D.

E. *Would Fairness Be Enhanced by Unilaterally Abandoning Source Taxation?*

Some who regard source-based taxation as grounded on the benefits principle rather than on the ability-to-pay principle have suggested that source taxation of nonresidents should either be confined to U.S. source active business income, with the United States forgoing taxation of U.S. source passive income,[46] or that the United States at least should cede primary taxing jurisdiction over U.S. source passive income[47] to residence countries.[48] The principal argument underlying both of these suggestions is that nonresident earners of U.S. source passive income are largely individuals and that these individuals should be subject to tax exclusively, or primarily, in their residence countries, which can address fairness concerns by applying an ability-to-pay tax to worldwide income.[49]

This argument raises interesting questions. Could, and should, the United States improve tax fairness domestically, or on a global basis, by unilaterally abandoning its taxation of individual nonresidents' U.S. source passive income?[50] We conclude that the answer to these questions is no. Domestic fairness requires that the costs of the U.S. government be borne both by (1) residents on the basis of ability to pay,[51] and (2) nonresidents on the basis of an appropriate charge for the privilege of exploiting the U.S. market.[52] 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. re-

[46] E.g., Avi-Yonah, Simplification, note 18, at 1310-16.

[47] Under customary international law, a source country has primary taxing jurisdiction over income earned within its borders, and countries that tax on the basis of residence are obligated to mitigate international double taxation by some reasonable means, usually either by giving their residents a credit for foreign source country tax or exempting their residents' foreign source income from residence country taxation. ALI International Project, note 17, at 6-7; 1 Restatement (Third), note 17, § 413, at 267-68; Ault, note 17, at 367; Harris, note 17, at 313, 318-20.

[48] E.g., Graetz, note 18, at 327-28, 333. Graetz has made this suggestion as part of a package of proposals with respect to which he provides the following caution: "I am not now urging adoption of the ideas that I shall discuss. My effort here is preliminary, and more work is needed both to estimate the consequences of such policy changes and to detail the rules needed for their implementation." Id. at 327.

[49] Avi-Yonah, Simplification, note 18, at 1311-12, 1316; Graetz, note 18, at 328, 333.

[50] Under current law the United States already has relinquished source taxation of interest on most portfolio debt, IRC §§ 871(h), 881(c), and most capital gains from dispositions of personal property, IRC §§ 864(c)(2), 871(a), 881(a); Reg. §§ 1.871-7(a)(1), 1.871-8(b)(1), 1.881-1(b)(1), 1.881-2(a)(1), 1.1441-2(b)(2)(i). We raise the issue whether the United States should give up the remainder of its source tax jurisdiction or revisit these earlier decisions.

[51] Fleming, Peroni & Shay, note 34, at 306-08.

[52] See text accompanying notes 27-29.

sidents. A failure of nonresidents to contribute to the costs of government, would therefore, diminish, not enhance, domestic tax fairness.

Does the answer change under a global perspective? It does not if the issue is examined from the viewpoint of the United States acting as a source country. From this perspective, it is relevant that many foreign countries unquestioningly allow a credit against their residents' domestic income tax liability for U.S. tax levied on U.S. source passive income[53] instead of restricting their residents to a deduction for U.S. tax in calculating net income. This permits the United States to claim revenue from the residence country's treasury to the extent of the credit and suggests that U.S. source tax is widely regarded as, at least, a not-unfair intrusion into the base of ability-to-pay residence taxes.

Measured solely by reference to the residence country's taxation of its own residents, however, the U.S. source tax effectively diminishes the extent to which the residence country can achieve its goal of equitably allocating the costs of government among its residents by imposing its own ability-to-pay tax on its residents' worldwide income, including U.S. source income.[54] Indeed, where the U.S. tax equals or exceeds the foreign tax, the credit allowed for U.S. source tax extinguishes the residence country's ability-to-pay tax.

Would global tax fairness improve if the United States unilaterally curtailed or eliminated its taxation of U.S. source passive income earned by nonresidents, so that other countries could better tax that same U.S. source income in the hands of their residents?[55] If all countries had regimes that taxed their residents comprehensively on the basis of ability to pay, then this action by the United States might increase global fairness. Global fairness would decrease in this scenario, however, to the extent the foreign countries either did not tax U.S. source income or taxed it regressively.

This point is rendered moot, however, by the fact that the primary obligation of U.S. tax policy is to improve the well-being, including the

[53] Even countries that generally exempt U.S. source income from residence-based taxation usually impose tax on U.S. source passive income (the subject of this discussion) and credit the U.S. tax thereon against their domestic tax. See Martin A. Sullivan, Treasury's Inversions Report Rocks the Boat, 95 Tax Notes 1289, 1294 (May 27, 2002) (citing France, Germany, Canada, the Netherlands, and Australia).

[54] A residence country measuring fairness only with respect to its residents, and pursuing ability-to-pay objectives to the exclusion of other objectives, would allow only a deduction for a foreign tax. In allowing a foreign tax credit, the residence country implicitly favors avoidance of double taxation over ability to pay in its taxation of cross-border income. Fleming, Peroni & Shay, note 34, at 328-32.

[55] This question recalls the debate over whether capital export neutrality or capital import neutrality enhances worldwide economic efficiency. See Fleming, Peroni & Shay, note 34, at 308 n.14.

fair treatment, of U.S. individuals.[56] The United States has no obligation to advance tax equity in a foreign country by unilaterally giving up or reducing the U.S. claim to tax the U.S. source income of nonresidents.[57]

Of course, it is often the case that the United States finds it advantageous to surrender source taxing rights unilaterally or through the bilateral treaty process in exchange for concessions by other countries.[58] This is, however, quite different from saying that the interest of a foreign country in applying an ability-to-pay tax to the worldwide incomes of its residents extinguishes or diminishes the source tax claim of the United States. The United States, at least historically, has not used fairness grounds to justify its treaty concessions with regard to source tax jurisdiction.

F. Should a Net Income Tax Be Imposed for Access to the U.S. Market?

The U.S. source tax on active business income of a foreign person is, in its current form, a levy on net profits attributable to a U.S. permanent establishment (if the foreign person resides in a country with which the United States has an income tax treaty)[59] or on net profits effectively connected with the conduct of a trade or business within the United States (if the foreign person resides in a nontreaty country).[60] Critics charge that these approaches to U.S. source taxation of foreign persons' U.S. active business income are rather imprecisely related to the rationale of such taxation, which is a charge on nonresidents who make use of the U.S. market. Specifically, advocates of this position point out that all foreign persons who avail themselves of the U.S. market are exploiters of the opportunities provided by the market's physical, legal, and economic infrastructure regardless of the size

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[56] Graetz, note 18, at 277-79, 311.

[57] See OECD, Harmful Tax Competition: An Emerging Global Issue 15 (1998); see also Graetz, note 18, at 277-78; Restatement (Second) of the Foreign Relations Law of the United States 104-05 (1965); 1 Restatement (Third), note 17, § 413 cmt. 1, at 268. If the United States abandoned or substantially curtailed its source tax jurisdiction, U.S. corporations would find it more attractive to transform themselves into foreign corporations (thus removing themselves from U.S. residence-based taxation), and corporate inversion transactions would multiply. See generally Mihir A. Desai & James R. Hines Jr., Expectations and Expatriations: Tracing the Causes and Consequences of Corporate Inversions, 55 Nat'l Tax J. 409 (2002).

[58] See U.S. Model Income Treaty, note 32, arts. 7, 10-12, 14-15; 1 Tax Treaties (CCH) ¶¶ 214.07, 214.10-214.12, 214.14-214.15.

[59] See id art. 7; 1 Tax Treaties (CCH) ¶ 214.07.

[60] IRC §§ 871(b), 882.

of their profits or whether they earn profits at all.[61] Moreover, the U.S. market activities of foreign persons in lean years or loss years may provide the foundation for highly profitable future years. Nevertheless, foreign persons pay no source tax with respect to their U.S. business activities in loss years and only a small tax in low-profit years. Furthermore, we cannot be certain that profits earned in good years will produce a tax that adequately reflects the value of access to the U.S. market in both the profitable and less rewarding years.

1. *The Appropriate Charge for Access to the U.S. Market by Businesses Without Positive U.S. Source Taxable Income*

We recognize the force of the preceding points but believe that a tax system must be practical and that a tax on U.S. source net income is the best practical measure of the appropriate charge to a nonresident for the privilege of doing business in the U.S. market. It also is the tax base that residents most likely will perceive as treating them no worse than nonresidents and at the same time satisfying the nondiscrimination principle. To buttress this argument, we consider alternatives to a tax on the net U.S. source income of nonresident-owned U.S. businesses.

One possible alternative would be to tax nonresidents on their gross U.S. active business income at a comparatively low rate. Under this approach, nonresidents who engage in U.S. business activities would pay tax even in loss years. The other results, however, would be quite ugly. To illustrate, assume that the United States taxed domestic businesses at 35% of net income and domestic business activities of foreign persons at 5% of gross income. In addition, assume four pairs of U.S. businesses: (1) a domestic business and a foreign-owned business, each with $100 of gross income and $99 of deductible expenses, (2) a domestic business and a foreign-owned business, each with $100 of gross income and $94 of deductible expenses, (3) a domestic business and a foreign-owned business, each with $100 of gross income and $85.71 of deductible expenses, and (4) a domestic business and a foreign-owned business, each with $100 of gross income and $1 of deductible expenses. Finally, assume that the residence country of the owner of the foreign-owned business either applies a low-rate net income tax (with a foreign tax credit) to U.S. source business income or exempts such income. (Either way, there would be no tax paid on the U.S. source business income in the residence country.) The results would be as follows:

[61] E.g., Green, Future, note 3, at 29-30; McLure, Alternatives, note 21, at 6:3-6:4, 6:12 n.15.

First Pair

Foreign-Owned Business		*Domestic-Owned Business*	
$100.00	gross income	$100.00	gross income
– 99.00	expenses	– 99.00	expenses
$ 1.00	pretax net income	$ 1.00	pretax net income
– 5.00	5% tax on gross income	– .35	35% tax on net income
($ 4.00)	after-tax loss	$ .65	after-tax income

Second Pair

Foreign-Owned Business		*Domestic-Owned Business*	
$100.00	gross income	$100.00	gross income
– 94.00	expenses	– 94.00	expenses
$ 6.00	pretax net income	$ 6.00	pretax net income
– 5.00	5% tax on gross income	– 2.10	35% tax on net income
$ 1.00	after-tax income	$ 3.90	after-tax income

Third Pair

Foreign-Owned Business		*Domestic-Owned Business*	
$100.00	gross income	$100.00	gross income
– 85.71	expenses	– 85.71	expenses
$ 14.29	pretax net income	$ 14.29	pretax net income
– 5.00	5% tax on gross income	– 5.00	35% tax on net income
$ 9.29	after-tax income	$ 9.29	after-tax income

Fourth Pair

Foreign-Owned Business		*Domestic-Owned Business*	
$100.00	gross income	$100.00	gross income
– 1.00	expenses	– 1.00	expenses
$ 99.00	pretax net income	$ 99.00	pretax net income
– 5.00	5% tax on gross income	– 34.65	35% tax on net income
$ 94.00	after-tax income	$ 64.35	after-tax income

The results for the first and second pairs illustrate that on the facts of this example, the 5% gross income tax would have a strongly protectionist and discriminatory effect when the business expenses range from $99 to $95. This is because within this range, the gross income tax would cause the otherwise profitable foreign-owned business to be unprofitable. The second and third pair results show that when expenses are in the $94 to $85.72 range, the foreign-owned business would be able to earn a profit but, nevertheless, would be taxed adversely compared to the domestic business. In each case, these differences might be a barrier to entry, and it seems clear that if a tax treaty between the United States and the foreign owner's country of residence was in effect, the United States would be in violation of the treaty's nondiscrimination article.[62]

Finally, the third and fourth pair results indicate that when costs are in the $85.70 to $1 range and the residence country with respect to the foreign-owned business either exempts U.S. source income, or taxes it at a low rate and allows a credit for the U.S. gross income tax, the foreign-owned business would pay less tax under the 5% gross income tax regime than similarly situated domestic businesses subject to a net income tax regime. Thus, in this situation, the lower gross income tax effectively would subsidize the foreign-owned business's participation in the U.S. market. Furthermore, this subsidy would be available for all foreign-owned businesses whose costs fell within the favored range even if no U.S. economic or foreign policy interests were furthered. It is not obvious how this untargeted subsidy effect enhances the well-being of U.S. individuals (and it clearly violates the parity or comparable taxation principle described below).

In summary, these examples indicate that even a low-rate gross income tax on business income is a discriminatory market entry barrier in the case of some foreign businesses and a subsidy in the case of others. By contrast, when a source tax on business income takes the form of a net income tax with the same rates that apply to domestic businesses, none of these untoward effects occurs. Thus, the net income tax is, on balance, a superior source tax alternative to the gross income tax even though the net income tax does not impose a charge on foreign-owned U.S. businesses operating at a loss.[63]

A value added tax ("VAT") regime, however, requires businesses to collect VAT on their sales even when operating at a loss. Thus, a VAT imposed on the U.S. sales of foreign-owned businesses operating in the United States has been suggested as a form of source tax that is superior to a tax on net U.S. source business income.[64] But a business tax system consisting of (1) a federal VAT that applies only to sales by foreign-owned businesses operating in the United States, and (2) a business net income tax that applies only to U.S. residents is problematic indeed. If the foreign businesses were able to shift the VAT forward, in the form of higher prices, to U.S. consumers who purchase

[62] See OECD, Model Tax Convention on Income and Capital, 2000, art. 24, Commentary ¶¶ 10, 39; cf. ALI International Project, note 17, at 85-87 (noting potential problems and unfairness of imposing tax liability on a gross income basis).

[63] Source taxation, nevertheless, usually is imposed on passive income in the form of a gross-basis levy. This is because withholding is usually employed to enforce the source tax on passive income and it is regarded as administratively unfeasible for withholding agents to make the deduction calculations that would be required to impose net basis taxation on the nonresident income recipients. Gustafson, Peroni & Pugh, note 17, at 196; Ault & Bradford, note 2, at 22.

[64] E.g., McLure, Alternatives, note 21, at 6:12 n.15.

goods and services from the foreign-owned businesses,[65] they would compete against U.S. businesses that do not suffer an analogous price effect from the income tax in loss years. If, on the other hand, foreign-owned businesses were unable to shift the VAT forward to U.S. customers and, therefore, had to absorb it, then at least in loss years, the foreign-owned businesses would bear a cost not borne by domestic businesses. Either way, the VAT would function as a discriminatory obstacle to market entry by foreign businesses who wished to compete in the U.S. market.

By contrast, a source tax structured as a net income tax with the same rates as those applicable to domestic businesses does not present these problems. Thus, a net income source tax fails to tax foreign-owned businesses in loss years, but for precisely that reason, it seems to be a superior source tax compared to a VAT. In summary, even if the failure of the U.S. net income tax regime to extract a source charge from businesses in loss years is regarded as theoretically problematic, a net income tax on U.S. source business income is, nevertheless, superior to the available alternatives as a practical approach to establishing a charge for access to the U.S. market.

2. *Flat v. Progressive Rates*

The usual justification for progressive income tax rates is that they are necessary if the tax is to be based on ability to pay.[66] As discussed above, however, the conventional view holds that source taxation is not grounded in the ability-to-pay principle because it generally does not take the taxpayer's worldwide income into account. Instead, we suggest that source taxation is best justified as the price charged for access to the domestic market. Would a flat tax rate be preferable in this context?

Consider *A*, a foreign person who earns $1 million of U.S. source net business income, and *B*, a foreign person who earns $100,000 of U.S. source net business income. If *B* had to pay the same amount of tax as is appropriate for *A*, she might suffer an after-tax loss and effectively be barred from the U.S. market. Stated differently, the source

[65] Conventional incidence analysis assumes this shifting will occur. E.g., Cong. Budget Office, The Economic Effects of Comprehensive Tax Reform ch. 2 (1997); Staff of the Joint Comm. on Tax'n, 105th Cong., Impact on Individuals and Families of Replacing the Federal Income Tax § IV.D.3 (Comm. Print 1997); Treasury Dep't, 3 Tax Reform for Fairness, Simplicity, and Economic Growth 29, 43 (1984) [hereinafter Treasury I]; Leif Mutén, A Critical Response: Rethinking Europe's VAT Systems, 26 Tax Notes Int'l 997 (May 27, 2002) (letter to the editor).

[66] See, e.g., Blueprints, note 18, at 98-99; Graetz, note 18, at 333; Martin J. McMahon, Jr. & Alice G. Abreu, Winner-Take-All Markets: Easing the Case for Progressive Taxation, 4 Fla. Tax Rev. 1, 32-37, 65 (1998).

tax might serve as a barrier to entry by small foreign businesses and there is no sound reason for the United States to adopt such a tax barrier. On the other hand, if *A* were charged a source tax that is appropriate in amount for *B*, *A* probably would pay far less than he would be willing to bear as the price for exploiting the U.S. market. In such a case, Congress would have set the price for U.S. market access too low.

An obvious way out of this dilemma is to impose source tax at a uniform, flat percentage rate on U.S. source net business income so that *B* is not thrown into an after-tax loss situation and *A* pays a source tax that is 10 times larger than *B*'s tax. But is that sufficient? Should *A* be taxed at a higher rate than *B*, that is, should the source tax employ progressive rates?

Arguably, the source tax should not employ progressive rates unless an assessment of market dynamics demonstrates that progressive rates are an appropriate pricing structure for U.S. market access.[67] We plead ignorance on this subject and leave its investigation to others. What is clear, however, is that if nonresident treaty beneficiaries were taxed under a flat rate regime that produced a significantly heavier tax on their U.S. source business income than under the progressive rates applicable to U.S. residents "in the same circumstances," the treaty nondiscrimination article would be violated.[68]

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[67] See generally Harris, note 17, at 456-57 (discussing whether a progressive tax is appropriately levied on domestic source income of nonresidents). Source taxation of the passive income of foreign investors usually involves a single rate of tax based on gross income. See, e.g., IRC §§ 871(a)(1), 881(a).

[68] See, e.g., Peter H. Blessing, Income Tax Treaties of the United States, ¶ 20.02[2][b][i], at 20-27 to 20-28 (1996) ("The permanent establishment provision [of a nondiscrimination clause] clearly does not prevent the imposition of different ('other') taxes on a permanent establishment than those imposed on a domestic business, as long as the taxes in the aggregate on the permanent establishment are not greater than those on the domestic business.") (footnote omitted); ALI, Federal Income Tax Project, International Aspects of United States Income Taxation II, Proposals on United States Income Tax Treaties 265-66 (1992) [hereinafter ALI International Project II] ("Income tax treaties usually provide that taxes imposed by a treaty country on the business profits of a permanent establishment of a resident of the other treaty country may not be other or more burdensome than those imposed on an enterprise of the taxing country engaged in similar activities.... The principle that a treaty country must not discriminate in taxing the income of a permanent establishment maintained by a resident of the other treaty country should be extended to apply to all types of income which are taxable by it under the treaty on a net income basis." (internal citations omitted); Treasury Dep't, Technical Explanation to the U.S. Model Income Tax Convention, Sept. 20, 1996, art. 24 [hereinafter Model Treaty Explanation]; Robert A. Green, The Troubled Rule of Nondiscrimination in Taxing Foreign Direct Investment, 26 Law & Pol'y Int'l Bus. 113, 122 (1994) [hereinafter Troubled Rule] ("the treaty nondiscrimination rule prohibits Home [the source country] from taxing the foreign firm on the income attributable to the permanent establishment less favorably than it would tax a domestic firm carrying on the same activities") (footnote omitted); see generally ALI International Project, note 17, at 9 (stating that "fundamental notions of fairness seem to require that the rules applicable to foreign persons be as similar as possible to

It hardly seems worth the resulting complexity to address this issue by legislating a structure that taxes nonresidents' U.S. source business incomes according to whichever is more favorable in the individual case: a flat rate or the regular progressive rate schedule. Stated differently, practical considerations suggest that in the case of business income earned in the United States by residents of the countries with which the United States has comprehensive bilateral income tax treaties, the progressive rate schedules applicable to U.S. residents should control. This will result in taxation of most U.S. source business income of nonresidents under those schedules. It does not seem worth the administrative bother to treat foreign persons differently when they reside in nontreaty countries. Thus, the graduated rates imposed by the United States on foreign persons' U.S. business income make practical sense even if they are open to the theoretical objection mentioned above.[69]

3. *Excessive Source Tax Rates*

There is, however, another set of objections to a net income source tax on foreign-owned businesses that focuses on the danger of setting the source tax rate too high. The first objection is that some foreign persons who invest or do business in the United States may confer benefits on the U.S. economy that are greater than the benefits they receive from the U.S. government and thus they should be relieved from U.S. source taxation.[70] One response to this assertion is that the proper comparison to government benefits received is not benefits provided to the U.S. economy but, instead, taxes paid to the U.S. government. After taking the full scope of government benefits received by nonresidents into account, the issue of excessive taxation diminishes. Moreover, this issue is irrelevant because source taxation is a charge for access to the U.S. market and the amount of the charge is a pricing decision driven by demand for such access and by the level of other countries' source taxes, not by benefits accounting. Thus, the nonresident will calculate whether the tax price of entering and participating in the U.S. market is worth the income derived therefrom. If the answer is no, the nonresident will go elsewhere and if the nonresi-

those applicable to domestic persons," and thus seemingly rejecting any effort to impose taxes on income earned in the United States by foreign businesses or permanent establishments that are materially higher than those imposed on fully domestic corporations even in the absence of treaty provisions requiring nondiscriminatory treatment of foreign-owed businesses).

69 Moreover, under the parity of taxation or comparative taxation principle, the U.S. source income of foreign businesses should bear the same tax rates as the U.S. source income of U.S. residents. See the discussion in Section III.C.

70 Green, Future, note 3, at 30.

dent decides to enter the U.S. market and pay the source tax, ipso facto the tax is a justifiable burden.

This point largely answers a second objection, which is that because nonresidents have limited participation in the U.S. political process, they cannot protect themselves and the United States may set source tax rates that are too high.[71] In a world of tax competition,[72] however, if the United States charges too high a price for access to the U.S. market, nonresidents will invest their capital elsewhere and Congress will be under pressure to lower the source tax rate.[73] Moreover, tax competition among source countries actually depresses tax rates[74] and has even led to the assertion that source tax rates are generally too low, not too high.[75]

G. *Summary*

The United States is justified in levying a source tax on the income of nonresidents as a charge for accessing and exploiting the U.S. physical, legal, and economic infrastructure.[76] Unilateral relinquishment of source taxation would not enhance, and might degrade, fairness. Accordingly, curtailment of source taxation by the United States should occur only in the context of carefully negotiated bilateral or multilateral tax treaties.

Although the current U.S. net income tax on a foreign-owned U.S. business may be imperfect in that it does not reach foreign-owned U.S. businesses that operate in the U.S. market at a loss, the objectionable characteristics of other source tax systems that would reach loss businesses make the current U.S. regime the better alternative. In theory, it also might be best for source tax regimes to employ flat rates, but practical considerations support the progressive rate approach employed by the United States in taxing foreign persons on

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[71] Avi-Yonah, Simplification, note 18, at 1312; Roin, note 17, at 581-83.

[72] See generally Reuven S. Avi-Yonah, Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State, 113 Harv. L. Rev. 1573 (2000) [hereinafter Globalization] (examining increased use of tax incentives to competitively attract international investment).

[73] See generally Harry Grubert & John Mutti, Do Taxes Influence Where U.S. Corporations Invest?, 53 Nat'l Tax J. 825 (2000) (showing that average effective tax rates significantly affect choice of location and amount of capital invested); Donald J. Rousslang, Deferral and Optimal Taxation of International Investment Income, 53 Nat'l Tax J. 589, 596 (2000).

[74] Avi-Yonah, Globalization, note 72, at 1576-83; Reuven S. Avi-Yonah, Tax Competition and E-Commerce, 23 Tax Notes Int'l 1395 (Sept. 17, 2001); Daniel J. Mitchell, OECD Tax Competition Proposal: Higher Taxes and Less Privacy, 89 Tax Notes 801, 806 (Nov. 6, 2000).

[75] See generally Harris, note 17, at 452.

[76] We discuss in the next Section how such a charge should be structured. See Section III.

their U.S. source business income. Finally, international tax competition will prevent source tax rates on foreign persons from being set too high.

III. What Criteria Should Guide the Structure of U.S. Taxation at Source?

In this Section, we consider the criteria that should dictate the structure of U.S. source taxation. Although source taxation is justified as the price for access to and exploitation of the U.S. market, the criteria for structuring the income taxation of nonresidents should be consistent with U.S. international income tax policy objectives generally. We review these policy objectives first and then apply them to source taxation issues in particular.

A. *U.S. International Tax Policy Objectives*

The broadest objective of the U.S. income tax system is to advance the welfare of U.S. citizens and resident individuals.[77] Thus, U.S. tax policy with respect to taxation of international income should have the same objectives as the taxation of domestic income. U.S. tax rules should be economically efficient, should be consistent with U.S. fairness objectives, and should raise revenue at a reasonable cost to the government and the taxpayer.[78] Application of these traditional income tax policy criteria in the context of a global tax system, however, must take account of the fact that U.S. rights and powers to tax international income[79] intersect with the tax systems of other sovereigns.[80]

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[77] Graetz, note 18, at 277. The federal income tax is the primary source of revenues to fund the national government's expenditures. The income tax, along with other taxes, is necessary to pay for the costs of a free and democratic society. Stephen Holmes & Cass R. Sunstein, The Cost of Rights: Why Liberty Depends on Taxes 31 (1999) ("Public policy decisions should not be made on the basis of some imaginary hostility between freedom and the tax collector, for if these two were genuinely at odds, all of our basic liberties would be candidates for abolition."). This Article does not address issues pertaining to the appropriate level or categories of governmental expenditures.

[78] See generally 1 Treasury I, note 65, at 13-19.

[79] The Sixteenth Amendment provides: "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration." U.S. Const. amend. XVI. The United States has long asserted jurisdiction to tax the worldwide income of U.S. citizens, Cook v. Tait, 265 U.S. 47, 56 (1924) (sustaining tax on income of nonresident U.S. citizen from property located in Mexico), and U.S. source income of nonresident aliens, DeGanay v. Lederer, 250 U.S. 376, 382-83 (1919) (sustaining tax on income of a nonresident from intangibles located in the United States).

[80] The United States recognizes, without reservation, that other countries have the right to tax their own residents on U.S. source income and U.S. residents on foreign source income. See 1 Restatement (Third), note 17, § 412, at 260-66.

The fact of competing claims to tax has several implications. Geographically limited jurisdiction to tax nonresidents constrains the ability of the source country to achieve fairness and efficiency objectives, and to assess and collect the tax. In addition, the source and residence country must divide revenue. Furthermore, decisions relating to source and residence taxation are intertwined because the same countries whose residents are being taxed by the United States at source will tax U.S. residents at source. We next consider the roles that efficiency and inter-nation division of income should play in the design of a source tax regime.

B. U.S. Source Taxation, the Efficiency Criterion, and Inter-Nation Division of the Income Tax Base

The efficiency criterion is satisfied when tax rules do not distort pretax economic decisions. An income tax inherently distorts choices between work or leisure (for some taxpayers, the tax on wages discourages work in relation to leisure, that is, the substitution effect; other taxpayers are stimulated to work more in order to achieve consumption and savings goals, that is, the income effect), and whether to save and invest or to consume (the tax on investment income discourages savings in relation to consumption).[81] In the cross-border context, however, economic efficiency usually refers to the effect of taxation on the decision where to locate a taxpayer's residence or investment. The efficiency objective is locational neutrality.

The neutrality criterion may apply to international income taxation in terms of either capital export neutrality or capital import neutrality.[82] Capital export neutrality is achieved when the aggregate income tax imposed by the source country and the residence country on income earned in the source country is equal to the tax on the same amount of income earned in the residence country.[83] Under conditions of pure capital export neutrality, the location of an investment will be determined according to the highest pretax return and without

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[81] A reduction of the tax rate on investment income, however, may not cause the savings rate to increase. E.g., McMahon & Abreu, note 66, at 62; Joel Slemrod, Do Taxes Matter? Lessons from the 1980's, 82 Am. Econ. Rev. 250, 251 (1992). The following discussion benefits from Robert Green's review of the efficiency criterion in relation to nondiscrimination. Green, Troubled Rule, note 68, at 123-37.

[82] Indirect taxes (VAT, GST, and the like) are not taken into account because they are expected to be borne by the consumer, not the producer. Whether this is true in practice depends on the price elasticity of the taxed product or service.

[83] Gustafson, Peroni & Pugh, note 17, at 16-17.

regard to differences in the effective rate of tax in the different locations.[84]

Capital import neutrality is achieved when the aggregate taxation of income earned in a country is the same regardless of the residence of the person earning the income.[85] This form of neutrality sometimes is referred to as competitive neutrality because all firms operating in the same market would be subject to the same tax.[86]

As a theoretical matter, economists generally favor capital export over capital import neutrality on the ground that capital export neutrality has the least distortive effect on the location of international investment and thus maximizes world economic welfare.[87] Significantly, as a matter of theory, these alternative neutrality standards apply without regard to how revenue is divided between the source and residence countries. For example, capital export neutrality would exist if all countries abolished their source tax regimes and taxed residents on their worldwide incomes.

To achieve theoretically correct capital export neutrality in a world where source taxation is rigorously practiced, a residence country must allow an unlimited and refundable credit for foreign taxes and must tax domestic and foreign income identically.[88] We are aware of no residence country income tax system that takes these steps to achieve pure capital export neutrality. An unlimited and refundable foreign credit is inappropriate because it would effectively reduce residence tax on domestic income. And the allure of providing incentives

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[84] Id. at 17; Daniel J. Frisch, The Economics of International Tax Policy: Some Old and New Approaches, 47 Tax Notes 581, 582-83 (Apr. 30, 1990).

[85] Gustafson, Peroni & Pugh, note 17, at 17.

[86] Id. at 17; Gary Hufbauer & David Foster, U.S. Taxation of the Undistributed Income of Controlled Foreign Corporations, in Essays in International Taxation: 1976, at 1, 15 (Treas. Dep't ed., 1976).

Under a third neutrality principle, referred to as national neutrality, the residence country taxes foreign income without regard to the level of foreign taxation. National neutrality is achieved when the pretax return on domestic income is equal to the return on foreign income net of foreign taxes. Frisch, note 84, at 583. Accordingly, a deduction, and nothing more, is allowed for foreign taxes. This approach is somewhat misnamed because it discriminates against foreign income in relation to domestic income and, in that respect, is not neutral. Gustafson, Peroni & Pugh, note 17, at 17.

[87] See, e.g., Treasury Dep't, The Deferral of Income Earned Through U.S. Controlled Foreign Corporations: A Policy Study 25-42 (2000), at http://www.treas.gov/offices/tax-policy/library/subpartf.pdf. Under the capital import (or competitive) neutrality principle, capital may be allocated on the basis of after-tax returns that may distort optimal worldwide capital allocation. Gustafson, Peroni & Pugh, note 17, at 17; Frisch, note 84, at 582.

[88] Gustafson, Peroni & Pugh, note 17, at 17. The structure of a country's source taxation arguably signals what it believes is internationally acceptable by other countries. One might expect that a credit-method residence country would allow a credit for any foreign source tax that is comparable to what it imposes itself at source. This logic goes too far, however. No country grants an unlimited foreign tax credit.

for domestic investment vis-á-vis foreign investment has proven irresistible.[89]

This analysis indicates that taxation of nonresidents at source is inconsistent with capital export neutrality unless the residence country provides complete relief, but no more than complete relief, from the source tax. To be specific, if a residence country taxes worldwide income and limits its foreign tax credit to the domestic tax on foreign income, capital export neutrality will be violated if the source country sets a source tax rate that exceeds the residence country rate because income earned in the high-tax source country will be taxed more heavily than income earned in the residence country.[90] Furthermore, if the residence country does not tax foreign income, under the so-called territorial principle, and the source tax rate is either higher or lower than the residence country rate of tax on domestic income, the source tax will distort the decision whether to invest in the residence country or the source country.[91] In other words, whether or not a source tax violates capital export neutrality depends on decisions by residence countries regarding their tax rates and their approaches to mitigating international double taxation. Since source countries cannot possibly set source tax rates that respond in a nondistortive way to the wide variety of residence country decisions on these points, a country that claims to pursue capital export neutrality might be expected to forgo source taxation altogether. Not surprisingly, this prescription is not the norm.[92] We know of no country with an income tax that forgoes source taxation of nonresidents.

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89 For example, accelerated depreciation is generally unavailable with respect to property used outside the United States. IRC § 168(g).

90 Gustafson, Peroni & Pugh, note 17, at 18-19; Joel Slemrod & Reuven Avi-Yonah, (How) Should Trade Agreements Deal With Income Tax Issues?, 55 Tax L. Rev. 533, 547-48 (2002) (source taxation at rates exceeding residence taxation in the foreign person's home country prevents achievement of capital export neutrality). For a discussion of analogous neutrality issues in the context of corporate integration proposals, see Reuven S. Avi-Yonah, Back to the 1930s? The Shaky Case for Exempting Dividends, 97 Tax Notes 1599 (Dec. 23, 2002).

91 Gustafson, Peroni & Pugh, note 17, at 18. Where a residence country does not tax its residents' foreign income, the only tax borne by that income is source tax. Because source tax rates differ among countries, they also will distort the decision by exemption country residents regarding the allocation of their investments among source countries.

92 H. David Rosenbloom, What's Trade Got To Do With It?, 49 Tax L. Rev. 593, 596 (1994) (Countries have not reduced their source taxation to mitigate double taxation; "[s]ome traditionally have looked to source basis taxation for a major contribution to revenues, while others have come to appreciate the potential for unfairness, and thus a threat to the entire tax system, if sourced based taxation is ignored."). The United States is not so slavish in pursuit of capital export neutrality that it fails to tax foreign persons at source. Cf. Graetz, note 18, at 269-97 (arguing against the strict pursuit of capital export neutrality by the United States).

Capital import neutrality exists when all firms operating in the same market are subject to the same rate of tax. Thus, the imposition of a source tax is consistent with capital import or competitive neutrality only when the source tax on nonresidents is equal to the tax on source country residents and there is no residual tax in the foreign residence country. The frequent imposition of residual taxes by residence countries means that source taxes often violate capital import neutrality and that source countries cannot correct the violations without abandoning their jurisdiction to impose source taxation on residents of residual taxation countries.

If capital export neutrality advances global economic efficiency and capital import neutrality does not, we may conclude that the efficiency criterion, as a general matter, would disfavor source taxation unless it applied only in circumstances where the residence country allows an unlimited, refundable credit for the source tax. This condition does not exist, and is not expected to exist, anywhere in the world.[93] Thus, although source taxation is strongly justified as an appropriate charge for access to the U.S. market, the efficiency criterion is of little help in achieving a well-designed source tax regime and guidance must be sought elsewhere.[94]

Much of the needed guidance comes from the intuitive proposition that those in the same market should be taxed on a roughly equal basis. This serves the important commonsense function of legitimizing the source country's taxation of its own residents. Particularly in an income tax system that relies on self-assessment, it is critical for residents to perceive that nonresidents do not have an inappropriate advantage. Moreover, if the level of source taxation of nonresidents is comparable to that of residents, it also protects against residents attempting to earn their income as nonresidents in disguise.[95]

Although it is difficult to achieve source taxation of nonresidents' income that is equal to the tax on residents' income, we propose two equality-related criteria for structuring taxation of nonresidents at source: (1) The level of source taxation should be comparable to the taxation imposed on residents earning the same income (the "parity principle" or "comparative taxation principle"). (2) The tax should

[93] Gustafson, Peroni & Pugh., note 17, at 18-19.

[94] See Section II.C.

[95] Another rationale for taxing income at source is to achieve a reasonable inter-nation division of the income tax base. Irrespective of the theoretical merits of residence taxation, a global system that consists solely of residence taxation favors the wealthy capital exporting countries over capital importing countries. Thus, it is simply unrealistic to expect countries that are the host to any substantial amount of inbound investment (including the United States) to abandon source taxation. A nondiscriminatory source tax using the same tax rates as on income of residents arguably results in as reasonable a division of income as any other rule.

not discriminate against the foreign investor (the "nondiscrimination principle"). We discuss each of these criteria in turn.

C. *Preserving the Legitimacy of Residence Taxation: Source Taxation and the Need for Perceived Parity*

Source and residence taxation are inextricably linked by the practical fact that a country's taxation of it own residents will lose legitimacy and efficacy if residents perceive that nonresidents with equal amounts of residence-country income pay less tax.[96] This concern leads to the proposition that tax policy should seek to assure that the U.S. income tax treats foreign-owned businesses no more favorably than comparably situated U.S. businesses.

Does the concern for perceived parity require that identical rules apply to foreign and domestic taxpayers? Clearly, this is not required and, indeed, cannot be required if the objective is substantially equivalent income taxation. For example, the allowance of a deduction for interest expense under the apportionment approach employed in § 1.882-5 of the regulations clearly is different than the rule that applies to a domestic corporation under § 163. In avoiding tracing, however, § 1.882-5 limits the nonresident's ability to reduce U.S. tax artificially by taking into account the global liabilities of the taxpayer in determining interest deductible in a U.S. branch. Thus, it does not offend the need for perceived parity.

The objective of preserving the legitimacy of taxation of residents is distinct from the "political realities" of source taxation discussed

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[96] T.S. Adams suggested the following in 1921: "If the members of a partnership engaged in business in Detroit all live in Canada, and the partnership competes with business concerns, the owners of which live in Detroit, our people will not consent to exempt the Canadians while the owners who live in the United States are taxed on their entire income . . . ." Graetz & O'Hear, note 20, at 1037 n.61 (quoting Thomas S. Adams, Fundamental Principles of Federal Income Taxation, 35 Q.J. Econ. 527, 542 (1921)). This rationale is similar in broad concept to that of the tax on unrelated business taxable income set forth in § 511.

In addition, if it is possible for a resident to achieve higher after-tax income by earning it as a nonresident, then resident taxpayers will takes steps to do so. The recent wave of U.S. publicly traded corporations reincorporating offshore in low-tax countries illustrates this problem. Treasury has concluded that one of the principal tax reduction objectives of reincorporation was to reduce U.S. tax on U.S. source income. Treasury Dep't, Corporate Inversion Transactions: Tax Policy Implications 20-21 (May 2002), available at http://www.ustreas.gov/press/releases/docs/inversion.pdf; Hearing on Corporate Inversions Before House Comm. on Ways and Means, 107th Cong. (2002) (statement of Pamela F. Olson, Acting Ass't Sec., Tax Pol'y, Treas. Dep't), available at http://waysandmeans.house.gov/fullcomm/107cong/6-6-02/6-6olso.htm; see also Desai & Hines, note 57. Legislation has been proposed to prevent such reincorporations. See, e.g., H.R. 3857, 107th Cong. (2002) (sponsored by Rep. McInnis); S. 2050, 107th Cong. (2002) (sponsored by Sen. Wellstone); H.R. 5095, 107th Cong. (2002) (sponsored by Rep. Thomas).

above.[97] It rests on the fundamental requirement that to induce compliance, residents must see an income tax as treating similarly situated nonresident taxpayers in a comparable manner. This is distinguishable from taxing the nonresident merely because she cannot vote.

But even if a source taxation regime is adopted for the purpose of achieving perceived parity, is there anything to prevent that regime from metamorphosing into excessive taxation of unfranchised nonresidents?

As noted above, the principal constraints on arbitrary and excessive source taxation are practical: the constraining force of international tax competition, the threat of reciprocal treatment for a country's own residents, and a refusal by other countries to afford double taxation relief for arbitrary source taxation. These same reasons support a restriction on source taxation by a nondiscrimination principle, discussed in the next Section.

D. Source Taxation and the Nondiscrimination Principle

There is no meaningful domestic law limitation on the level of source taxation in the absence of a treaty containing the usual nondiscrimination clause. Nevertheless, the United States generally does not discriminate in its source taxation of foreign persons' U.S. business income. Foreign persons engaged in U.S. business activities determine their income under the same tax accounting principles and are subject to the same tax rates as U.S. residents. In our view, it is appropriate to employ this nondiscrimination principle in structuring taxation at source. As an exporter of goods, services, and capital, the United States would seek nondiscriminatory treatment of its own residents and must be prepared to reciprocate. Moreover, tax discrimination against nonresidents can be a barrier that interferes with the free flow of international commerce and investment.

In addition, the United States has comprehensive bilateral income tax treaties with more than 64 countries, including all major U.S. trading partners. Each of these has a nondiscrimination article.[98] The nondiscrimination article requires that the United States not subject

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[97] See text accompanying notes 19-23.

[98] See, e.g., Income Tax Convention, Aug. 16, 1984, U.S.-Can., art. XXV, 1 Tax Treaties (CCH) ¶ 1901.25; Convention for the Avoidance of Double Taxation, July 9, 1972, U.S.-Japan, art. 7, 3 Tax Treaties (CCH) ¶ 5203.15; see also U.S. Model Treaty, note 32, art. 24, 1 Tax Treaties (CCH) ¶ 214.24. But see H. David Rosenbloom, International Tax Arbitrage and the "International Tax System," The David R. Tillinghast Lecture, NYU School of Law (Oct. 1, 1998), 53 Tax L. Rev. 137, 152 n.51 (2000) ("All countries routinely 'discriminate' against foreign persons in tax matters, but the United States has been especially sensitive to charges of discrimination. When plainly discriminating against foreign persons, it has allowed them to elect to be taxed as domestic persons, justified the discrimination by

residents of our treaty partners to more burdensome taxation than that imposed on U.S. residents "in the same circumstances,"[99] all of whom pay tax on their net income pursuant to graduated rate tables.[100] The U.S. gross-basis withholding tax seemingly violates this edict.[101] Nevertheless, in the absence of withholding at the source, a nonresident who receives U.S. source passive income can avoid the U.S. tax liability more readily than can a U.S. resident. For this reason, there is virtually unanimous agreement that such nonresidents are not in "the same circumstances" as U.S. residents and, therefore, imposition of the U.S. flat-rate, gross-basis withholding tax on a nonresident's U.S. source passive income does not violate the nondiscrimination article.[102]

The OECD and U.S. Model nondiscrimination articles also proscribe discrimination against foreign-owned businesses operating in the source country.[103] The consensus view holds that because foreign-

(dubious) comparison to tax-exempt domestic persons, and talked itself into the conclusion that discrimination did not exist.") (citations omitted).

[99] See authorities cited in note 68.

[100] IRC §§ 1, 11.

[101] Compare § 1441 (imposing a 30% flat-rate, gross-basis withholding tax on nonresident aliens), with § 1 (imposing a graduated income tax on U.S. residents at rates ranging from 10% to 38.6% in 2002) and with § 11(b)(1) (imposing tax on U.S. resident corporations at rates ranging from 15% to 35%).

[102] See, e.g., ALI International Project II, note 68, at 260-63; Model Treaty Explanation, note 68, art. 24, 1 Tax Treaties (CCH) ¶ 214A ("the common underlying premise is that if the difference in treatment is directly related to a tax-relevant difference in the situations of the domestic and foreign persons being compared, that difference is not to be treated as discriminatory" under the nondiscrimination article); Blessing, note 68, at 20-15 to 20-16 ("For certain purposes, such as subjecting foreign persons who derive dividends, interest, royalties, or certain other types of income not connected with a permanent establishment to a gross-basis tax coupled with a withholding requirement, it is universally acknowledged that the different tax regime is justified by the dissimilar circumstances of the recipient."); Green, Troubled Rule, note 68, at 122-23 ("The nondiscrimination rule, being inapplicable, requires neither that the nonresident be taxed on a net basis nor that the gross-basis withholding taxes be comparable to the net-basis tax."); see also Gustafson, Peroni & Pugh, note 17, at 196 (The flat-rate, gross-basis withholding tax on passive income "at least theoretically, is intended to approximate the tax burden on net income that would be borne by the foreign person in question if it were feasible to take account of allowable deductions."). Some commentators, however, have suggested that gross-basis withholding taxes could violate the treaty nondiscrimination rule in some cases. Goldberg & Glicklich, note 32, at 81 ("In order to be nondiscriminatory, the premise must be that the income being withheld upon has a high content of net income because any related expenses are not significant. Where this is not true, then, a withholding on gross income could well be discriminatory.") (footnote omitted); O'Brien, note 32, at 550-51, 557-58 (critiquing U.S. reasoning that foreign persons are not in the same situation as U.S. residents solely because U.S. residents are necessarily taxed on worldwide income while foreign persons are not).

[103] U.S. Model Treaty, note 32, art. 24(2), (4), 1 Tax Treaties (CCH) ¶ 214.24; OECD, Model Double Taxation Convention on Income and on Capital, art. 24 (Apr. 29, 2000), available at http://www.oecd.org/pdf/M00005000/M00005346.pdf [hereinafter OECD Model Treaty].

owned businesses operating in the United States generally do not present as serious an enforcement problem as do nonresident recipients of U.S. source passive income, such businesses are "in the same circumstances" as U.S. businesses. Therefore, deductions are to be allowed to the foreign-owned enterprise to the same extent as to the U.S.-owned enterprise[104] and the foreign-owned business is taxed under the graduated rate tables that apply to U.S. residents.[105]

This reality-based distinction between restricting discrimination against foreign-owned U.S. business activity and permitting seeming discrimination in respect of nonresidents who receive U.S. source dividends, interest, and royalties can have the perverse effect of creating an analytical misperception that prevents reality-based examination of other nondiscrimination issues and that leads to explanations of U.S. tax policy that lack credibility.[106]

The earnings stripping rules of § 163(j) are a case in point.[107] They were structured in part to prevent treaty residents from taking undue advantage of U.S. treaty reductions in withholding tax on U.S. interest paid to a related foreign person. A domestic or foreign corporation that has a debt-to-equity ratio in excess of 1.5 to 1 may not currently deduct interest paid to a related foreign person to the extent the interest is not subject to a withholding tax (or is paid to a tax-exempt person) and the payor's interest deduction exceeds 50% of taxable income (with certain adjustments).[108] If applicable, the rule defers the deduction to a year in which the taxable income ceiling is not exceeded.[109] The consequence of deferral, however, is that because of the time value of money the suspended deductions effectively diminish in amount as time passes.

Although the legislative history justifies § 163(j) as consistent with the treaty nondiscrimination article on the grounds that comparable

[104] U.S. Model Treaty, note 32, art. 24(2), 1 Tax Treaties (CCH) ¶ 214.24; OECD Model Treaty, note 103, art. 24(3).

[105] See Gustafson, Peroni & Pugh, note 17, at 118.

[106] See, e.g., Notice 89-90, 1989-2 C.B. 394 (§ 884(f)(1)(B) branch tax on excess interest deducted by branch is no less favorable taxation than of domestic enterprise).

[107] See generally Gustafson, Peroni & Pugh, note 17, at 241-43.

[108] IRC § 163(j).

[109] § 163(j)(1). As a practical matter, the rule applies to treaty residents, because interest paid to a related foreign person would not qualify as portfolio interest and would be subject to withholding tax. This would prevent the interest from being disqualified interest. See IRC §§ 163(j)(3)(A), (5)(B). House Ways and Means Committee Chairman Bill Thomas recently introduced the American Competitiveness and Corporate Accountability Act of 2002, H.R. 5095, 107th Cong. § 201, which would eliminate the 1.5 to 1 debt-to-equity safe harbor and reduce the protected level of net interest expense from 50% to 35% of "adjusted taxable income" (that is, taxable income with certain noncash deductions added back). The bill also would eliminate the carryforward of excess limitation allowed under current law, § 163(j)(2)(B)(ii), and would limit the carryforward of deferred interest deductions to five years.

debt-equity restrictions apply in the domestic market,[110] this position is disingenuous and compromises the credibility of the United States as a treaty partner. In fact, § 163(j) imposes a tighter restriction than would apply in a typical domestic context. For example, related LBO fund debt-equity ratios of 3 to 1 generally are regarded as acceptable.[111] There is, however, a different line of analysis demonstrating that § 163(j) is, indeed, compliant with the nondiscrimination article. An analytical approach that considers the U.S. corporation and its foreign owners jointly instead of separately shows that a foreign-owned U.S. corporation is, in substance, differently positioned than a U.S.-owned domestic corporation. This is because a U.S.-owned domestic corporation cannot "earnings strip" to a foreign affiliate without running afoul of the Subpart F provisions but a foreign-owned U.S. corporation can. The § 163(j) earnings stripping rule constrains the excessive use of debt by a foreign-owned corporate group that otherwise could achieve a lower global tax rate on U.S. income initially earned by a domestic corporation than could be achieved if the same domestic corporation were owned by a U.S. group. A treaty nondiscrimination rule that does not accommodate the ability of a source country to address such matters not only will not be observed, but will lose its utility in the circumstances in which it should be applied.

The preceding analysis notwithstanding, the nondiscrimination principle should be employed in both the treaty and nontreaty contexts to restrict source taxation that systematically subjects a foreign investor to greater taxation than a domestic taxpayer who is truly similarly situated. But even under the more complete approach used above to assess whether taxpayers are similarly or dissimilarly situated in connection with § 163(j), the nondiscrimination principle should continue to play an important role in structuring U.S. source-based taxation because of the interests of the United States in free trade and in nondiscriminatory taxation of its residents by other countries.

E. *Jurisdiction to Tax and Enforcement of Taxation at Source*

Taxation regimes should be efficacious and not merely symbolic. Therefore, a source tax on nonresidents must be capable of being administered and enforced. For this reason, the limits on a country's jurisdiction to tax play a central role in the design of the system of source taxation used by most countries.

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110 H.R. Conf. Rep. No. 101-386, at 569-70, reprinted in 1989-3 C.B. (vol. 5) 569-70 (§ 163(j) consistent with arm's length standard).

111 See Jack S. Levin, Structuring Venture Capital, Private Equity and Entreprenurial Transactions ¶ 602.8.8.1 (2002).

1. *Jurisdiction to Prescribe Tax Laws*

A country may exercise the power to tax within accepted international norms.[112] A conventional statement of the U.S. view is that there is no limit on the jurisdiction of the United States to prescribe tax rules.[113] The ALI position is that a country may tax: (1) the worldwide income of a national or a resident natural or juridical person, (2) the income of a person present or doing business in the country that is derived from or associated with that presence or business, or (3) income derived from property located in the country.[114] This statement of standards parallels those implied in the OECD Model Treaty.[115]

The statement of generally accepted bases to tax (jurisdiction to prescribe), however, is incomplete without also taking into account the limits on jurisdiction to adjudicate and enforce.[116] A country cannot enforce an income tax in the absence of information and the ability to compel compliance.[117] The United States taxes the worldwide income of its residents and taxes certain income of foreign persons at source. In order to enforce an income tax imposed on nonresidents and on income earned outside the United States, it is necessary to

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[112] International law governing the jurisdiction to prescribe underlies the accepted jurisdictional bases to tax income. Accepted international bases for the jurisdiction to prescribe are nationality and territoriality, subject to reasonableness criteria where the person or activity has connections with another state and the exercise of the jurisdiction would be unreasonable. 1 Restatement (Third), note 17, at §§ 402, 403. This Article does not consider the complex issue of the relationship of U.S. domestic law and international law. See id., introductory note to ch. 2, at 40–69 (noting that "the relation between international law and United States law raises complex conceptual issues that have important legal consequences" and discussing generally the status of international law and agreements in U.S. law); Ramon J. Jeffery, The Impact of State Sovereignty on Global Trade and International Taxation 36-42 (1999) (discussing relationship between international law and national law generally).

[113] Stanley S. Surrey, Current Issues in the Taxation of Corporate Foreign Investment, 56 Colum. L. Rev. 815, 817 (1956) ("The boundaries of the tax jurisdiction of the federal government are here not limited by any legal lines. Instead, the assertion of jurisdiction is essentially a matter of national policy and national attitudes as to the proper obligations of American citizens and corporations in meeting the costs of government." (footnote omitted)); see also Arnold, note 32, at 7; Sol Picciotto, Int'l Bus. Tax'n 307 (1992). But see Jeffery, note 112, at 43 (discussing view that there are international limits on fiscal jurisdiction).

[114] 1 Restatement (Third), note 17, at § 412(1).

[115] OECD Model Treaty, note 103, arts. 6, 7, and 21; see Nancy H. Kaufman, Fairness and the Taxation of International Income, 29 Law & Pol'y Int'l Bus. 145, 148 (1998) (suggesting that the accepted jurisdictional bases to impose income tax have acquired the status of customary international law). For purposes of this discussion, we need not consider whether these taxation standards have achieved the status of customary international law.

[116] Arnold, note 32, at 7 ("A country's legal authority to levy tax is effectively limited only by practical considerations of enforcement and collection.").

[117] Deterrence plays a critical role in tax compliance. It is a function of the perceived ability and will of the taxing state to compel compliance.

have sufficient information to determine whether the correct amount of income is subject to tax and to collect a tax judgment.[118] The scope of jurisdiction to enforce delineates a country's ability to compel production of information by imposing civil and criminal sanctions and to compel collection of tax obligations.

2. *Jurisdiction to Enforce Tax Laws*

If a country exercises its jurisdiction to prescribe a tax rule, it may employ judicial or nonjudicial measures to compel compliance or punish noncompliance.[119] Under U.S. law, court proceedings often are necessary to enforce an administrative summons; accordingly, these proceedings must satisfy criteria for jurisdiction to adjudicate.[120]

U.S. courts have exercised their jurisdiction to compel production of information of a U.S. resident held abroad, including information held by a subsidiary of a U.S. parent corporation[121] and information held by a foreign parent corporation of a domestic subsidiary (where the foreign parent corporation exposed itself to U.S. jurisdiction).[122] Section 6038A also provides a powerful inducement for foreign affiliates of a foreign-controlled domestic corporation to consent to U.S. jurisdiction for the limited purpose of the enforcement of an administrative summons. Absent an income tax convention or the application of § 6038A, however, it is difficult to obtain information located

118 Even a country that only taxes income or transactions within its territory often needs to obtain information from a foreign location or be able to collect tax from a person resident in another country. Source taxation of income under an income tax and imported services taxed under a VAT on a reverse charge basis each involve taxation of a nonresident person. Even territorial countries, such as France and the Netherlands, have requested that the United States assist in obtaining information relating to their taxation of their residents. See Lidas, Inc. v. United States, 238 F.3d 1076 (9th Cir. 2001) (upholding U.S. summons to obtain bank records at request of France under U.S.–French treaty); United States v. Bache Halsey Stuart, Inc., 563 F. Supp. 898 (S.D.N.Y. 1982) (upholding U.S. summons to obtain financial records relating to a Swiss bank account at request of Netherlands under U.S.–Netherlands treaty).

119 1 Restatement (Third), note 17, at § 431(1). The Restatement provides that a country may employ enforcement measures against a person outside its territory if the person is given reasonable notice and the opportunity to be heard, and, in the case of judicial enforcement, the country has jurisdiction to adjudicate. Id. § 431(3).

120 See id. § 431(3)(c).

121 IRC § 7602; United States v. Vetco. Inc., 691 F.2d 1281 (9th Cir. 1981) (parent corporation ordered to cause foreign subsidiary to produce records under balancing analysis that found U.S. interests outweighed Swiss confidentiality interests); see also Doe v. United States, 487 U.S. 201 (1988) (petitioner, who was target of grand jury investigation into unreported income, could not assert self-incrimination privilege as a basis for refusing government order to sign forms consenting to disclosure of bank records in the Bahamas and Cayman Islands).

122 United States v. Toyota Motor Corp., 569 F. Supp. 1158, 1162-64 (C.D. Cal. 1983) (enforcing summons issued to foreign corporation with a U.S. subsidiary after applying balancing test relevant to foreign-located documents).

abroad where a U.S. court does not have jurisdiction over the person controlling the information.

Although the Service has authority to issue a summons outside the United States,[123] it will not be enforced unless the jurisdictional requirements, including service of process, are met. Under international law, a country may determine the conditions for service of process in its territory in aid of litigation in another country.[124] Extraterritorial service of an investigative summons by a country is an intrusion of its sovereign power into the other country and U.S. courts have declined to enforce such a summons unless served in a manner explicitly authorized by a U.S. statute or with evidence of the consent of the other country.[125]

With respect to nonresident taxpayers, the Service clearly may compel production of information held in the United States. It also may compel production of a nonresident's bank account information at a foreign branch of a U.S. bank if appropriate need is demonstrated.[126] These cases are important, particularly in a self-assessment system, for their deterrence value.[127] Notwithstanding these successes by the Service and Justice Department, it is very difficult to obtain foreign-located information that is not in the control of a person subject to in personam jurisdiction in the United States.

The Service has concluded that it may utilize the Hague Service Convention[128] to serve a summons on a U.S. citizen resident outside the United States.[129] If the requested country accepts this service, the U.S. District Court for the District of Columbia would have jurisdiction to enforce under § 7604, because § 7701(a)(39) deems U.S. citizens and residents residing abroad to be resident in the District of

[123] The Service can issue a summons to any "person the Secretary may deem proper" for ascertaining the correctness of any return and for determining the tax liability of any person, or to examine any records and to take testimony of any person. IRC § 7602. The Code does not restrict this power to the geographic boundaries of the United States.

[124] 1 Restatement (Third), note 17, at § 471(1).

[125] See FTC v. Compagnie de Saint-Gobain-Pont-A-Mousson, 636 F.2d 1300 (D.C. Cir. 1980) (refusing to uphold FTC service of subpoena on French company headquartered in Paris by registered mail).

[126] United States v. Chase Manhattan Bank, N.A., 584 F. Supp. 1080 (S.D.N.Y. 1984).

[127] Every international practitioner of any experience has been asked the question "Can the IRS find out?" In many cases the answer is "yes." In other cases, there are pragmatic reasons for compliance. Few foreign business executives would write off the future ability to sell into or operate in the U.S. market. In other cases, personal reasons dictate a desire to be able to return to the United States. Marc Rich seemingly was able to conduct his trading business successfully without coming to the United States; however, personal reasons apparently were the motive for seeking a Presidential pardon. See Alison Leigh Cowan, Plotting a Pardon, N.Y. Times, Apr. 11, 2001, at A1.

[128] Hague Convention on the Service Abroad of Judicial and Extrajudicial Documents in Civil or Commercial Matters, Nov. 15, 1965, 20 U.S.T. 1361, 658 U.N.T.S. 163 (1977).

[129] IRS Chief Counsel Advice 200143032 (Sept. 21, 2001).

Columbia for purposes of enforcing an administrative summons. In the absence of a treaty, there is no comparable basis to achieve extraterritorial jurisdiction over a non-U.S. person to enforce an IRS administrative summons. Even if jurisdiction is achieved, a taxpayer may decline to cooperate if there is no effective judicial sanction available. Although the Service may make a jeopardy assessment, if the taxpayer's assets are located abroad, collection of the assessment must surmount the "revenue rule."

In addition to jurisdictional limitations on the ability to obtain information to make an assessment, the so-called "revenue rule" holds that one country will not provide assistance to another country in collection of the other country's final revenue claim. This hoary and archaic common law doctrine dates back to 1775.[130] In 2001, the Second Circuit affirmed that the revenue rule is alive and well in the United States.[131] Although the court implicitly acknowledged that Canada had standing to pursue a RICO claim in U.S. federal courts,[132] it declined to permit a RICO action against R.J. Reynolds for lost sales tax revenues attributable to cigarette smuggling for which an R.J. Reynolds affiliate had been indicted.[133] The court held that the action was both a direct and indirect enforcement of a Canadian revenue claim.[134]

The Second Circuit noted pointedly that the plaintiff was Canada itself and concluded that the revenue rule barred an action that would indirectly enforce a Canadian revenue law.[135] The court supported application of the revenue rule to bar the claim on the grounds that: (1) the revenue rule is grounded in respect for sovereignty and avoids an inquiry whether the other country's penal and revenue laws are

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130 "No country ever takes notice of the revenue laws of another." Holman v. Johnson, 98 Eng. Rep. 1120, 1121 (1775).

131 Att'y Gen. of Canada v. R.J. Reynolds Tobacco Holdings, Inc., 268 F.3d 103 (2d Cir. 2001), petition for cert. filed, 70 U.S.L.W. 3580 (U.S. Mar. 6, 2002) (No. 01-1317). The revenue rule is a discretionary, not a jurisdictional, limitation, European Community v. RJR Nabisco, Inc., 150 F. Supp. 2d 456, 476-77 (E.D.N.Y. 2001), but in the light of the breadth of its application, it has a similar effect.

132 Id. at 107-09.

133 Id. at 134-35.

134 *R.J. Reynolds*, 268 F.3d at 130-32. The revenue rule also was applied to bar enforcement in a U.S. court of a Canadian province's final judgment against U.S. individuals for logging taxes. Her Majesty the Queen in Right of the Province of British Columbia v. Gilbertson, 597 F.2d 1161 (9th Cir. 1979). The Second Circuit in *R.J. Reynolds* noted that Canada, as well as other common law countries, observes the revenue rule. *R.J. Reynolds*, 268 F.3d at 110-11, citing United States v. Harden, [1963] S.C.R. 366 (Can.) (rejecting enforcement of a stipulated settlement of a tax case). But see *European Community*, 150 F. Supp. 2d at 471-86 (extensively discussing the revenue rule and refusing to invoke it as a basis for declining jurisdiction, although ultimately rejecting on other grounds European Community RICO damages claim based in part on lost taxes).

135 *R.J. Reynolds*, 268 F.3d at 106.

consistent with the enforcing state's notion of what is proper, and (2) if the court acted, it might be encroaching on the political branches' authority, namely, the executive's foreign relations power and the legislature's policies on extraterritorial collection assistance as expressed in treaty reservations.[136]

Judge Calabresi, in dissent, pointed out that since the law in question (RICO) was a U.S. law, Congress passed the law and therefore its enforcement did not present separation of powers concerns.[137] Moreover, the U.S. courts were in fact capable, when properly briefed, of applying another country's revenue laws and indeed the Second Circuit had done so in a recent case.[138] Irrespective of whether one agrees with the decision in this particular case, it is clear that the revenue rule remains firmly entrenched in international law.[139]

The only way to overcome the revenue rule is to reciprocally agree by treaty to assist in collection.[140] In the absence of assistance from another country under a treaty (or a future domestic law provision), the United States will not be able to collect a tax judgment against a foreign person not physically present in the United States unless the foreign person holds assets in the United States and the United States acquires quasi in rem jurisdiction to collect against those assets.

In summary, the United States' ability to enforce its tax laws against foreign persons in the absence of a treaty relies on the presence in the United States of the foreign person (or their consent to U.S. jurisdiction) and either information sufficient to make a tax assessment against the foreign person or a U.S. person with such information. And if a judgment is rendered, absent a treaty that overcomes the revenue rule, collection requires assets in the United States. We discuss below the innovative use of qualified intermediaries to surmount these limitations on jurisdiction to enforce the withholding tax.[141]

3. *Enforcing Exceptions to U.S. Withholding Tax on U.S. Source Gross Income Payments to Foreign Persons*

The scope of jurisdiction to enforce plays a pivotal role in the extent to which the United States asserts jurisdiction to tax non-U.S. persons on U.S. source fixed and determinable annual and periodical income ("FDAP") that is not effectively connected with a U.S. trade or busi-

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[136] Id. at 111-12, 119; see discussion of treaty collection articles in text accompanying notes 192-203.

[137] *R.J. Reynolds*, 268 F.3d at 136-37 (Calabresi, J., dissenting).

[138] Id. at 137-38 (Calabresi, J., dissenting) (citing United States v. Pierce, 224 F.3d 158, 165 (2d Cir. 2000)).

[139] See, e.g., United States v. Harden, [1963] S.C.R. 366, 369-70 (Can.).

[140] *R.J. Reynolds*, 268 F.3d at 118-23; see discussion in text accompanying notes 192–203.

[141] See text accompanying notes 160-76.

ness.[142] The United States imposes a tax on the gross amount of such income and collects the tax through withholding at source.[143] This internationally accepted system of having the payor withhold a gross basis tax at source addresses directly the inability of the source country to collect the tax imposed on income of a nonresident. The joint and several liability of the withholding agent for the tax to be withheld enables the United States to enforce source taxation over payments to those outside its jurisdiction.[144]

In addition to providing a mechanism for collecting tax on payments of income to nonresidents, withholding tax at source also partially protects the residence tax base from erosion by residents who would avoid domestic information reporting and back-up withholding rules by masquerading as a foreign person and investing through a tax haven corporation in securities issued by U.S. residents.[145] A withholding tax collected on income paid to the tax haven corporation recovers some of the lost tax. The source tax, however, does not reach the tax evader who invests in securities of foreign issuers ("foreign securities"), including foreign securities denominated in dollars.

Withholding tax at source has the appearance of being a secure and reliable mechanism to assure payment of source tax on fixed and determinable income. In practice, however, the withholding tax regime has proven to be a blunt instrument. A withholding tax regime is easiest to administer and enforce if tax is withheld from the gross amount of every payment at the same rate. Yet, this has never been the case.[146] It is particularly difficult to administer exceptions to withholding and at the same time protect against the risks of both tax evasion by U.S. persons and granting treaty relief to foreign persons not eligible for treaty benefits. Because the U.S. withholding agent often is remote from the beneficial owner of the income, it cannot obtain information to evaluate self-certified claims of eligibility for relief from the tax.

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142 IRC §§ 871(a), 881(a).

143 IRC §§ 1441, 1442.

144 IRC § 1461.

145 Domestically, the United States relies on comprehensive information reporting for payments of interest, dividends, and gross proceeds from the sale of securities to individuals and other nonexempt recipients.

146 Under the Revenue Act of 1913, withholding agents were expected to withhold amounts sufficient to pay the net income tax on the item of income. Revenue Act of 1913, Pub. L. No. 63-16, § II(A)(2), 38 Stat. 114, 166. Fortunately for withholding agents, the government did not enforce this. A concerted attempt to enforce the law in 1934 resulted in retreat by the government and enactment in 1936 of gross withholding on payments of FDAP to nonresidents and foreign corporations. Pub. L. No. 74-740, §§ 143(b), 144, 211, 231, 49 Stat. 1648, 1701-02, 1714-15, 1717 (1936). Congress raised the rate to its current 30% level in 1942. Pub. L. No. 77-753, §§ 106-08, 56 Stat. 798, 807-08 (1942).

The withholding rules exclude several important items realized by nonresidents from U.S. investments. The most significant statutory exclusion from gross taxation at source is for gains from the sale of personal property, other than U.S. real property interests, that are not effectively connected with a U.S. business. This exclusion includes most gain from the sale of stocks and securities in a U.S. corporation (unless the corporation is a U.S. real property holding corporation) and intangible property (unless the consideration is contingent on use).[147]

The exception for gains is justified on the grounds that (1) the source country does not have a strong claim to tax the income, and (2) absent information regarding the taxpayer's basis, it is not feasible for the source country to determine the correct amount of net gain.[148] (A tax on the gross amount realized could result in a very high effective tax rate on the net gain.) If the market access rationale, however, is sufficient to support a source tax on dividend income derived from U.S. economic activity, as a matter of logic it should equally support a source tax on capital gains from the same instruments since the capital gain is essentially a market capitalization of future earnings.[149] Moreover, the failure to tax a nonresident's stock gains offers her an opportunity to completely avoid the shareholder tax on U.S. corporate income to the extent that the nonresident's capital gains are exempt in her residence country or she may successfully avoid residence country tax through use of a tax haven. U.S. residents are comparatively disadvantaged because they do not lawfully have this opportunity.[150] Accordingly, the decision not to tax capital gains at source would seem to rest largely on administrative and enforcement considerations and not on principles of substantive tax policy.[151]

There also is a statutory exclusion from source taxation for payments of bank deposit and portfolio interest.[152] The argument for ex-

[147] IRC § 897; Reg. 1.1441-2(b)(2)(i).

[148] See ALI International Project, note 17, at 110-14; Cynthia Blum, How the United States Should Tax Foreign Shareholders, 7 Va. Tax Rev. 583, 638 (1988) (withholding tax on stock gains raises issue of how to take account of and verify foreign person's stock basis).

[149] See Richard A. Brealey & Stewart C. Myers, Principles of Corporate Finance 72-73 (6th ed. 2000). We do not discuss here the overbreadth of the U.S. corporate income tax on foreign earnings beneficially owned by a foreign shareholder. See Fleming, Peroni & Shay, note 34, at 321-22.

[150] This advantage should translate into a pricing advantage for non-U.S. acquirors of U.S. businesses.

[151] Cynthia Blum has pointed out that many of these issues have been addressed in applying the § 1445 withholding tax to gains from the sale of stock in a U.S. corporation that is a U.S. real property holding corporation. Blum, note 148, at 643-51.

[152] IRC §§ 871(h), 881. The withholding tax on portfolio interest was repealed by the Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 127(a)(1), 98 Stat. 494, 648. For back-

cluding these interest payments is that imposition of a withholding tax on the gross amount of interest income in a liquid capital market with ready alternative investments bearing the same risk/return characteristics results in the burden of the tax being borne by the borrower through higher interest rates. The ultimate effect of a tax on foreign persons not resident in treaty countries may not be so clear, because of the exemption available for treaty residents, but this is an issue for the economists.[153] Nevertheless, the concern that the debtor country will suffer costs attributable to decreased access to foreign capital that may outweigh the benefits from increased tax revenue reflects a widespread international reluctance to impose withholding tax on most interest from unrelated payors.[154]

In repealing the portfolio interest withholding tax, Congress was concerned about tax evasion by U.S. persons.[155] Significantly, eligibility for the exemption with respect to registered obligations rests on the beneficial owner providing a statement of eligibility to the withholding agent.[156] Enforcement of this exemption has been difficult.[157]

Under the U.S. regime for relief from withholding tax at source, as opposed to a refund system, a withholding agent generally withholds tax on a payment unless the foreign person evidences its eligibility for relief from the withholding tax.[158] Before adoption of the final § 1441 withholding regulations in 1997, there was no practical regime for a

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ground on the enactment of the repeal of the withholding tax on portfolio interest, see James P. Holden, Note and Comment, Repeal of the Withholding Tax on Portfolio Debt Interest Paid to Foreigners: Tax and Fiscal Policies in the Context of Eurobond Financing, 5 Va. Tax Rev. 375, 389-94 (1985). For criticism of the repeal of the portfolio interest withholding tax and a proposal for reimposition of a tax, see Avi-Yonah, Globalization, note 72, at 1579-87, 1667-71 (2000).

153 Charles McLure observes that the sharp reductions in taxation of capital in the Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 172 (1981), may have increased the demand for foreign capital in a manner that increased interest rates sufficiently to attract foreign capital. Charles E. McLure Jr., International Considerations in United States Tax Reform, in Tax Differentials, note 17, at 1, 7-8. The repeal of the withholding tax on portfolio interest, see note 152, facilitated the financing of the current account deficit in the U.S. balance of payments by expanding the availability of the withholding exemption previously allowed to large corporate borrowers through the Netherlands Antilles finance company structure. The U.S. Treasury had not availed itself of the Netherlands Antilles Eurobond financing structure and was the largest borrower beneficiary of the repeal. Also benefited were those U.S. investment and commercial banks that did not have a strong European presence in the Eurobond market. Id. at 8-9.

154 McLure, note 152, at 8.

155 Joint Comm. on Tax'n, 98th Cong., General Explanations of the Revenue Provisions of the Deficit Reduction Act of 1984, at 393 (Comm. Print 1985).

156 IRC § 871(h)(2)(B)(ii).

157 Holden, note 152, at 394-404.

158 IRC § 1441(a); Reg. § 1441-1(b). The possibility of a 30% withholding tax on a fixed income investment is more significant than for dividends, because interest generally is a larger portion of the return on a bond than dividends are of the return on an equity investment. The international market for bonds is largely a market for interest that is tax-free at

U.S. withholding agent to collect documentation from a foreign beneficial owner of income holding a security through a foreign financial institution. The final withholding regulations address this problem by (1) placing the burden of investigating beneficial ownership on foreign financial institutions rather than on U.S. custodians, and (2) providing clear rules requiring withholding in the absence of documentation (whether or not through the qualified intermediary structure).[159] The centerpiece of the final withholding regulations is the qualified intermediary ("QI") regime.[160]

Generally, a QI is a non-U.S. financial institution that is subject to know-your-customer rules that have been approved by the Service and has entered into a contractual agreement with the Service to report annually certain aggregate information concerning the beneficial owners of U.S. source payments and to make any necessary tax payments.[161] The QI must agree to engage an external auditor to verify that it is in compliance with the QI agreement.[162] In return, the QI avoids the burden and competitive drawback of forwarding documentation with respect to each customer that is a beneficial owner of U.S. income subject to withholding to a U.S. withholding agent in order to claim reductions in the U.S. withholding tax. The QI, however, must identify U.S. customers that hold accounts covered by the QI agreement.[163] A foreign financial institution that executes a QI agreement

source. Indeed, Avi-Yonah suggests that the interest is not only tax-free at source, but is tax-free in the residence country as well. Avi-Yonah, Globalization, note 72, at 1580-86.

[159] Reg. § 1.1441-1(d)(4), -1(e)(3), -1(e)(1)(ii)(B).

[160] Reg. § 1.1441-1(e)(5). The background to the development of the QI regime is instructive. Before the 1997 withholding regulations, the portfolio interest rules required that a Form W-8 be provided from the beneficial owner of the income. See Reg. § 35a.9999-5 (1997). A foreign financial institution acting for customers often would provide a single Form W-8 to its U.S. financial institution acting as custodian, where the foreign financial institution clearly was not the "beneficial owner" of the income. This situation was ignored for many years, in part because the U.S. custodian faced the unpalatable choice of either withholding a tax that in most cases would not be appropriate (because the vast preponderance of the foreign financial institution's customers were foreign) or losing the account to another custodian that would accept the Form W-8. See Stephen E. Shay, Leonard Terr, Thomas O'Donnell & Percy Woodard, Proposal: Alternative Portfolio Documentation Procedures 2-3 (July 8, 1992) (describing issues faced by U.S. custodial banks holding omnibus accounts for foreign financial institutions) (unpublished manuscript, on file with the Tax Law Review). The situation eventually became intolerable, even though the probability of attack by the Service was low, because the level of the tax risk to the custodians far exceeded profits from the business. Significantly, the final regulations eventually provided rules for nonqualified intermediaries to be able to supply the required documentation in a manner that did not expose foreign customers to back-up withholding if they did not disclose their identities. This significantly relaxed potential pressure on the intermediary financial institutions.

[161] Reg. § 1.1441-1(e)(5).

[162] See Rev. Proc. 2002-55, 2002-35 I.R.B. 435 (providing final audit guidelines for external audits of QI compliance with QI agreement documentation procedures).

[163] Rev. Proc. 2000-12, § 2 of Model Agreement, 2000-1 C.B. 387.

does not have to identify U.S. customers that hold accounts not covered by the QI agreement.[164] There are special rules permitting a QI that discovers a U.S. person in such an account to avoid disclosure of the person to the Service if back-up withholding is imposed with respect to the assets in the account (including on gross proceeds).[165]

The QI regime is an innovative development in the international withholding system. It essentially attempts to "privatize" foreign assistance in enforcement of reductions in source taxation. The fundamental exchange is that the foreign financial institution's customer is granted anonymity in relation to the U.S. tax authorities provided the foreign financial institution cooperates with the Service in prohibiting tax reduction benefits to U.S. investors and confirming treaty eligibility for non-U.S. investors. Under the withholding rules of the final regulations, the United States seeks to surmount the practical limitations on its enforcement jurisdiction without having to request foreign tax authorities to obtain or certify residence information from investors,[166] or implement a refund system as the mechanism to obtain the information.[167]

To avoid administrative burdens and excess withholding (and the consequent need for the foreign investor to file a U.S. tax return and claim a refund), the final withholding regulations contain at least three important concessions that limit the identification of beneficial owners and the reach of disclosure. These concessions reflect the strength of the tension between the need to assure eligibility for relief from the tax while not interfering with efficient operation of the capital markets.

First, the regulations treat a foreign corporation as the beneficial owner of its income, irrespective of whether it is located in a tax haven, and its owner(s) need not be identified.[168] Although this may seem a strange concept to many foreign bankers who view the shareholder as the beneficial owner under know-your-customer rules, it is

[164] Id. § 6.04.

[165] Id.

[166] By contrast, withholding regulations proposed in 1984 would have required Certificates of Residence from treaty partners. Withholding on Items of Income Covered by an Income Tax Convention, 49 Fed. Reg. 35511 (Sept. 10, 1984).

[167] After the repeal of the withholding tax on portfolio interest, Treasury and the Service determined that a refund system would not be feasible because there would be insufficient "float" to finance the costs of a refund system. It was believed that a refund system would require a new and separate processing center and there would not be sufficient interest income from the amounts withheld until repaid to foreign investors to pay for the costs of such an operation. See International Tax Evasion/Tax Treaty Issues: Hearing Before the House Commerce, Consumer, and Monetary Affairs Subcommittee of the Committee on Government Operations, 100th Cong. 12-13 (1987) (statement of Lawrence Gibbs, Commissioner of Internal Revenue).

[168] Reg. § 1.1441-1(c)(6).

consistent with U.S. tax principles. This was a significant decision by the Service to limit the extent to which the withholding tax rules would be used as a means to catch U.S. tax evaders (or to obtain information that could be exchanged with treaty partners regarding their residents' investments in U.S. securities through offshore entities).

Second, the regulations employ so-called presumption rules to permit a withholding agent to presume that an investor is a foreign person and thereby avoid imposition of back-up withholding in the absence of documentation of foreign status.[169] This permits a presumptively foreign payee to accept a 30% withholding tax on income (instead of 30% withholding on gross proceeds) as the sole price for not providing withholding documentation.[170] The absence of exposure to back-up withholding is a significant structural element of the withholding rules. Non-U.S. investors seeking confidentiality (and presumably tax-evading U.S. investors as well) may use a foreign tax haven corporation as a private investment company to hold equity securities and thereby only suffer 30% withholding tax on dividends in order to avoid disclosure of their identities to the Service.[171] If the

[169] Reg. § 1.1441-1(b)(3)(iii)(D). The final withholding tax regulations have carefully avoided applying back-up withholding on gross proceeds in such a way as would compel disclosure of the identity of investors, whether U.S. or foreign, that are not direct payees. For example, if a Cayman Islands limited partnership provides a withholding exemption foreign partnership certificate (generally on a Form W-8IMY) to a U.S. withholding agent without documentation from its partners, the U.S. withholding agent must presume that the undocumented investors are non-U.S. payees and withhold 30% of income subject to withholding if paid to a foreign person. Reg. § 1.1441-5(d)(3). The non-U.S. payee presumption, however, insulates that investor from back-up withholding on gross proceeds, which does not apply to payments to foreign persons. See, e.g., Reg. § 1.6045-1(g)(1)(i) (and cross-references) for this conclusion. The U.S. withholding agent must report to the Service on Form 1042-S the amount paid to an undocumented foreign payee. Reg. § 1.1461-1(c). If a foreign partnership is organized in a tax haven and is not tax-resident in a country with a treaty with the United States, there is no way to relate the Form 1042-S information to the nondisclosed partners.

[170] IRC § 3406 (imposing 30% withholding tax, calculated with reference to § 1(c), adjusted for inflation under § 1(i)). Pursuant to the 2001 Act, the withholding rate declines from 30% in 2002-2003 to 29% in 2004-2005, and 28% in 2006 and thereafter. Pub. L. No. 107-16, § 101(a), 115 Stat. 38, 42. Under the sunset provision of the Act, the rate reverts to 31% in 2011 (its rate before the 2001 Act went into effect). Pub. L. No. 107-16, § 901, 115 Stat. 38, 150.

[171] A U.S. tax evader resident in the United States might arrange with a fiduciary in a country with confidentiality protections to organize a corporation to hold investment assets. Although a U.S. tax evader resident outside the United States might be presumed to avoid contacts with treaty countries that could (and would) exchange information with the United States if requested, it is not beyond imagination that a U.S. citizen resident, but not ordinarily resident, in the United Kingdom (and therefore taxed on a remittance basis) would hold investments, including U.S. securities, through a corporation organized in a tax haven. In this case, the United Kingdom would not have information in its files to exchange with the United States that would link the U.S. citizen with the investments.

average dividend return on a broad range of equities is 3%, then the withholding tax is 90 basis points. The marginal cost of nondisclosure under these assumptions is only 45 basis points when the 30% withholding rate is compared with a treaty rate on dividends of 15%.[172] The calculus for the confidentiality-minded investor would be dramatically different if the threatened withholding were 30% of gross proceeds from the sale of securities.[173]

Third, as discussed above, the final withholding tax regulations provide that a foreign beneficial owner customer of a QI may claim exemption from withholding on interest without disclosing her identity to the Service (or the U.S. withholding agent).[174]

Notwithstanding these concessions, the new withholding regime for the first time holds at least a modest promise of defending against U.S. taxpayers taking advantage of source tax exemption—with a major exception for foreign-targeted bearer bonds.[175] In due course, if the QI system proves workable and even is adopted by other countries, these concessions should be re-examined.

In summary, the withholding mechanism works reasonably well for collecting tax but is an awkward mechanism for administering relief from or reductions in tax. A statutory exemption from withholding tax, as opposed to a treaty exemption, is particularly problematic to administer and enforce, because there is no mechanism, as there is in a treaty, to confirm the eligibility of the beneficial owner of the income for which the exemption is claimed.[176] In the case of portfolio interest, taxpayer-reported information provided to the withholding agent (or QI) is the only basis on which to confirm eligibility for the exemption from withholding tax notwithstanding the advances of the

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[172] OECD Model Tax Convention, note 62, art. 10(2)(b), 1 Tax Treaties (CCH) ¶ 10,507.

[173] See note 170.

[174] See text accompanying notes 152-57.

[175] Since the repeal of the withholding tax on portfolio interest in 1984, corporate issuers of bonds, but not the U.S. Treasury, have been permitted to issue foreign-targeted bearer bonds. The procedures carry no meaningful protections against U.S. persons acquiring the bonds as beneficial owners in the secondary market. The bearer bond procedure in today's marketplace perpetuates an anachronism to allow investment bankers to say they offer bearer bonds when in fact almost no bonds are issued in physical security form anymore. The principal effect is to permit these bonds to be held outside the QI and nonqualified intermediary regimes and thereby facilitate tax evasion by U.S. as well as non-U.S. investors.

[176] If a U.S. citizen opens an account with a foreign financial institution using Liechtenstein documentation, there is no practical way to look behind the documentation provided to determine eligibility for the exemption. The audit guidelines for external auditors look to whether the QI followed acceptable process and procedures and do not separately scrutinize the eligibility for the exemption of an individual account holder or test eligibility against information obtained from third parties. The identity of account holders is not provided to the Service. See Rev. Proc. 2002-55, note 162.

new withholding regulations.[177] The significance of a treaty is that at the discretion of the treaty partner, it permits use of its compulsory process to obtain documentary and testimonial information. At a minimum, this prospect provides some level of deterrence against fraud and evasion. Under the current regulations, such deterrence is nonexistent in the case of foreign-targeted bearer obligations and remote in the case of a U.S. or non-U.S. payee of a U.S. withholding agent or a QI outside of a treaty jurisdiction.

4. *Enforcement of Net Basis Source Taxation in the Absence of a Treaty*

The traditional view is that source taxation of active income is a sound if not a preferred basis on which to tax international income. An implicit assumption of a tax on net income is that if there is sufficient jurisdiction to tax the income, there will be in personam or in rem jurisdiction to compel production of requested information that is not provided voluntarily. Increasingly often, this is not true.

This was a limited concern when inbound activity consisted principally of direct taxpayer presence in the United States, either in the form of bricks and mortar production facilities or through a taxpayer's sales and distribution activity. The emergence of remote selling activity, seen in e-commerce, and direct sales of a variety of retail financial products such as insurance and financial services, foretell a future where this limited exposure may become substantially greater. Absent assistance under an income tax treaty, information exchange agreement, or other similar instrument, jurisdiction to prescribe a tax rule covers numerous cases where there is little practical ability to enforce the rule.[178] We consider below an example where a foreign person may be taxed on income connected with a U.S. business when the taxpayer is not physically present, but other examples could be used.[179]

The United States imposes net basis taxation under a "doing business" standard that does not require a physical presence of the tax-

[177] Those not eligible for the portfolio interest exemption are 10% shareholders of the issuer, foreign banks making a loan under a loan agreement, certain controlled foreign corporations, and U.S. persons who have not been identified in beneficial owners statements (with respect to whom information reporting and back-up withholding apply). IRC §§ 871(h)(3), 881(c)(1), (3).

[178] Enforcement of source taxation, like residence taxation, is vulnerable to taxpayer use of countries that will not share tax information in cases where the taxpayer does not have sufficient U.S. presence to afford enforcement jurisdiction over the taxpayer.

[179] An example not discussed in the text is enforcement of § 877 with respect to expatriated U.S. citizens or departed long-term residents who do not file a tax return with respect to income subject to tax under § 877.

payer itself, as opposed to its agents, in the territory. The general rule is that if a foreign person is engaged in a U.S. trade or business, her U.S source business income, except for periodical income or capital gains that are not derived from the trade or business, will be treated as effectively connected and therefore subject to U.S. taxation.[180] At the margin, the amount of activity required for a foreign person to qualify as engaged in a U.S. trade or business often is unclear.[181]

Whether a foreign person is engaged in a U.S. trade or business is based on all the facts and circumstances.[182] One of the challenges facing the Service is enforcing U.S. tax rules on a business carried on from an offshore location that is not a party to a tax treaty. The following hypothetical fact pattern illustrates this.[183]

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[180] IRC § 864(c)(2), (c)(3) (the vestige of the force of attraction concept). The general source rule for purchased inventory is that the source of income from the sale of inventory is based on where title to the property passes to the buyer. Reg. § 1.861-7(c). Even if title to inventory is transferred by a foreign person to the buyer outside the United States, the sale produces U.S. source income if the sale is attributable to a foreign office or fixed place of business of the foreign corporation, unless (1) the property is for use outside the United States, and (2) a foreign office or fixed place of business of the foreign corporation participates materially in the sale. IRC § 865(e)(2). The Code still provides that income from foreign sales attributable to a U.S. office constitutes U.S. source effectively connected income and thus is taxable in the United States if a foreign office does not participate materially in the sale. IRC § 864(c)(4)(B)(iii). Since 1986, this rule has been anachronistic because such a sale gives rise to U.S. source income under § 865(e)(2) and is effectively connected income unless the seller is a nonresident alien with a tax home in the United States. See Gustafson, Peroni & Pugh, note 17, at 146. Under this convoluted statutory structure, income from the sale of tangible inventory by a foreign person is not effectively connected income and is not subject to U.S. income tax if (1) title passes outside the United States and the sale is not attributable to a U.S. office or fixed place of business of the foreign corporation, or (2) even if the sale is attributable to a U.S. office or fixed place of business, the property is sold for use or consumption outside the United States and a foreign office participates materially in the sale. For a path through the effectively connected income maze, see generally Dale, note 10.

[181] Richard Crawford Pugh, Policy Issues Relating to the U.S. Taxation of Foreign Persons Engaged in Business in the United States Through Agents: Some Proposals for Reform, 1 San Diego Int'l L.J. 1, 3 (2000).

[182] In one of the relatively few U.S. trade or business cases, a foreign individual inherited four parcels of improved commercial real property that were under long-term lease. During the year, his agent sold one property to his lessee, and used the proceeds from the leases and some of the proceeds from the sale to acquire a residential property and an option to purchase another parcel of commercial real property. The Tax Court held that the individual was engaged in a trade or business in the United States, since his activities went beyond mere ownership into "considerable, continuous, and regular" management for profit. Lewenhaupt v. Commissioner, 20 T.C. 151, 163 (1953), aff'd, 221 F.2d 227, 227 (9th Cir. 1954). For purposes of determining whether a foreign corporation is engaged in a U.S. trade or business, activities of an agent, apparently whether or not independent, are attributed to its principal. Amodio v. Commissioner, 34 T.C. 894, 904 (1960), aff'd on other grounds, 299 F.2d 623, 625 (3d Cir. 1962); see Pugh, note 181, at 8.

[183] We have taken the fact pattern from Tillinghast, note 6, at 343-74, and modified it slightly to fit the needs of the illustration.

SoftCo is a software company of unknown ownership organized in the Bahamas[184] that contracts with *USCo* for rights to distribute software programs developed by *USCo*. *SoftCo* also contracts with software programmers to develop software programs for *SoftCo*. The programmers are independent contractors but act for *SoftCo* on an ongoing basis. *SoftCo* distributes the programs over the Internet to customers in the United States and abroad. *SoftCo* offers service support from employees in the Bahamas or from one or more of the independent contractors. The independent contractors may or may not be resident in the United States. Assume alternatively that *SoftCo* does not file an income tax return and that *SoftCo* files a protective income tax return to start the statute of limitations and to preserve its deductions.[185]

The first issue for the taxpayer is whether to file a return (assuming that there is a reporting position that the taxpayer is not engaged in a U.S. trade or business). This presents a classic dilemma for a taxpayer. Is it better to file a return in the event the taxpayer is found to be engaged in a U.S. trade or business to avoid a possible 35% tax on gross income plus penalties?[186] Or is the likelihood that the Service will audit the structure so remote in the absence of a return, that, notwithstanding the substantial downside risk, it would be irrational to file? In practice, notwithstanding the risk-adverse nature of the taxpayer's advisors, the sensible business judgment often is not to file. Absent a return, it would be extremely difficult for the Service to be aware that there might be an issue.

Assume that a protective return is filed or the Service otherwise has reason to determine whether *SoftCo* is engaged in a U.S. trade or business. The Service may request information from *USCo*, but *USCo* may not possess information relevant to determining what U.S. activities *SoftCo* carries on. *USCo* presumably would know the identity of the bank through which *SoftCo* makes payments to *USCo* and, if the bank has a U.S. presence, the Service could summons information regarding payments by *SoftCo* to other U.S. persons for services or other activities. If *SoftCo*'s payments to *USCo* are through a U.S. bank that has a correspondent relationship with *SoftCo*'s Bahamas bank, or are through a non-U.S. bank without a U.S. office, this avenue would be foreclosed.

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184 The Tillinghast hypothetical used an Irish public company that operated through a branch in Bermuda. Id. at 343. Both Ireland and Bermuda are parties to conventions with the United States under which tax information may be exchanged, so we move the place of organization and operation of the company to the Bahamas.

185 IRC §§ 882(c)(2), 6501.

186 IRC § 6651.

Next, assume that *SoftCo* does use a bank with a U.S. presence, that the Service issues a summons to the bank requesting *SoftCo*'s banking records from the Bahamas, and that *SoftCo* moves to quash the summons on the grounds that there is no factual basis for the inquiry. (Ironically, it would appear that *SoftCo* would be better off in this regard by not filing a protective income tax return, since a return would be a de facto admission of a potential U.S. tax presence.) Nevertheless, assume the summons is enforced and the bank turns over records that show payments to U.S. persons. Those persons provide information regarding the nature of their programming activities for *SoftCo*, their service support for *SoftCo* products, or both.

Turn now to the factual nature of the legal analysis required to determine whether the activities of these persons would cause *SoftCo* to be engaged in a U.S. business and, if so engaged, whether *SoftCo* has effectively connected income.[187] Without the ability to summons *SoftCo*'s employees or records, could the Service propose an adjustment? Could it collect the tax? Finally, how many IRS agents, with other presumably easier cases to pursue, would want to take on this quagmire? Notwithstanding the enforcement difficulties, in this example *SoftCo* clearly exploits the U.S. market.

What conclusions are to be drawn from the preceding discussion of the limits on jurisdiction to enforce and its implications for source taxation in the absence of a treaty? With respect to source taxation of nonresidents not engaged in a U.S. business, it is clear that withholding is an essential enforcement tool. From an administration and enforcement perspective, exceptions from withholding are extremely difficult to police and therefore expose the residence tax base to erosion. With respect to source taxation of U.S. business income, it is difficult to administer and enforce a net tax on income of a foreign person that does not have a physical presence in the United States. These are not surprising conclusions, but commentators do not appear to have highlighted them. As discussed in the next Subsection, the availability of an exchange of information provision in a treaty or a tax information agreement potentially improves the ability to obtain information both to police exemptions from source withholding and to administer a net tax on income from a U.S. business carried on from outside the United States.

[187] See Tillinghast, note 6, at 344-56. Tillinghast observes that the "seemingly simple question" whether income is effectively connected with a U.S. business "is one of Byzantine complexity." Id. at 348. The analysis requires determining (1) the character of the income from the transfer as a sale or royalty, (2) whether the source of the income is U.S. or foreign (or part U.S. and part foreign), and (3) whether the (U.S. or foreign) income is effectively connected income. Id. at 344, 353.

5. *Overcoming Limitations on Jurisdiction to Enforce Tax Rules: Bilateral or Multilateral Tax Information Exchange Agreements*

Information outside the limits of a U.S. court's jurisdiction may be obtained with the assistance of the jurisdiction where the information is located. Because most countries have domestic law confidentiality or privacy protections for taxpayer information and banking information, generally the other country must undertake this assistance under the authorization of a treaty or other international agreement with the United States.

The United States is a party to over 64 bilateral income tax treaties, 14 tax information exchange agreements, and the Multilateral Convention for Mutual Assistance on Tax Matters, each of which provides for assistance in obtaining tax information.[188] These international agreements play an important role in overcoming limitations on U.S. jurisdiction to enforce. The *SoftCo* hypothetical discussed above illustrates the impact of an agreement.

An exchange-of-information agreement with the Bahamas in the *SoftCo* case would materially change the burden versus benefit calculus for the Service and the risk of enforcement calculus for *SoftCo*. Such an agreement would allow the Service to direct a request, through the Bahamas authorities, directly to *SoftCo* and its employees. IRS personnel could request copies of records and arrange interviews. Although an exchange-of-information request involves its own bureaucratic burdens and is dependent on the other country's authorities for success, it is a material improvement over the situation without a treaty relationship. The *SoftCo* example involves U.S. source-basis taxation of a foreign person; however, the availability of information exchange is, if anything, equally important for protecting residence-based taxation of U.S. persons both with respect to U.S. business and nonbusiness income.

Treaties are essentially reciprocal obligations. For treaty information exchange to work, the flow of information must be bilateral. Not only is this in the self-interest of each of the contracting countries, but the ability of countries to impose income taxes increasingly requires that countries have the ability to obtain information from outside their borders. Current U.S. tax policy decisions that in effect facilitate foreign investors in hiding their income from their home country tax authorities by avoiding routine exchange of information under treaties

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[188] See Richard Gordon, John Venuti & Diane Renfroe, Current Status of U.S. Tax Treaties, 31 Tax Mgm't Int'l J. 266, 270 (2002); OECD Convention on Mutual Administrative Assistance on Tax Matters, Jan. 25, 1988, 1 Tax Treaties (CCH) ¶ 215.

regarding their investments in U.S. securities or banks may need to be revisited in the future. Two examples illustrate this point.

Generally, a U.S. withholding agent that makes payment of income subject to withholding to a foreign person reports the amount of the payment and the identity of the payee to the Service on a Form 1042-S attached to the withholding agent's own return on Form 1042. The information from Form 1042-S is one of the most important elements of information provided to certain treaty partners under the Service's program for routine exchange of information under income tax treaties.

Under the current QI regime, the QI does not pass on to the withholding agent the identity of beneficial owners claiming treaty relief but does retain the information. Assuming, as is the case most of the time, that the QI has not assumed withholding responsibility, the withholding agent makes payments to accounts grouped according to withholding pools and files a single Form 1042-S for the pool without identifying the individual payee. Thus, for example, the withholding agent files a single Form 1042-S for the pool of accounts eligible for the 15% treaty dividend rate. In this case, the identity of the payee remains unknown unless the Service makes a specific request for the identity of payees. The pooling approach, which is central to the efficiency and attractiveness of the QI regime to a foreign financial institution, cuts off the potential practical utility of pooled information for exchange under income tax treaties. This is because the information is not broken down by taxpayer and therefore is unsuitable for exchange with a treaty partner. Similarly, the United States for years limited its information exchange of bank deposit interest to accounts held by Canadians and, after strong lobbying by banks, recently proposed only a limited extension of collection of this information from foreign persons resident in a limited number of selected treaty countries.[189]

[189] Prop. Reg. § 1.6049-8(a). After strenuous lobbying by Florida banks in particular, prior proposed regulations that would have required reporting of interest paid to nonresidents irrespective of their country of residence were withdrawn and re-issued. Prop. Reg. § 1.6049-8(a), 62 Fed. Reg. 53387, 53491 (Oct. 14, 1997), Prop. Reg. § 1.6049-8(a), 66 Fed. Reg. 3925, 3928 (Jan. 17, 2001). The Florida International Bankers Association claimed that Florida banks would lose between $18 billion and $34 billion of deposits and that operating business profits in Florida alone would decline between $4.4 billion and $8.46 billion annually. Miriam Lopez, Alex Sanchez, Tom Dargan, David Konfino, Al Valdes, and Pat Roth, Bankers Associations Urge Withdrawal of Nonresident Reporting Requirements (Oct. 1, 2001) TNT 198-36, Oct. 12, 2001, available in LEXIS, TNT File. Governor Jeb Bush also wrote Secretary O'Neill and arranged for Florida bankers to meet with then Assistant Secretary of the Treasury for Tax Policy Mark Weinberger and a White House representative. Jeb Bush, Governor Bush urges the U.S. Treasury to Reconsider Proposed Regulations on Reporting Requirements (June 7, 2001), 2001 WTD 123-45, June 26, 2001, available in LEXIS, WTD File. In July, 2001, Florida Congressman Dave Weldon withdrew an appropriations bill amendment to block Treasury from using funds to implement

Why is this significant? Domestically, the United States relies on comprehensive information reporting for payments of interest, dividends, and gross proceeds from the sale of securities to individuals and other nonexempt recipients. If a taxpayer does not supply a correct taxpayer identification number, the threat of a back-up withholding tax on the payment, currently at a rate of 30%, provides a significant backstop to the information reporting rules.[190] The final withholding tax regulations integrate the domestic information reporting and back-up withholding rules with the Chapter 3 withholding rules so that payments to foreign intermediaries acting for U.S. persons are covered by the domestic information reporting system. There are limits on the reach of these rules, however. Generally, U.S. persons, controlled foreign corporations, and foreign corporations more than 50% of whose income is effectively connected with a U.S. trade of business must apply the information reporting and back-up withholding rules.[191] The QI regime also preserves Form 1099 reporting with respect to U.S. persons that are not exempt from information reporting under domestic rules.[192] As a practical matter, however, the comprehensive U.S. regime for enforcement of tax on income from capital stops at the water's edge.

If a long-term U.S. interest is to receive information from treaty partners that is usable and will assist enforcement of U.S. tax laws, it is necessary to achieve seamless information reporting so that adequate information can be routinely exchanged with a treaty partner regarding income paid to its residents so that it may process the information.[193] To be effective there cannot be wide gaps in the information collected. Acceptance of pooled QI reporting may be a reasonable decision today, because of the need to implement the QI system successfully. Moreover, currently most treaty partners have limited ability to process electronically information provided under routine exchange of information programs. In the not too distant future, how-

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the regulation after House Ways and Means Committee Chairman William Thomas promised to hold hearings on the matter if the proposed regulations were adopted without modification. 147 Cong. Rec. H4592-H4593 (July 25, 2001); see generally Marshall J. Langer, New EU, U.K., and U.S. Reporting Rules on Bank Deposit Interest Paid to Nonresidents (Dec. 10, 2001), 2002 WTD 18-19, Jan. 28, 2002, available in LEXIS, WTD File.

[190] See note 170.

[191] The information reporting and back-up withholding rules are modified for application to foreign offices of U.S. financial institutions. Reg. § 1.6049-5(c).

[192] See Rev. Proc. 2000-12, note 163, § 8.01 (model QI agreement).

[193] It is well known to treaty administrators that critical to this objective is agreement on a numbering or processing system that will permit income information received from the other country to be related by the residence country to an individual taxpayer. This has been the subject of ongoing work at the OECD. OECD, Model Agreement on Exchange of Information in Tax Matters, available at http://www.oecd.org/pdf/M00028000/M00028528.pdf.

ever, it will be appropriate to re-visit the extent to which bank deposit and Form 1042-S information is collected for exchange with countries that are parties to treaties and, as appropriate, tax information exchange agreements with the United States.

Treaties also potentially serve another enforcement objective. As discussed above, the revenue rule is a barrier to assistance in collection of foreign tax claims in many countries. This limitation also may be overcome through agreement in a treaty to assist in the collection of the treaty partner's tax claim. The United States has a mixed history in its commitment to overcoming the revenue rule by treaty.

The United States has entered into five income tax treaties under which the contracting parties have agreed to provide general assistance in collecting tax judgments.[194] The treaties with four of these countries—Denmark, France, Sweden, and the Netherlands—were first signed and ratified in the late 1930's and 1940's. In 1948, however, responding to complaints about French tax collection against U.S. persons, the Senate ratified a Supplementary Protocol providing that collection assistance under the treaty would not be given with respect to taxpayers of the requested state.[195] In 1951 reservations to the collection provisions in treaties with Greece, Norway, and South Africa further restricted the U.S. position.[196] Subsequent treaties have authorized collection assistance with respect to withholding taxes that were not correctly withheld at source.[197]

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[194] Third Protocol to U.S.-Can. Income Tax Convention, Mar. 17, 1995, art. 15, 1 Tax Treaties (CCH) ¶ 1946 [hereinafter Canada-U.S. 1995 Protocol]; Income Tax Convention, Aug. 19, 1999, U.S.-Den., art. 27, 2 Tax Treaties (CCH) ¶ 2500.27; Income Tax Convention, Aug. 31, 1994, U.S.-Fr., art. 28, 2 Tax Treaties ¶ 3001.29; Income Tax Convention, Dec. 18, 1992, U.S.-Neth., art. 31, 3 Tax Treaties (CCH) ¶ 6103.33; Income Tax Convention, Sept. 1, 1994, U.S.-Swed., art. 27, 4 Tax Treaties (CCH) ¶ 8801.28.

[195] See Supplementary Protocol to U.S.-Fr. Income Tax Convention, May 17, 1948, art. I, reprinted in 1 Tax Conventions, note 19, at 1151, 1191.

[196] The Senate Foreign Relations Committee report stated in part:

> [T]he committee believes that the collection provisions of the South African, Greek, and Norwegian income-tax conventions are too broad, and it repeats that, as a general rule, it is not believed wise to have one government collect the taxes which are due to another government. . . . Thus, the committee recommends the acceptance of the collection provisions . . . subject to the understanding that each of the governments may collect the other's tax solely in order to insure that the exemptions or reduced rates of tax provided under the respective conventions will not be enjoyed by persons not entitled to such benefits.

S. Exec. Rep. No. 82-1, at 21 (1951), reprinted in 1 Tax Conventions, note 19, at 605.

[197] The broadest collection assistance provision in an existing U.S. treaty, the OECD Convention on Mutual Administrative Assistance in Tax Matters, note 188, is the subject of a reservation that is permitted under the terms of the treaty and may be withdrawn. In ratifying the OECD Mutual Administrative Assistance Convention, Treasury recommended, and the Senate adopted, a reservation to the treaty's reciprocal provisions for collection assistance (as well as service of process). 136 Cong. Rec. S13294 (daily ed. Sept.

The most recent broadly drafted collection provision was adopted in the 1995 Protocol to the Canadian treaty. The mutual collection assistance provision provides broad assistance for a revenue claim that has been certified by the applicant state as "finally determined."[198] A claim has been "finally determined" when "the applicant State has the right under its internal law to collect the revenue claim and all administrative and judicial rights of the taxpayer to restrain collection in the applicant State have lapsed or been exhausted" and the claim is not to be reexamined in the requested state.[199] The provision applies "to all categories of taxes collected by or on behalf of the Government of a Contracting State."[200] Thus, the collection provision applies to taxes that are not covered by the treaty, such as customs and excise taxes. The collection provision bars assistance with the collection of a revenue claim arising during the time an individual or corporation was a citizen of or incorporated in, respectively, the "requested State"[201] and provides that a finally determined revenue claim "may be accepted for collection."[202] This collection provision with our most important treaty partner is an important breakthrough and its use in practice will be watched carefully.[203]

F. Summary of Criteria for U.S. Source Taxation

We suggest that a parity or comparable taxation principle of source taxation requires that the level of effective source taxation be comparable to that imposed on residents carrying on the same activity. As a country whose residents invest abroad, the United States also has strong reasons to resist excessive or discriminatory taxation of nonresidents. Thus, we suggest that the United States adhere to the nondiscrimination principle in source taxation. In this regard, however, we suggest that the existing treaty concept of nondiscrimination be modified to take account of differential taxation of non-U.S. owners of U.S. business entities in evaluating whether a tax rule results in discrimina-

18, 1990) (statement of Sen. Pell) ("The administration stated, and the Committee on Foreign Relations concurred, that it did not believe it appropriate, at this time, to participate in the other aspects of the convention, that is cooperation in tax collection efforts . . . ."); see also 136 Cong. Rec. S13295 (daily ed. Sept. 18, 1990) (vote on the reservation).

[198] Canada-U.S. 1995 Protocol, note 194, art. 15, para. 2, 1 Tax Treaties (CCH) ¶ 1946.

[199] Id. art. 15, para. 3.

[200] Id. art. 15, para. 9.

[201] Id. art. 15, para. 8.

[202] "Paragraph 3 . . . clarifies that the Contracting State from which assistance was requested . . . has discretion as to whether to accept a particular application for collection assistance." Treas. Dep't, Technical Explanation of the Canada-U.S. 1995 Protocol, art. 15, 1 Tax Treaties (CCH) ¶ 1951 (released June 13, 1995).

[203] The OECD also recently proposed amendments to its model convention authorizing assistance in collection. OECD Model Treaty, note 103, art. 27 (proposed).

tion in fact. Finally, we conclude that administration of source taxation would be less burdensome and enforcement less problematic if exceptions from source taxation were adopted only by treaty. We also conclude that enforcement of net basis taxation at source on a remote seller (of goods, intangibles, or services) without a physical presence is extremely difficult in the absence of a treaty.

We turn next to a discussion of source rules using these criteria. What does source have to do with source taxation?

IV. What Is the Proper Role of Income Source in U.S. Source Taxation?

A. *The Weakness of the Connection Between Income and Geographic Source*

A fundamental reason for the difficulty in assigning income to a geographic source lies in the nature of the net income concept underlying the U.S. federal income tax. The idealized Schanz-Haig-Simons definition of income as equaling consumption, plus, or minus, the change in the taxpayer's wealth between the beginning and the end of a year[204] is an attribute of a person, not a place. Because a person is not divisible into geographic parts, the Schanz-Haig-Simons net income concept can describe only a taxpayer's worldwide income. It cannot allocate that worldwide income among the various countries whose legal and economic infrastructures may have contributed to the production of the income.[205] Nevertheless, an allocation must be made in order to apply the rule that gives source taxation primacy over residence taxation and also to sort out competing source tax claims. In this Section, we focus on the issue of resolving countries' conflicting assertions of source tax jurisdiction.

Where it is necessary to assign net income to specific time periods, the tax system relies on tax accounting methods, principally the cash and accrual methods. Unfortunately, there is no analogue to the cash

[204] Henry C. Simons, Personal Income Taxation 50 (1938); Robert M. Haig, The Concept of Income-Economic and Legal Aspects, in the Federal Income Tax 1, 7 (Robert M. Haig ed., 1921), reprinted in Am. Econ. Ass'n, Readings in the Economics of Taxation 54 (Richard A. Musgrave & Carl S. Shoup eds., 1959); Georg van Schanz, Der Einkommensbegriff und die Einkommensteuergesetze, 13 Finanz-Archiv 1-87 (1896). With respect to the relationship of the Schanz-Haig-Simons income definition to corporate income, see Fleming, Peroni & Shay, note 34, at 318-23.

[205] Ault & Bradford, note 2, at 30-32. Ault and Bradford also question whether reference to the idealized Schanz-Haig-Simons definition of income is useful as a tax policy guide because income actually is measured by reference to observable transactions. We address the fact that source rules also are related to transactions in the following text and consider illustrative cases in Subsection IV.C. We do not consider in this Article the question of when a person, corporate or individual, should be considered a tax resident in a country.

method's constructive receipt doctrine or the accrual method's "all events" test to assign income to a geographical source. Instead, the United States resorts to a series of discrete source rules based on the categorization of the item of income. These rules are often arbitrary.

An example illustrates the point. Suppose that a U.S. resident lawyer, who is educated in the United States and practices patent law in Boston for 20 years, spends over six months at an office in Paris rendering advice. Assuming that France asserts jurisdiction to tax the lawyer's entire related income, the United States treats the income as having its source wholly in France and, under the primacy-of-source rule, the United States contents itself with collecting a residual tax after allowing a credit for France's tax on 100% of this income. Yet, the intellectual capital that underlies the advice was developed entirely in the United States. While we acknowledge the administrative reasons for giving this income a single source, surely an objective observer would say that there is an economic basis for attributing some of the income to the United States and freeing it pro tanto from French source taxation.

Commentators have noted that the existing international network of source rules is not consistent in terms of either prescriptive content or fidelity to fundamental economics.[206] Nevertheless, some legal commentators have developed rationales to support a particular source rule or have articulated standards for sound source rules.[207] We endorse these efforts, although not necessarily the outcomes. In other cases, a source-of-income rule has been referred to as support for an assertion of tax jurisdiction.[208] We conclude that this is incorrect.

B. *Distinguishing Source of Income and Jurisdiction to Tax*

It is important to clearly distinguish between determining the proper scope of a country's jurisdiction to tax at source and formulat-

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[206] Ault & Bradford, note 2, at 33-40; Green, Future, note 3, at 32-46 (criticizing reliance on arm's length transfer pricing principle to allocate income to source country); Robert J. Patrick, Jr., General Report, Rules for Determining Income and Expenses as Domestic and Foreign, 65b Cahiers de Droit Fisc. Int'l 1, 15 (1980) (reporting that countries' characterization of income as domestic or foreign is so varied that they must be seen merely as "convenient labels for designating activities that are or are not to be subject to tax . . . ."); Vogel, note 17, at 136 ("The definition of source is not a basis from which to proceed, it is a part of the problem.").

[207] See Andrus, note 6; Lokken, note 24.

[208] See, e.g., Blum, note 148, at 625 ("Further support for a United States assertion of source-based tax jurisdiction over a foreigner's gain from sale of stock in a United States corporation is provided by section 865(f) . . . .").

ing rules to implement that determination.[209] Because source rules lack inherent normative content, they should be used only for the latter purpose. To be more specific, we submit that U.S. source taxation should be justified under the market access charge rationale explained in Section II, that its scope should be determined under the principles articulated in Section III, and that income source rules should be articulated for the limited purpose of implementing those principles.

Earlier in the history of the U.S. income tax, the source rules were coextensive with the scope of U.S. source taxation with the result that the United States taxed foreign persons on all of their U.S. source income.[210] This has not been true at least since 1966.[211] There have been increasing instances in which the Code treats income source as different for different purposes[212] and former source rules have become substantive taxing rules.[213] Generally, these changes further a particular source or residence taxation objective, but this purposive approach to source rules has been applied only episodically. We propose that source rules generally be formulated for the purposes of implementing principled decisions regarding the scope of source or residence taxation. The next Subsection uses examples to illustrate the need for this approach.

C. *U.S. Income Source Rules Should Be Re-Examined in Relation to Their Role in Source Taxation*

1. *Example: Source Rules for Personal Services and Royalties*

In this Subsection we examine the source rules for services and royalties.[214] We conclude that for purposes of taxation at source, these source rules are arguably both over- and under-inclusive.

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[209] Some countries do not employ separate source rules to determine income attributable to a permanent establishment, but instead allocate or attribute business profits to a single source, without regard to the items of income that constitute the business profits. Vogel, note 17, at 132.

[210] Id. at 129-30 (describing the evolution of U.S. source rules).

[211] See IRC § 864(c)(4); see also authorities cited in notes 9-10.

[212] Compare IRC § 865(e)(1), with IRC § 865(e)(2) (specifying different standards for when gain is considered attributable to an office or fixed place of business); see also IRC § 865(f) (specifying when gain from the sale of stock in a foreign affiliate by a U.S. resident is foreign source income; there is no comparable rule treating gain of stock in a U.S. affiliate by a foreign person as U.S. source income).

[213] See, e.g., IRC § 871(i) (excluding certain bank deposit interest from withholding tax). Prior to 1987, the same result was accomplished by treating this income as foreign source income in former IRC § 861(a)(1)(A), (c).

[214] For an analysis of the source rules for income from intellectual property, see Lokken, note 24.

The general source rule for services is the place of performance.[215] If compensation is paid for services performed partly within and partly outside the United States, regulations provide that the compensation generally be apportioned on a strict time basis.[216] This personal services source rule is appropriate for low-value services. In the absence of accumulated human capital or related productivity-enhancing property, the country where the services are performed would seem to have a reasonable claim to tax all the income from the activity. If, however, the services have high value, either because they involve the use of sophisticated tangible or intangible property or because of the extensive human capital required to perform the services, then the country where the property or human capital was developed also would seem to have a claim on some portion of the income.

But even if the personal services source rule may be questioned as a theoretical matter, does it nevertheless achieve the objectives of the principles for structuring source taxation described in Section III? The place-of-performance rule does assure that services performed in the United States are subject to source taxation (in the absence of treaty protection). Assuming reasonable allowance of related deductions, it would seem that the parity (or comparable taxation) and nondiscrimination criteria should be satisfied. And clearly, the United States may assert jurisdiction to tax services performed within its territory. Thus, the place-of-performance rule has a superficial appeal.

The principal difficulty with the place-of-performance rule as currently applied to U.S. services is administrative: the current de minimis rule excluding U.S. services from source taxation is too narrow in scope. Under current law, any foreign entity that earns one dollar of U.S. services gross income must file a tax return and, absent treaty protection, pay tax.[217] In other words, any foreign corporation earning services income that sends an employee to the United States for a day must file a tax return, whether or not the foreign corporation is eligible for treaty protection and whether or not the foreign entity has positive net income.[218] In the absence of treaty protection, an income tax must be paid if net income is earned. Where the U.S. con-

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215 IRC §§ 861(a)(3), 862(a)(3). A de minimis exception applies to treat services performed by a nonresident individual in the United States as foreign source income if the individual is present in the United States for 90 days or less in the taxable year, the compensation for these services does not exceed $3,000 in the aggregate, and the services are performed for a foreign person or a foreign office of a U.S. person. IRC § 861(a)(3).

216 Reg. § 1.861-4(b).

217 IRC §§ 863(a)(3), 864(b), 864(c)(3), 6012; Reg. § 1.6012-1, -2.

218 Treas. Reg. § 1.6012-1(b), -2(g). Thus, an income tax technically is required even if the U.S. activity would qualify for transfer pricing at cost under the § 482 cost safe harbor for services. Reg. § 1.482-2(b)(7).

tact is minimal, these requirements simply are not observed and there is no meaningful prospect of enforcement.

Several observations are in order. The de minimis rule is a self-imposed limitation on the jurisdiction to tax and should not be part of the source rules. For administrability reasons, the current de minimis rule should be expanded to (1) cover presence by employees or agents of entities as well as individuals, (2) increase the exempted amount (in the case of an individual to some minimum number of days of average compensation and in the case of an entity to a meaningful amount (for example, $25,000) indexed to inflation), (3) eliminate the requirement of a non-U.S. payor, and (4) apply for tax return filing as well as income determination purposes. This would be a more realistic de minimis rule that would not foster systematic disregard of the tax return filing requirements.

Although the place-of-performance source rule has the apparent advantage of administrative convenience, what if a payment for services is made to a foreign corporation that subcontracts for the services to be performed in the United States? The Tax Court in *Miller v. Commissioner* concluded that the payment to the foreign corporation was not U.S. source compensation income subject to withholding.[219] Judge Körner observed that the subcontractor would pay tax on the income from the services performed in the United States.[220] He also asserted that the foreign corporation could earn U.S. source service income only from activities of its own agents or employees.[221] Although this decision seems questionable as an interpretation of the statutory source rule, it avoided the imposition of a gross withholding tax on income that also was taxed in the hands of the subcontractor, which would have given rise to unrelieved double taxation.

But arguably there was a second way to avoid double taxation. The foreign corporation might have been treated as engaged in a U.S. trade or business, through its agent the subcontractor, and taxed on the payment that it received minus the amount paid to the subcontractor. It appears, however, that the Service did not seek to assert a source tax on a foreign corporation that only carried on U.S. activity through agents that were subject to full U.S. tax.[222]

Was the principal's income in *Miller* U.S. source income from carrying on a U.S. trade or business? Under the literal language of the Code, the better answer is "yes." But as a matter of U.S. tax policy, should the foreign corporation have been subject to U.S. source tax if

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[219] Miller v. Commissioner, 73 T.C.M. (CCH) 2319 (1997).

[220] Id. at 2323.

[221] Id.

[222] It is not clear why the Service did not assert that the principal, which was resident in a nontreaty country, was engaged in a U.S. trade or business and taxable on its net income.

all it did was utilize a U.S. subcontractor? This is a different and more difficult question that should not be determined by the mechanical application of a source rule, but rather on a weighing of (1) the need to tax business activity that has a substantial U.S. nexus (though carried on by a subcontractor) to achieve comparable taxation in relation to U.S. persons carrying on the same activity against (2) the administrative and enforcement difficulties of imposing a net basis source tax on the foreign principal's income from contracting for services in the United States. In the light of the increased ability to structure remote activities, using electronic communications or otherwise, serious consideration should be given to imposing tax at source and relieving the tax by treaty. The business profits and permanent establishment articles of most bilateral treaties would provide exemption from source taxation—but only for a resident of a treaty partner.

We now consider application of the place-of-performance rule to foreign-performed services. For example, what if a foreign corporation employs software programmers in India and sells its software services through an office in the United States? Under current law, all, or substantially all, of the foreign corporation's income would be exempt from U.S. tax, notwithstanding that the foreign corporation is accessing the U.S. market. In the absence of a treaty, is this consistent with the parity or comparable taxation rule? Is it tolerable if a U.S. software programming company employing programmers in Cambridge, Massachusetts and selling to U.S. customers is subject to full U.S. taxation while the foreign corporation is subject to little or no U.S. tax on its sales to the same U.S. customers?[223] Under the parity or comparable taxation principle, the United States arguably should tax the foreign corporation on some portion of foreign-performed software services sold to U.S. customers.

Would the answer change if the foreign corporation did not have a U.S. office through which services were sold? We conclude that, under the parity or comparable taxation principle, the United States reasonably should be allowed to tax the foreign corporation on the foreign-performed services sold to U.S. customers. (It would be possible of course to exempt this income by treaty.) Source-based taxation of this income would not be discriminatory. The difficulty would be in enforcing the tax, unless there were withholding on the payment. We discuss this below.

We now alter the facts of *Miller* to contrast the personal services source rule with the royalty source rule. Assume that the foreign prin-

[223] If the income were from sales of manufactured goods to U.S. customers, and the sales were attributable to a U.S. office of the foreign corporation, a portion of the income would be U.S. source and subject to full U.S. tax. IRC §§ 865(e)(2)(A), 864(c)(3).

cipal uses its own employees to conduct research and development activity in the United States, resulting in a valuable foreign patent that is licensed by the principal's foreign headquarters to customers outside the United States. Note that Judge Körner would agree that in this case the principal would have U.S. source income if the licensing receipts could be characterized as compensation income.[224] In this hypothetical, however, the principal earns royalty income and all of the related marketing activity giving rise to the license is carried on from the principal's home office outside the United States. Under current law, unless royalties are attributable to a U.S. office, they are sourced according to their place of use, which in this example would be outside the United States; accordingly, the foreign principal would not be subject to U.S. tax on the royalty income because the income would not be attributable to a U.S. office or place of business.[225] As noted previously, however, if the transaction with the licensee is instead a contract to provide R&D services,[226] substantially all of the income in this hypothetical would be taxed as effectively connected U.S. source income.

The theory behind the source rule for royalties is that the law of the place of use offers legal protections that support the right of the source country to impose tax.[227] But where the development activity was dependent upon the legal and economic infrastructure of a different country, that country also has a source tax right. Although we acknowledge the difficulty of allocating income between the development country and the country where the property is used, should the royalty source rule deny the country of development the ability to tax income attributable to the development activity?

2. *Example: Residence-Based Source Rule for Stock Gains*

The United States has adopted a number of rules that grant primacy to residence country taxation but that provide varying degrees of exceptions to permit U.S. source taxation.[228] In most of these cases, the

224 See Westreco, Inc. v. Commissioner, 64 T.C.M. (CCH) 849 (1992).

225 See IRC § 864(c)(4)(B)(i), (5)(B); Reg. § 1.864-6(b)(2)(i) (marketing (not developing) is the essential element of attribution of foreign royalties to a U.S. office). It seems clear that the principal is carrying on a U.S. trade or business. An interesting question is whether deemed compensation income including an arm's length mark-up should be attributed to the U.S. business.

226 See, e.g., *Westreco*, 64 T.C.M. (CCH) 849; Karrer v. United States, 152 F. Supp. 66 (Ct. Cl. 1957).

227 Lokken, note 24, at 240-41.

228 See, e.g., IRC § 865(a) (gains from the sale of personal property), § 863(d) (income from space and ocean activities), § 988(a)(3) (currency gains and losses). In addition, regulations provide for residence-based taxation of notional principal contract income. See Reg. § 1.863-7(b).

apparent congressional concern was to limit foreign tax credits rather than to preclude source taxation.[229] Modifications to the general rules to accommodate U.S. source taxation generally require a U.S. presence or place of business.[230]

A source rule that does not adequately preserve source taxation unilaterally relinquishes taxation rights. The issue with respect to the residence-based source rules of the United States is whether they concede too much taxation in the absence of a U.S. physical presence. For example, should gains of a nonresident from the sale of a substantial stock interest in a U.S. corporation carrying on U.S. business not be subject to source-based taxation? The unilateral failure to tax such gains is inconsistent with the parity or comparable taxation principle where U.S. residents are subject to a second level of tax on corporate income.[231] Indeed, the only reason not to tax such gains is administrative—which may be an anachronistic concern. We consider this below.

D. *Reexamining U.S. Source Taxation of Portfolio Interest, Gains From Sales of Substantial Stock Interests, and Remote Activity Directed at the U.S. Marketplace*

We have not undertaken a comprehensive analysis of the appropriateness of U.S. source rules as they apply in the context of U.S. source taxation, limiting our discussion to a few illustrative examples in the preceding Subsection. These examples nevertheless suggest that the scope of U.S. source taxation warrants a fuller review informed by the principles described in Section III. Under the approach we propose, the policy question of whether a particular type of income should be taxed at source should not be determined by a source rule. Instead, the policy analysis should weigh (1) the need to tax U.S. activity of nonresidents so that there is comparable taxation in relation to U.S. persons carrying on the same activity against (2) the administrative and enforcement difficulties of imposing a net basis source tax on the nonresidents' activity. This weighing should always be subject to the nondiscrimination principle.

Based on the preceding discussion, we recommend reexamination of the U.S. source taxation of three categories of income: (1) income

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229 For criticism of the failure of the space and ocean source rule to take account of the possibility of legitimate foreign taxation, see Andrus, note 6, at 841-44.

230 See, e.g., Reg. § 1.863-7(b)(3); see Andrus, note 6, at 846-47 (arguing that this rule is over-inclusive because taxation of the entire amount of notional contract income attributable to a U.S. office can result in unrelieved double taxation).

231 For a discussion of issues relating to whether stock sale gains are entitled to special treatment, see Blum, note 148, at 629-32.

from foreign business activities that generate sales of goods or services into the United States, (2) foreign persons' gains from the sale of substantial interests in U.S. corporations, and (3) portfolio interest. We consider the feasibility of these in reverse order.

Two alternatives to the current portfolio interest exemption are worthy of discussion. First, should the current exemption be limited to registered obligations and allowed only to residents of countries that exchange tax information with the United States?[232] These countries would consist of all of the current U.S. treaty partners (that cooperate in information exchange) irrespective of the interest withholding rate in the treaty, as well as countries that are parties to tax information exchange agreements.[233] A second alternative would be to repeal the portfolio interest and bank deposit interest exemptions from withholding tax and rely on bilateral income tax treaties for relief from taxation at source. Proponents of unilateral exemption should be required to establish that the benefits of unilateral relief from withholding tax could not be substantially achieved if relief were limited to residents of treaty partners.

We similarly would reexamine the continuing need to provide unilateral exemption from source taxation of gains on the sale of substantial stock interests in U.S. corporations. Congress considered proposals to impose tax on nonresidents' stock sale gains in the late 1980's and mid-1990's but did not enact them.[234] After 18 years of experience with withholding on sales of U.S. real property interests, it should be feasible, though burdensome, to impose withholding on stock sales proceeds under rules similar to § 1445. We call for a reanalysis of this issue.

Finally, we urge an examination of source taxation of remote foreign business activity that generates sales of goods or services in the United States. Although this proposal has been the subject of the least prior analysis, technological changes in the distribution of goods and services support the need for such a reexamination. The principal difficulty lies in the enforcement of a source tax on foreign activity that earns income from sales into the U.S. market through electronic

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232 See, e.g., IRC § 871(h)(6).

233 IRC § 871(h)(6) authorizes Treasury to deny the portfolio interest exemption from withholding to payments made to persons within countries that are not cooperative in information exchange. This is an important potential tool already in the law, but it would be preferable not to have to single out countries for punishment. Instead, the availability of a portfolio interest exemption would be an important carrot for an information exchange agreement.

234 See generally David Benson & William F. Leary, Senate Measure Would Tax Foreigners' Stock Sales and Limit Treaty Benefits, 11 Tax Notes Int'l 1278 (Nov. 13, 1995); Stanley G. Sherwood & Siv Janger Bonney, Foreign Tax Equity Bill of 1990: More Trouble for Foreign Companies, 19 Tax Mgm't Int'l J. 231, 238-41 (June 8, 1990).

commerce or other remote seller techniques. Although it theoretically would be possible to construct a withholding regime on payments, subject to reductions on establishment of a lesser net income (similar to that imposed on U.S. real property gains), it currently is impractical to require withholding by vendors on retail sales to consumers. Because electronic sales cannot use cash, but must rely on credit or debit card 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. An alternative approach would be to impose a return filing requirement similar to that currently imposed by the European Union on nonresident sellers of digital content into the EU.[235] The questions are whether the potential loss of revenue from failure to tax this activity at source would justify the burdens of imposing this kind of a requirement on foreign sellers and whether the requirement would be enforceable.

Historically, the United States has taken the view that, as a substantial exporter of goods, services, and capital, it disfavors source taxation. In our analysis, we have not discussed the effects of our suggested changes on the division of income among nations. Instead we have examined the issue from the perspective of the structure of the statutory U.S. international tax regime. The United States, however, may, and should, continue to agree to reciprocal reductions in source taxation by entering into treaties. Thus, any change to enhance the U.S. source taxation of active income presumably would be subject to treaty relief, but would protect against use of nontreaty jurisdictions to earn U.S. source income tax-free in the U.S. market.

We submit that increased source taxation of foreign-based activity targeted at the U.S. market is justifiable and feasible. The question is whether it is in the overall U.S. economic interest. It is time for U.S. international tax policymakers to reanalyze these issues.

V. Outbound Taxation: Mitigating International Double Taxation Without Providing an Incentive for Foreign Investment

As discussed above, the United States generally asserts extraterritorial taxing jurisdiction over U.S. persons and taxes the worldwide income of its citizens, residents, and domestic corporations.[236] This extraterritorial system for taxing U.S. persons creates the potential for

[235] Council Directive 2002/38, 2002 O.J. (L 128) 41.

[236] Cook v. Tait, 265 U.S. 47 (1924); see Gustafson, Peroni & Pugh, note 17, at 14-15, 30, 32-34. This is consistent with international norms. Adrian Ogley, The Principles of International Tax 23 (1993) ("[t]he majority of countries impose tax on the worldwide profits of resident companies.").

international double taxation as both the United States and the foreign country of source seek to tax a U.S. person's income from activities and investments conducted abroad. The United States provides relief in the form of a credit for foreign income taxes imposed on foreign source income.[237] Accordingly, the major function of the source rules in the outbound context is to help delineate the proper scope of the unilateral double taxation relief granted through the U.S. foreign tax credit. In effect, the source rules "define the circumstances under which the United States is willing to concede [sic] primary jurisdiction to a foreign country to tax U.S. citizens and residents on income earned by them in that foreign country."[238] Thus, the design of the foreign tax credit source rules should be consistent with this purpose. Stated differently, the source rules in the outbound context should treat a U.S. person's income items as derived from a foreign source only in situations where double taxation relief with respect to such income items is appropriate.

The United States and many other countries have chosen the foreign tax credit as the principal unilateral mechanism for mitigating international double taxation.[239] The foreign tax credit mechanism is used in part because it is substantially consistent with capital export neutrality,[240] still the prevailing norm in the U.S. international tax system.[241] In one important respect, however, the U.S. foreign tax credit

[237] IRC § 901.

[238] 2 Treasury I, note 65, at 364. This also would be the case if the United States chose to mitigate international double taxation by adopting an exemption system because such systems exempt only foreign source income.

[239] IRC §§ 901-903. In practical effect, there may be little difference between worldwide taxation subject to a credit for foreign income taxes and an exemption system where the foreign effective tax on an item or grouping of foreign source income is equal to or greater than the U.S. tax on the same income. Where the foreign tax is lower than the U.S. tax, efficiency and fairness considerations favor use of a foreign tax credit over an exemption system. For a discussion of the issue of fairness and the foreign tax credit, see Peggy Brewer Richman, Taxation of Foreign Investment Income: An Economic Analysis 13-15 (1963); Fleming, Peroni & Shay, note 34, at 328-33.

[240] E.g., Gustafson, Peroni & Pugh, note 17, at 18-19, 255. We have argued elsewhere, however, that regardless of the relationship between the foreign tax credit and capital export neutrality, the foreign tax credit is superior to an exemption system because the foreign tax credit does not provide U.S. residents with an incentive to invest in low-tax foreign countries whereas an exemption system has precisely that effect. See Fleming, Peroni & Shay, note 34, at 342-44; see also Robert J. Peroni, Deferral of U.S. Taxation on International Income: End It, Don't Mend It—Why Should We Be Stuck in the Middle With Subpart F?, 79 Tex. L. Rev. 1609, 1613-14 (2001).

[241] The U.S. international tax system is a hybrid system, which primarily follows capital export neutrality but has significant elements that reflect capital import neutrality, e.g., IRC §§ 871(b), 882 (rules for taxing foreign persons at source on U.S. business income), § 911 (foreign earned income exclusion for U.S. individuals), and even national neutrality, e.g., IRC § 901(j) (denial of the foreign tax credit for certain foreign income taxes), § 908 (reduction of credit for participation in or cooperation with an international boycott).

deviates from complete conformity with capital export neutrality. If a foreign country imposes a foreign tax in excess of the U.S. tax rates, strict adherence to capital export neutrality would hold that the United States, as the country of residence, should grant a full refundable credit for the foreign tax. The United States and other foreign tax credit countries do not, and should not, follow such a policy. This is because a foreign tax credit that involved sending refund checks to U.S. residents for the amounts by which their foreign tax liabilities exceeded U.S. tax on their foreign income would encourage foreign countries to impose high foreign taxes on U.S. taxpayers without having to suffer the consequences of losing inbound direct investment because of high taxes in excess of the world norm.[242] In effect, the U.S. fisc, and not the U.S. taxpayer, would bear the portion of the foreign tax in excess of the U.S. rate. Allowing such an unlimited foreign tax credit would lead to an erosion of U.S. taxing jurisdiction over U.S. source income since the effect would be the same as if the foreign tax credit offset U.S. tax on the U.S. taxpayer's U.S. source income.[243] This would be an unacceptable result because the purpose of the foreign tax credit is to alleviate the double tax burden on foreign-source income, not to eliminate U.S. tax on U.S. source income.

Accordingly, the United States limits the credit to an amount that equals the U.S. tax on foreign source income in the same income category.[244] This prevents the credit from offsetting U.S. tax on U.S. source income.[245] In this sense, the foreign tax credit limitation preserves U.S. sovereignty to tax U.S. source income. Additionally, by breaking up the limitation into different categories of foreign source income, the foreign tax credit limitation prevents the U.S. person from cross-crediting high-taxed foreign source income in one category against low-taxed foreign source income in another category.[246] By doing so, the foreign tax credit limitation preserves U.S. sovereignty to impose a residual tax on its residents' low-taxed foreign source income.[247]

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[242] E.g., Green, Troubled Rule, note 68, at 128; see also Gustafson, Peroni & Pugh, note 17, at 351-52.

[243] E.g., Gustafson, Peroni & Pugh, note 17, at 351-52; Green, Troubled Rule, note 68, at 128.

[244] IRC § 904(d); see generally 1 Joel D. Kuntz & Robert J. Peroni, U.S. International Taxation ¶ B4.16 (1992) (discussing § 904 limit on use of foreign tax credits).

[245] See, e.g., Gustafson, Peroni & Pugh, note 17, at 351-52; Alan R. Rado, United States Taxation of Foreign Investment: The New Approach 49-52 (1963); Richman, note 239, at 48.

[246] E.g., Gustafson, Peroni & Pugh, note 17, at 357-62; 1 Kuntz & Peroni, note 244, ¶ B4.16[5][a], at 200-01.

[247] The foreign tax credit limitation also should provide a signal to the source country as to what is an acceptable assertion of source taxation. Source taxation that is inconsistent

As noted above, the proper purpose of the foreign tax credit is to mitigate international double taxation and prevent such double taxation from interfering with efficiency enhancing cross-border transactions. It is the tax system's attempt to ensure that multiple jurisdictions seeking to impose their full taxes on the same income do not hinder the comparative advantage economic theory that supports free trade. Accordingly, the foreign tax credit and its associated rules for determining the source of income and deductions for purposes of limiting that credit should be aimed at providing double taxation relief with respect to foreign source income and should not be designed to subsidize foreign investment, favor or disfavor particular types of investment, or serve nonrevenue raising foreign policy objectives.

The proper scope of relief under the U.S. foreign tax credit limitation, thus, requires identifying income by source (and category) (under U.S. tax law principles unless a treaty applies).[248] Nowhere has the myth of source had a broader impact than on the foreign tax credit limitation. The generalized statement of the U.S. foreign tax credit regime is a credit for foreign taxes on foreign source income up to the amount of U.S. tax on foreign source income in the same category. The source rules for income and expense items are a critical measure of the scope of foreign tax credit relief.[249]

Acknowledging the arbitrariness of many source rules, what principle should govern the design of the foreign tax credit limitation? Clearly, it has become an accepted international norm that the residence country should give primacy to taxation by the source country,[250] but it also is accepted that this obligation does not require erosion of the residence country's power to tax domestic income.[251]

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with the international consensus for the division of taxing jurisdiction over income should not be eligible for a foreign tax credit or other unilateral double taxation relief.

248 See IRC § 904. Under an exemption system, the exempt income is income permitted to be taxed by the other country. In both cases, it is necessary to determine the taxpayer's expenses that are allocable to the income in question.

249 This Article does not discuss or take a position on other important issues relating to the proper scope of foreign tax credit relief, including the debate over whether relief should be limited to taxes meeting the standards of the regulations under § 901 and foreign taxes "imposed in lieu of" generally applicable foreign income taxes under § 903 and whether such relief should be denied for so-called soak-up taxes. For a discussion of these issues, see generally Glenn E. Coven, International Comity and the Foreign Tax Credit: Crediting Nonconforming Taxes, 4 Fla. Tax Rev. 83 (1999); Joseph Isenbergh, The Foreign Tax Credit: Royalties, Subsidies, and Creditable Taxes, 39 Tax L. Rev. 227 (1984); Karen Nelson Moore, The Foreign Tax Credit for Foreign Taxes Paid in Lieu of Income Taxes: An Evaluation of the Rationale and a Reform Proposal, 7 Am. J. Tax Pol'y 207, 224-47 (1988).

250 See, e.g., Gustafson, Peroni & Pugh, note 17, at 14-15.

251 Again, in the U.S. context, the purpose of the limitation usually is stated to be allowing the residence country to prevent foreign taxes from offsetting U.S. tax on U.S. source income. See text accompanying notes 243-45.

Other countries essentially use a subject-to-tax measure providing double taxation relief only if the income is taxed abroad above a minimum rate.[252] We propose that a similarly purposive approach be taken to the U.S. foreign tax credit limitation. The limitation is fundamentally a measure to protect U.S. residence tax interests, yet it should not impair the objective of mitigating double taxation that acts as a barrier to cross-border investment.

Having constructed an income tax that measures income based on transactions, it is theoretically possible to analyze double taxation relief on a transaction-by-transaction basis. Although the item-by-item approach to applying the foreign tax credit limitation has been rejected as impractical,[253] at a minimum, income not taxed by the source country should be excluded in calculating the limitation.[254] This concept is not novel. For example, certain personal property sales gain realized by a U.S. resident may be treated as foreign source only if it bears at least a 10% foreign tax[255] (although in our view the 10% threshold may be too low).

Under a purposive interpretation of source, the income source rules utilized for double taxation relief need not be symmetrical with those applied for source taxation purposes if the difference relates to the

[252] See Timo Viherkenttä, Tax Incentives in Developing Countries and International Taxation 59-62 (1991) (discussing foreign countries with exemption systems that require taxation in the source country as a condition for exemption). But see National Foreign Trade Council, Inc., The NFTC's Report on Territorial Taxation, 27 Tax Notes Int'l 687, 702 (Aug. 5, 2002) (arguing that such an approach is impractical if a minimum effective tax rate, as opposed to a statutory tax rate, is used to determine whether income has been sufficiently taxed in a foreign country).

[253] E.g., ALI International Project, note 17, at 319-20.

[254] In the usual case, this will result in income items being sourced to the location of the economic activity that generates the income. See 2 Treasury I, note 65, at 365 ("[A]ppropriate source of income rules should allocate income to the place where the economic activity generating that income occurs."). For example, gain from the sale of inventory manufactured in the United States by a U.S. person would end up being sourced to the place of manufacture, the United States, unless the inventory sale was attributable to an office or other fixed place of business in a foreign country and the country imposed a significant income tax on the sale, cf. IRC § 865(e)(1). In the case of income for which there is no clear country of origin of the economic activity giving rise to it, the income should be sourced to the seller's country of residence because that country is most likely to impose a tax on the income. See, e.g., IRC § 865 (the residence-of-the-seller source rule for personal property sales not falling within any of the specific rules). Income that is exempt from foreign taxation by reason of a U.S. income tax treaty should be treated as U.S. source income for purposes of the foreign tax credit limitation. See Julie Roin, Rethinking Tax Treaties in a Strategic World with Disparate Tax Systems, 81 Va. L. Rev. 1753, 1775 (1995) (recommending that income of a U.S. person that is exempt from foreign tax under a U.S. tax treaty or benefiting from treaty-based source tax reduction be placed in its own foreign tax credit limitation category).

[255] IRC § 865(e)(1)(B).

objectives of source taxation and the foreign tax credit.[256] Thus, for purposes of the foreign tax credit limitation, the foreign source portion of the income from an inventory sale under §§ 865(b), 863(b), 861(a)(6), and 862(a)(6) would not be treated as foreign source income if the sale were not subject to a specified minimum foreign tax. This proposal would prevent a U.S. taxpayer from manipulating the place of title passage in order to produce untaxed foreign source business income for cross-crediting with other high-taxed foreign business income.[257]

We acknowledge that this approach to determining source presents administrative difficulties. It is not easy to determine whether a particular item of income has borne the minimum level of tax. First there are questions of tax incidence, that is, who is the actual taxpayer with respect to the tax paid. For this purpose, as well as for allowance of a credit under § 901, the nominal taxpayer would be respected as the actual taxpayer for purposes of applying the minimum foreign tax test. We would permit deviation from the technical taxpayer approach in cases where the two tax systems did not mesh for this purpose, for example, in the case of conflicting classification of persons or income.

A second problem with a minimum-level-of-tax test is that it requires a foreign law analysis to determine how an income item is taxed in the source jurisdiction. This necessitates a level of inquiry exceeding that currently required under the § 901 regulations to determine what is a creditable tax. A third issue is the allocation of expenses.[258] Finally, there must be a decision regarding the effects of

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[256] One leading commentator, however, has argued that "source rules that are not reciprocal, that do not treat U.S. and foreign taxpayers the same way, inevitably lead to inappropriate double taxation or under taxation." Andrus, note 6, at 843 (pointing to the source rules for international communications income as an example of source rules having this effect). The authors of the ALI study on international taxation take a similar view:

> Under current law, a single set of source rules is generally applied both for purposes of delimiting U.S. taxing jurisdiction over foreign taxpayers and limiting the foreign tax credit. As a general proposition, this approach seems conceptually correct. If a source rule used to define U.S. taxing jurisdiction over foreign persons specifies that an item of income has a U.S. source, then it would clearly seem necessary for the U.S. to give a credit for a foreign tax imposed by another country applying the same rule in determining its own source-based taxing jurisdiction. If the U.S. would tax the income in the case of a foreign taxpayer, it should logically respect a foreign country's assertion of its source-based jurisdiction over income in the reciprocal situation. Thus, presumptively at least, the "inbound" and "outbound" source rules should be the same.

ALI International Project, note 17, at 348-49. We respectfully disagree.

[257] See 2 Treasury I, note 65, at 365 ("Because the place of title passage may be arbitrarily determined by affected taxpayers, the existing [title-passage] rule permits artificial manipulation of the foreign tax credit limitation and the U.S. tax base.").

[258] See Andrus, note 6, at 847.

foreign law loss carryforwards and carrybacks and of currency translations on determining whether the minimum tax test has been met with respect to an item of income.[259]

For these and other reasons, one leading commentator argues that source rules should be "based on reasonable expectations about the tax rules likely to be applied in other countries."[260] Such an approach for designing the foreign tax credit limitation source rules leaves substantial room for cross-crediting or averaging, at least in the absence of a per-country limitation on the foreign tax credit. Before taking that path, we believe that there should be a thorough investigation of the feasibility of constructing foreign tax credit limitation source rules that generally treat income as foreign source only where a foreign country imposes a significant tax on such income in the proper exercise of its source-based taxing jurisdiction in accordance with international norms.[261]

One additional point is clear. Source rules in the context of the foreign tax credit limitation must contain some type of look-through rule (or special resourcing rule) with respect to income earned through foreign entities.[262] Although such a rule adds considerable complexity to the design of the limitation, they are necessary in order to preserve its integrity. Without look-through rules, a U.S. taxpayer can route U.S. source income through a foreign corporation and thereby convert U.S. source income into foreign source dividend income if a place-of-incorporation test is used for determining the source of dividend income.[263]

Finally, two additional important points deserve mention. In designing the source rules for U.S. persons for purposes of the foreign tax credit limitation, one must keep in mind the essentially inverse relationship between the restrictiveness of the source rules for U.S. persons and the contours of the basket limitations for foreign tax credit purposes.[264] Source rules for U.S. persons designed to allow easily manipulable income that is not taxed by a foreign country to be

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[259] See id.

[260] Id. at 843.

[261] Double taxation relief is inappropriate if a foreign country's assertion of source-based taxing jurisdiction is inconsistent with international norms. ALI International Project, note 17, at 348 ("[G]enerally speaking the relief of double taxation through the foreign tax credit mechanism is only appropriate in situations in which a foreign country is asserting a jurisdiction to tax that is reasonable by U.S. standards."). In cases where the United States decides to cede primary taxing jurisdiction to a foreign country over income that the foreign country treats as domestic source income but that the United States treats as U.S. source income, the bilateral treaty process and not the unilateral foreign tax credit mechanism, should accomplish that result. Id. at 347, 349.

[262] See, e.g., IRC § 904(g).

[263] See, e.g., ALI International Project, note 17, at 349, 407-21.

[264] Id. at 348.

treated as foreign source income, intensifies the pressure on the strictness of the foreign tax credit limitation.[265] Conversely, source rules properly designed to treat only income that is properly subject to significant tax by a foreign country as foreign source income reduce the pressure on the foreign tax credit limitation.[266] Accordingly, future revisions of the source rules and limitation rules should be coordinated to reduce the opportunities for cross-crediting more than has been done in past international tax reform efforts.[267]

The last point relates to the proper design of the foreign tax credit limitation.[268] If the foreign tax credit limit is calculated on an overall basis, rather than on a per-country basis, a U.S. taxpayer in an excess credit position with existing investments in a high-tax foreign country has an incentive to shift other investments to low-tax foreign countries. This would allow the U.S. taxpayer to offset (that is, cross-credit or average) the foreign taxes in excess of the U.S. rate in the high-tax country against the residual U.S. tax on the foreign source income earned in the low-tax countries. A basket limitation system, such as current § 904(d), places most types of foreign business income (other than financial services income and shipping income) in the same general limitation or residual category and thereby preserves extensive cross-crediting opportunities.[269] Indeed, the expansiveness of U.S. foreign source income rules and the cross-crediting permitted with respect to most active foreign business income has expanded the foreign tax credit limitation artificially to the point that the U.S. foreign tax credit system is more generous to taxpayers than a traditional exemption system.[270] A per-country limitation would eliminate this incentive for tax-motivated locational decisions with respect to business and investment activities and is more consistent with the basic policy of the foreign tax credit to mitigate international double taxation.[271]

[265] Id.

[266] Id.

[267] See id.

[268] A detailed discussion of the proper design of the foreign tax credit limitation is beyond the scope of this Article.

[269] IRC § 904(d)(1).

[270] Harry Grubert & John Mutti, Taxing International Business Income: Dividend Exemption Versus the Current System 12-13 (2001); Fleming, Peroni & Shay, note 34, at 339-40; Robert J. Peroni, The Proper Approach for Taxing the Income of Foreign Controlled Corporations, 26 Brook. J. Int'l L. 1579, 1586 (2001).

[271] E.g., 2 Treasury I, note 65, at 360-63; Robert J. Peroni, Back to the Future: A Path to Progressive Reform of the U.S. International Income Tax Rules, 51 U. Miami L. Rev. 975, 995-96 (1997).

VI. Conclusions

Our examination of source rules confirms that although taxation at source has a robust normative foundation, the source rules that implement this form of taxation lack a strong theoretical or prescriptive content. Source rules are simply devices to describe the income that either should be taxed at source pursuant to normative taxation criteria or taken into account in implementing the rationale of the foreign tax credit limitation. Thus, the content of any particular source rule should relate to the rule's purpose and not to debates over geographical origin.

Source rules are central in the U.S. source taxation of foreign persons. In this context we conclude that source taxation is justified as a charge for use of the U.S. physical, legal, and/or economic infrastructure. This theoretical justification for source taxation extends to portfolio as well as direct investment into the United States. We also conclude that taxation of net business income at the same progressive rates applicable to U.S. residents is the best alternative.

With respect to the principles that should guide the structure of U.S. source taxation, we observe that source taxation of nonresidents on their U.S. business income is important to preserve the perceived legitimacy of residence-based taxation of similar activities carried on by U.S. persons. Specifically, we suggest that a need for "perceived parity" requires a level of effective source taxation comparable to that imposed on residents engaged in the same activity. As a country whose residents invest abroad, the United States also has strong reasons to resist excessive or discriminatory taxation of nonresidents. Accordingly, we argue that U.S. source taxation should not discriminate in substance against foreign investors. In this regard, however, we would take account of the actual tax position of foreign owners of U.S. entities in evaluating whether there is discrimination in fact in taxation of a U.S. entity. The formulation of source tax rules also should take account of geographical limitations on the source country's jurisdiction to enforce. Applying these principles to source rules for services and royalties, we find that the rules are in some respects over- and underinclusive in the income treated as U.S. source.

Our analysis leads us to reevaluate the current scope of U.S. taxation at source. In the absence of a treaty, the objective of the U.S. source taxation regime should be to achieve parity in taxation of U.S. and foreign-owned businesses carried on in the U.S. marketplace and to impose a desired level of taxation on income earned by foreign-owned capital employed in the U.S. marketplace. Treaties should extend relief from source taxation in order to obtain reciprocal benefits and the treaty partner's assistance to assure that treaty benefits are realized by appropriate persons. It is time to consider whether reciprocal treaty exemptions should replace the current U.S. unilateral exemption of portfolio interest and gains on the sale of large stock holdings. We also suggest that consideration be given to developing mechanisms to tax at source income from U.S. sales of goods and services by remote sellers, subject to relief by treaty.

We also conclude that source rules for double taxation relief need not be symmetrical with source rules for source taxation purposes if the differences reflect the different objectives of the foreign tax credit and source taxation. In the light of the purpose of double taxation relief, we suggest that source rules only treat income that is taxed by the foreign country as foreign source. We disfavor source rules, such as the inventory source rule, that would treat income that is not taxed by foreign countries as foreign source and, in effect, provides an incentive for exports only for taxpayers with excess foreign tax credits. We find that the importance of source rules is related to the scope of the cross-crediting allowed under the foreign tax credit limitation employed.