Reflections on Some Small, Medium and Large Design Issues with Income Source Rules in International Taxation

Mitchell A. Kane

It is difficult to find vocal defenders of current instantiations of source rules in international taxation. As a category, source rules would seem to reflect an assertion of tax jurisdiction -- namely on a principle of territoriality -- which lacks a firm and universally agreed normative basis. Worse, even under the best articulation of an assumed normative basis of territorially-based taxation (likely some variation of a benefits theory), the existing rules seem to mismatch the normative base in substantial (and irremediable) ways. Worse yet, within the category of source rules, we encounter a range of categorizations that bump up against one another, allowing taxpayers substantial flexibility in substantive outcome based on how they arrange their affairs to achieve one characterization or another. Nor do these problems reflect, as is often the case in disputes about international taxation, the views of some subset of losing countries in a zero sum game. Note, for example, that complaints seem to arise across the range of both developed and developing countries, even though such countries frequently have adverse interests in the setting of international tax policy. Thus developing countries often seem aggrieved by the way current instantiations of source taxation ascribe to them what they view as insufficient tax base. For their part, developed countries may find that under current approaches taxpayers have too much flexibility in sourcing income to jurisdictions that impose little or no tax.¹

One possibility is that the various difficulties with source stem from a basic category mistake, namely that the geographic location of income is not a coherent economic concept because physical location is not a property that can ever properly be ascribed to income (much as Gilbert Ryle famously argued that substance could not properly be ascribed to mind, as under Cartesian dualism). From what I can tell, Hugh Ault and David Bradford were the first scholars

to make this argument. The basic idea is that the normative income base under Schanz-Haig-Simons at most implicates the geographic location of individuals (as either representative consumers or savers) but not the geographic location of income. Moreover, this supposed category mistake has been specifically identified as the ostensible culprit responsible for the incoherence of the current particular instantiation of source rules. The category mistake argument has gained substantial traction in the literature. That is not to say that endorsement is universal. Scholars thus continue to publish work which would seem to be premised on the notion of rationalizing source rules based on a more thorough-going and consistent treatment of source determinations and economic fundamentals. One might also observe that for a concept that is supposed to have no economically determinate meaning, very prominent economists continue to use the concept of "source" in a way that admits of at least some nonproblematic applications.

If the category mistake argument is correct, this does not mean, of course, that there is no functional role for the concept of "source" in the international tax system. But it does mean that "source," and the rules implementing that concept, would be reduced to distributional rules
only (and there would be little point in tinkering with the source rules at the margin in an attempt to make them sounder reflections of the location of income). By attributing “source” what we would mean to do (and all that we would do) is identify the jurisdiction which will claim the tax receipts with respect to a certain stream of income. And, perhaps as importantly, where the jurisdictions agree on the source determination we would simultaneously identify (either through the operation of a foreign tax credit or exemption method) the jurisdiction which will not claim a right to tax the receipts of income. Note that such a distributional exercise does not require associating some geographic location with a stream of income, which would implicate again the category mistake. It requires only pairing the stream of income with a sovereign recipient of the tax revenues. In practice that may often evolve into an exercise that comes to resemble one premised on identifying geographic location of the income. It is natural to think that if the income “belongs” to the jurisdiction in a determinative geographic sense, then the revenue generated from the taxing of such income likewise belongs to such jurisdiction. But this goes to the normative justification of particular instantiations of source rules, rather than the basic functional point of the source concept as an inter-nation distributional mechanism in the first instance. After all, even if one can overcome the category mistake critique and positively associate income with a jurisdiction in a geographically determinative sense, this still would not really answer the inter-nation revenue sharing question without further normative argument. One can certainly imagine alternative normative bases for sharing. Suppose that one jurisdiction in a two jurisdiction case is relatively wealthy and is the location of most factors of production. The two jurisdictions could well agree to write a “source” rule that allocates to the poor jurisdiction the taxing rights to income from factors of production that seem to be squarely located in the wealthy jurisdiction, even if one’s best assessment of where such income is located in a

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7. For an extended development of this distinction between source of income as geographical determination versus source of income as jurisdictional determination, see Shay, Fleming, and Peroni, *What's Source Got to Do With It?*, supra note 4, at 138-46.
geographic sense is in the wealthy jurisdiction. Perhaps the wealthy jurisdiction endorses this approach on welfarist grounds (taking some account of the utility of the individuals in the other jurisdiction) and views the distribution of income through a source rule as preferable to collecting the income in the first instance and then transferring it under its spending power.

My immediate point here is not to forward any particular argument regarding the optimal sharing rule. Quite to the contrary, I believe this implicates political preferences regarding internation distribution which are impossible to say much about on an a priori basis. My point is a different one. If “source” has no content other than as a distributional rule, there would seem to be little merit in scholars addressing source rules analytically at all. The best one could do is to observe that conditional on some preferences about utility weights across jurisdictions and limits on direct transfers across countries, source modifications can be second best optimal solutions to dealing with international distributional issues. What I would like to suggest in this comment, though, is that there is in fact still substantial analytical work to be done regarding source. I divide the discussion into three parts, what I will refer to as the small, medium, and large problems of source. The first part concerns a doctrinal distinction which has not drawn much prior attention -- the distinction between domestic systems that embody stand-alone source rules versus domestic systems that pair the source determination with the question of allocation of tax base across jurisdictions. Here, I suggest the doctrinal choice has important implications for likelihood of double taxation, in both a static and dynamic sense, where countries make divergent unilateral base determinations. The second part addresses the limits of the category mistake argument and thus attempts to carve out space for incremental improvements to existing source rules, where “improvement” here is to be understood as implying more than simply an

8. Cf. Michael P. Devereux & Peter Birch Sørensen, The Corporate Income Tax: International Trends and Options for Fundamental Reform, EUROPEAN COMMISSION ECONOMIC PAPERS NO. 264 at 20 (“[I]f direct transfers among governments are not feasible, it may be second-best optimal to use distortionary source-based taxes combined with subsidies to capital exports to shift tax bases and fiscal resources towards ‘fiscally needy’ countries which are poor and/or which are faced with a high marginal cost of public funds (a high deadweight loss from taxation).”).
improved distribution across countries. The third part addresses the limits of how one could view the function of “source” determinations as efficiently sub-dividing an income tax base along the axes of normal versus supernormal returns to capital and mobile versus non-mobile capital. The basic argument advanced here is that different parts of the base ideally receive different treatment (both as to level of tax and jurisdiction levying the tax) and that optimal source rules under an income tax should seek to draw the relevant distinctions.

I. Small Problems with Source: Coupling or Decoupling Source from Base Allocation

In drafting source rules one faces an initial doctrinal issue regarding the question whether the rules should appear as standalone constructs or whether the source determination, rather, should be embedded in the doctrinal provisions regarding income allocation across jurisdictions. The U.S. source rules notably take the former approach. Thus the rules in sections 861 through 865 of the Internal Revenue Code attribute U.S. or foreign source to various net income streams, dependent on categorization of gross income, various relevant factors considered under those categories, and the rules (largely spelled out in regulations) regarding the allocation and apportionment of expense. The resulting source determinations by themselves have no standalone effect for substantive tax liability, either for inbound or outbound situations. In order to determine tax significance one must apply the source results to rules on substantive tax liability, either the effectively connected or FDAP rules for the inbound case, or under the foreign tax credit in the outbound case. Other jurisdictions often take a different approach, coupling the source and allocation determinations into a single doctrinal inquiry.9

What I would like to suggest here is that there is more at stake in this design issue than might meet the eye. This is not merely a mundane question, that is, about statutory drafting and the separation (or not) of source and allocation rules across code sections. The doctrinal

9. See, e.g., EStG sections 34c, 34d, 49.
significance is that the U.S.-style approach conceives of the problem as a discrete two-step analysis: (i) determine source and (ii) determine base allocation. Other jurisdictions conceive this as a single doctrinal step: determine “source and base allocation.”

I would initially observe that the choice of approach here likely has bearing on how one greets the basic category mistake argument. That argument is likely to gain more traction in a system with the U.S.-style approach, with its attempt to make source determinations, in the first instance, in a vacuum. Indeed, if you were to tell a colleague steeped in the other approach that there is no need to worry about the economic indeterminacy of the geographic location of income because the real nature of the exercise is about jurisdictional base allocation, you are likely to receive the bewildered look of somebody who is made privy to a novel “insight” that he or she has understood all along and never questioned. On the other hand, if the arguments presented in parts II and III below (which attempt to show that there is more at stake than the bare distributional base allocation question) have merit, then the bundled source/allocation approach may tend to obscure the relevance of these points.

Under existing international norms source-based income taxation incorporates a central distinction between active and passive income. That distinction has important consequences for the issue under discussion here, which is the way in which source determinations may or may not be bundled together with broader questions of base allocation. For passive income the source/allocation question essentially collapses, as the determination of source will generally have the following consequences: accepted right of the source jurisdiction to tax the income (typically through a gross basis withholding regime) and the granting by the residence country of either an exemption or credit for withholding taxes paid. For active income the determinations are much more complicated. Here, one generally confronts, in addition to the narrow question of “source,” issues related to threshold (i.e., does the active business activity surpass a minimum threshold to become taxable); what factual connection is required between local source income
and the minimum business activity that surpasses the threshold in order to generate tax liability; what sort of factual connection is required in the case of income that is sourced to some other jurisdiction; and how does one deal with deductions (given that taxation of active income is generally on a net basis rather than a gross basis). In the treaty context this series of issues undergoes a substantial degree of coordination through the agreed terms of the treaty. This generally occurs through the operation of treaty articles on permanent establishment and attributable business profits. Where such coordination is in place the issue regarding one-step or two-step doctrinal analyses for source and allocation questions takes on substantially less importance. Where one lacks such coordination, however, (which will be the case either where there is no treaty or where there is substantial disagreement about what the treaty requires under domestic law), then the issue about one-step versus two-step analysis takes on increased importance regarding the way in which countries unilaterally approach the issue of discordant views on allocation of tax base.

As a general matter one can expect the two-step approach to lead to fewer instances of double taxation in a static sense, though perhaps not in a dynamic sense. The basic fact pattern of concern here is where the residence jurisdiction, under a two-step analysis, identifies income to be foreign source, but would not under its own law regarding inbound transactions find that the threshold requirements are met (or perhaps that the threshold is met but that the income is not allocable to the local business). In such a case the residence jurisdiction would not tax reciprocal flows in the inbound case but because of the foreign source determination will generally grant double tax relief, either through the operation of a foreign tax credit or an exemption. By contrast, jurisdictions that apply a unified analysis of source and allocation essentially condition the grant of double tax relief on the adoption of their domestic standards regarding threshold and factual connection. Thus if the residence jurisdiction would under its single step analysis allocate income to itself, then this will generally preclude the availability of
either an exemption or credit. In this way the prospects for double taxation increase. The static-dynamic distinction is important, however. The source jurisdiction that seeks to increase revenues by adopting lower thresholds for active business taxation or more expansive attribution rules is essentially imposing an incremental tax on the activity, given the absence of double tax relief. This may well drive capital away.\textsuperscript{10} Essentially, this is just a case of tax competition, though with respect to base rather than rate. Standard tax competitive pressures may induce the jurisdictions to conform base in ways that are likely to give rise to double tax relief from residence jurisdictions applying a one-step analysis to base allocation.

II. Medium Problems with Source: Incremental Improvements to Source and Closed Economy Analogs

In this second part I would like to explore the limits of the category mistake argument and how the nature of such limits might bear on how one views modifications to source rules such as those in the U.S. on the margin. My working hypothesis is that while the category mistake argument may explain certain frailties in the source rules, the claim that geographic location of \textit{income} is not a well-defined economic concept is actually \textit{not} at the root of many issues and complications we face with source rules. The argument in defense of that proposition has two aspects. The first is that there actually is some core way in which source of income is coherent as a geographic concept. The second is that once we focus on this core concept we will see that many of the perceived problems with source rules can be seen as having closed economy analogs, thus refuting the claim that the fundamental problem is with the conceptual incoherence of geographic source of income determinations.

I am not exactly sure what it would mean for source to be an economically well-defined concept. But to motivate the inquiry, I propose to work with a distinction between cases that are

\textsuperscript{10} The conditional claim is appropriate because the other possibility is a clientele effect, where the jurisdiction disproportionately attracts capital from a jurisdiction that will grant tax relief under a one-step analysis.
pure coordination games versus cases that are not pure coordination games. The position that takes source to be an ill-defined economic concept regarding income would seem to view the issue as a pure coordination game, along the lines of the old "which side of the road to drive on?" problem. In such a game we know that coordination is better than no coordination, and we also know that the substantive outcome (drive on the right or left/residence or source country tax) is purely a feature of positive law. Arguments about the "correct" side of the road to drive on or the "correct" country to tax, which transcend positive law in favor of some pre-legal economic argument, would simply be a huge waste of time. Further, on this view the fact that some number of scholars and policymakers sit around attempting to have precisely that useless discussion before drafting, or modifying, or interpreting the source rules is precisely to blame for their supposed sorry state. But are matters really as bad as all that?

I would like to draw an initial distinction here and suggest that we might be able to produce two basic principles of source which are in some sense not wholly determined by positive law. Again, I am not sure this would satisfy an economist's conditions for something to be well defined. What I have in mind, though, is a fairly simple claim. It is a coherent and sensible course to search for consensus, even if only baby steps towards coordination, across countries on the basis of some principles connected with the economic definition of income (the "origin" of which I will happily leave unspecified) that is not itself an output of substantive source rules. Because my focus in these comments is on the connection between source and an income tax, we can begin by separating out the labor income tax component and the capital income tax component of a comprehensive income base. Regarding the labor income tax component, then, I would suggest that we have, at least in the first instance, something like a pure coordination game. This is the Ault-Bradford category mistake argument at its strongest. Consider an individual who lives near the border of country A and country B, working at a factory in the former and consuming all wages in the latter. Assume no other labor or capital
income.

There is absolutely nothing in the Schanz-Haig-Simons definition of the income base which could help us answer the question in which jurisdiction the income arises. This, of course, is just the old origin versus destination question under a consumption tax. There may be good administrative reasons to favor one or the other (relating to matters such as border adjustments, transfer pricing, and transition) but none of those issues have anything at all to do with the economic (pre-legal) determination of the extent of the base. But how much does this indeterminacy shed light on the state of the source rules? Perhaps not that much.

Let’s begin with the articulation of my first principle, which is that conditional on a choice about whether to coordinate the labor income tax component on an origin or destination basis, one will be able to identify some substantial consensus regarding the location of either the production of labor income, or its consumption. And, crucially, such consensus is not a feature merely of the positive legal rules. If I may push the driving analogy one step further, it is like the case where everybody has already coordinated around a rule of drive on the right with two way traffic and conditional on that decision there is good reason to coordinate around a rule stipulating that one-way traffic in a roundabout should move in an anti-clockwise direction. That further rule is not determined by the first rule and one could, of course, coordinate around a drive on the right/clockwise pair. But it is the fact that making everything a left turn in a drive on the right system is a less efficient, and more dangerous, way to move traffic which will lead to a further coordination around the anti-clockwise result.

We can add to this point about consensus conditional on choice of an origin or destination principle the observation that most discussion of source rules will take place in circumstances where this basic origin-destination issue has already been resolved. Moreover, because of practical issues surrounding measurement and collection of the income base (very...
often through employer withholding, for example, in the case of income from wages), there will be, and is, a widespread preference for an origin principle. That is, within the scope of modern income taxes we see no attempt to assess the labor income tax component on a destination basis. (Note that even proposals for formulary apportionment which would include a substantial sales factor are dealing with the entity-level base where labor costs are deducted and still taxed under an origin approach.) To be clear I don’t mean to suggest that we will have universal consensus regarding source determinations for the labor income tax base once we have settled the origin/destination point. As I discuss below, however, I think the class of cases likely to arise can be understood as having closed economy analogs and thus are potential candidates for analysis which does not run aground because of the category mistake point.

We can turn now to the capital income tax component of the comprehensive income tax base. Although some will take a contrary view, I do not think that this portion of the base presents the sort of pure coordination issue that we saw above. Because we deal here with the non-consumed portion of the base, a natural response to the location of such income is the place where the productive capital giving rise to such income is put in place. One could forward an alternative view, namely that the location of this part of the income base is equally indeterminate, with the alternate candidate being the location of the individual saver. This would just replicate the origin-destination dichotomy from above. The situations are not exactly parallel, however. In the first case the question is which of two actions (labor provision or consumption) each of which has relatively determinate physical location ought to take primacy. In the second case we have a distinction between savings and production. But saving is not really an action so much as a non-action -- the decision not to consume (or at least not to consume until later). As such, it would seem to have no physical location, not even an indeterminate one. One cannot spatially locate something that has not happened.  

Perhaps one could take the position that the

12. One might draw a comparison here to the cases in which courts have confronted the issue about how to source income from a covenant not to compete. See, e.g., Korfund Co. v. U.S., 1 T.C. 1180 (1943).
source of capital income could be determined based on the physical location of consumption in some future accounting period. This is a practical impossibility, however. The task at hand is to source the return to capital income in a given period when one doesn’t know the location of ultimate consumption. My supposition is that this pushes matters towards a source rule based on the physical location of productive capital. This leads to my second basic principle, which is neither radical nor new but rather captures, I think, the basic intuitive grasp that people feel with respect to the substance of source of economic income. It would state simply that one will be able to locate some substantial consensus in advance of positive law that the location of income from capital is the place where the capital is deployed.

These two principles may well create more problems than they solve. My point, though, is to focus on the particular types of problem that are likely to arise in the application of these principles -- and to suggest that the sorts of problems are reminiscent of ones we would find under an income tax in the closed economy and thus have little, if anything, to do with indeterminacy regarding geographic location of income. Consider then four discrete types of issues that might arise.

The first type of issue relates to the determination of where labor services are performed within a system that coordinates along an origin approach for income from labor. In the case of labor services with relatively constant value and relatively minor human capital accumulation, source determinations for services should not present substantial issues. Problems are likely to arise, though, where one or both of those conditions does not hold. The problems are familiar from international tax practice. These involve cases such as athletes or performers who may perform very high value services at the point of delivery but also spend a lot of time on preparation and practice. Or, one has similar issues in the learned professions, where people

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13. Observe that one actually generates the same issue even with respect to the labor income tax if implemented in a pre-paid fashion rather than as a cash-flow tax. The implication of this would be that we would expect greater consensus regarding an origin principle under a pre-paid consumption tax.
spend many years accumulating valuable human capital (possibly in one jurisdiction) in advance of service delivery (possibly in some other jurisdiction). Without meaning to understate the difficulty of these problems, I would like to observe only that these are familiar sorts of problems from domestic income tax situations, which must deal with matters such as whether to income average for variable earners under a progressive rate table and the appropriate treatment of human capital accumulation under rules dealing with matters such as the deductibility of education expenses.

A second set of issues relates to the labor/capital line and questions that can arise particularly when the value from labor services come to be embodied in alienable property. Perhaps the paradigm case of this in the source context occurs along the services-royalty dimension. Suppose one has widespread adoption of a source rule for services that looks to place of performance (subject to the complications just mentioned) and a source rule for royalties or licenses of intellectual property that looks to where property is used/protected. When labor services become embodied in something like a patent which is exploited in a remote jurisdiction this creates complicated sourcing problems. These are problems, however, that derive from complication in administration of separating out the relevant components as a practical matter and not because of geographical indeterminacy. And again we confront a similar set of issues under domestic law. One appropriate analog, for example, is the issue that arises in assignment of income cases where one must navigate the line between impermissible assignment of labor income and permissible assignments of income producing property, which may well embody value from services. A second appropriate analog might be the blurred labor/capital line at issue in the carried interest controversy. And a third possible analog is the treatment of receipt of property for services under section 83, particularly in cases such as the grant of non-qualified stock options where the taxpayer holds property and continues of offer services (in theory incentivized by such property) on an ongoing basis.
A third set of issues relates to the distinction between real and financial capital. To the extent one can generate some pre-legal consensus regarding the location of productive capital under my second principle, this will tend to be a consensus about real assets rather than financial assets, the latter of which tend to have amorphous spatial characteristics. In the real world application of sourcing rules, however, it will often be necessary to source flows from financial capital in addition to flows from real capital. This leads immediately to familiar clashes under sourcing rules which attempt to strike some sort of workable balance between administratively feasible rules which apply some arbitrary source determination to financial capital and substantively more accurate rules which attempt to apply some type of tracing or look-through approach. Indeed, I tend to think that arguments that assert the fundamental conceptual weakness of the source concept generally are actually very much grounded in the fundamental conceptual weakness of the concept as applied specifically to deductible payments to holders of financial capital. It does seem true that there is no meaningful way in which a geographically determinate concept of source as applied to interest will be adequate to prevent taxpayers from shifting large amounts of profit to tax favorable jurisdictions through deductible interest payments. But this is not an indictment of the concept of source generally. Moreover, the deep problem is not obviously one about international tax or geography at all. One encounters essentially the same set of problems in a closed economy whenever one has deductible payments from a base that give rise to no offsetting inclusion. The corporate tax presents the most obvious cases of this phenomenon, with age-old problems relating to equity returns converted into some type of payment like interest or salary deductible from the corporate base. To see that the sourcing of interest issue is only one piece of a larger problem of source, which I believe can be

14. See, e.g., Kleinbard, Stateless Income, supra note 1, at 750-51 (describing the norms that define geographic source of income as “largely artificial constructs” but justifying that claim on the basis of artificiality regarding the sourcing of interest specifically); Michael J. Graetz, A Multilateral Solution for the Income Tax Treatment of Interest Expenses, 62 BULL. FOR INT’L TAX. 486, 489 (2008) (offering observation that “as is well known, the ‘source’ of income is not well grounded economically” as prelude to extended discussion of interest expense).
meaningfully analyzed to some extent with concepts of geographical determinacy, observe that even if you “solved” the interest problem for related party taxpayers through some explicitly non-source approach (such as an arbitrary but agreed allocation across countries), one would still need to confront the question of allocation of returns to real capital as between parties contracting at arm’s length. On these questions consensus (pre-legal) views on the physical location of real capital will again be relevant.

A fourth set of issues relates to the identification of ownership for tax purposes. In the source context this implicates the line between sales on the one hand and rents/royalties on the other. Although this is a notoriously problematic area in the source context I would suggest that once again we should view these issues simply as manifestations of the same general set of problems one encounters with tax ownership in the closed economy.

I would conclude this discussion with two general observations. The first is that although I would tend to view many source complexities as generated by essentially non-geographic problems which have closed economy analogs, this is not universally the case. There is a class of cases regarding the deployment of real physical capital which will generate little, or no, consensus under my second principle. Perhaps the paradigm case here is income from “space” income such as that covered by the rules under section 863(d) of the Internal Revenue Code. Where income producing capital, such as a satellite in orbit, is deployed outside the territory of any state, then we are indeed left with a purely arbitrary sourcing questions and something that should be analyzed as a pure coordination game. The second observation is that although I offer in these brief comments no analysis of particular modifications to problematic source rules, I have tried at least to suggest that there is still room for an analytical approach that would seek to rationalize and improve source rules based on principles that transcend the brute distributional consequences of positive law. The way forward for such an analysis would both take seriously

15. For a proposal to coordinate the treatment of interest expense based on worldwide allocation keyed to assets, see Graetz, "A Multilateral Solution for the Income Tax Treatment of Interest Expenses," supra note 14, at 492-93.
accumulated wisdom regarding the closed economy analogs and not introduce spurious discontinuities in seeking to deal with the fault lines identified above.\(^6\)

To close with a concrete example, consider the amendments to the Internal Revenue Code in 1986 which treat gains from sale of property with a contingent purchase price under the royalty sourcing rule. How should one analyze the merits of such a change? One approach, which would basically be premised on the idea that source rules have little independent content, might look something like this. The prior rule which allowed one to source gain from a “sale” with contingent payments on a residence principle but to source gain from a “license” with similar or identical cashflows under a place of use principle would seem to draw a largely meaningless doctrinal distinction, giving taxpayers substantial discretion in the resulting source determinations with certain inter-nation distributional consequences. The question then on the merits of the modification would be analyzed based on the distributional consequences of removing or curtailing taxpayer discretion and applying, in this case, a uniform place of use standard.

A different sort of analytical approach, though, would take the substantive underpinning of the source rules more seriously. It would also draw upon the similarities with the closed economy analogs above. In this particular case, for example, one would observe that this is basically an instantiation of the labor/capital/alienable property problem discussed above. From that perspective each of the sales and royalty rules have some sense, at least as imperfect proxies. A residence rule for sale of intellectual property for a fixed price can be seen as a proxy labor services sourcing rule, with the assumption (surely imperfect) that services have been performed in the jurisdiction of residence. The place of use rule for variable royalties can be seen as instantiating a source rule based on location of capital deployment. This rule is surely also imperfect as it makes no attempt (for sound administrative reasons) to break-out the embedded

labor component and apply the appropriate sourcing rule. With the paradigm cases in mind it would now seem possible to apply a richer line-drawing analysis to the case of a sale with contingent payments. The basic question would be how the contingent payment structure affects the labor/capital character of the taxpayer’s income streams. Consider a numerical example in which the taxpayer has performed labor services which are embodied in zero basis intellectual property which can be transferred for either $100 fixed sum or a contingent stream which will pay either $200 or $0 with equal probability. It would seem that the “correct” way to treat the latter case would be as consisting of $100 income for services plus either a $100 gain or $100 loss from bearing risk associated with the remote deployment of property. From a sourcing perspective it would be administratively very difficult to apply such a rule (because in the contingent payment case neither the taxpayer nor the administrator is likely to have any access to the $100 fixed sum baseline). The current U.S. rule opts for treatment based on a 100% capital model. My suggestion here is that one can analyze the merits of such a rule by inquiring into matters such as the predicted relative capital/labor component on average (thus the current rule comes to seem more accurate as contingent payment streams manifest greater variance) and the relationship to application of the source rules under an actual license/royalty arrangement (which itself is just an approximation). The mode of analysis here also suggests the ways in which one might fine tune the current rule by making its application sensitive to the relevant parameters (like variance), though this obviously comes at the cost of increased administrative complexity.

III. Large Problems with Source

In this final part I would like to consider a different sort of approach to source rules which is rather more ambitious than the way the problem has traditionally been approached. This is an aspirational discussion. Under the norms suggested here current instantiations of the
source rules perform very poorly. As the ensuing discussion should make clear, however, improving matters would be a very complex endeavor.

The general template for discussion attempts to meld the problems of inter-nation distribution and efficient tax base design. Regarding the former I take it to be a central function of any set of source rules to achieve a non-overlapping allocation of the income tax base which is mutually acceptable to the involved jurisdictions on distributional grounds. At the core of the efficiency-based analysis that I offer here is the observation that tax competition plays out differently for different categories of income. We could begin by dividing income into four general categories, each of which suggests a different tax treatment.

The first category relates to the case where the income reflects a location specific rent. In that case it will be efficient for some jurisdiction to tax the rent. In addition it is quite possible that there will be good reason to have the sovereign in respect of which the rent is location specific to tax the rent. The case for this is not on distributional grounds but rather on the ground that the location specific rent might reflect returns to prior sovereign investment (or decisions not to dis-save natural resources). In that case channeling the tax on the rent to the relevant sovereign would be consistent with incentives to generate the rents in the first place. Although this seems to be likely in at least some cases the very concept of a “location specific” rent is sufficiently ambiguous that I do not mean to make the claim, at least not yet, that there is universal correspondence with location of the rent and the proper sovereign to tax.

The second category covers income reflecting mobile (i.e., non-location specific) rents. Here the efficient result would again be for some jurisdiction to tax the rent. But we have no clear answer about who should tax the rent. The incentives argument stated above does not run. There is also a larger problem. General tax competitive pressures will tend to drive the tax on the mobile rent to low or zero levels.

The third category covers what we can think of as mobile non-rents. In that case we are
in the standard tax competition case. It will generally be advisable for jurisdictions not to tax in this case, as the incidence of the tax will simply be shifted to non-mobile factors.

The fourth category covers non-mobile non-rents. Here, there may be a desire to tax some portion of the returns. To the extent that state revenue needs cannot be fully satisfied through the taxation of rents, this will be the appropriate category to tax. There is no efficiency based argument, as in the case of rents, demanding that the jurisdiction where the non-rent arises tax the return. By definition the return is an ordinary one and thus no embedded return reflecting a return to state investment. There may likely, however, be cost savings in an administrative sense from having the local administration collect the tax. We can sum up these categories in the following chart:

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<thead>
<tr>
<th>Is Tax Desirable?</th>
<th>Who Should Tax?</th>
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<tbody>
<tr>
<td>1. Non-mobile rent</td>
<td>Yes</td>
</tr>
<tr>
<td>2. Mobile rents</td>
<td>Yes</td>
</tr>
<tr>
<td>3. Mobile non-rents</td>
<td>No</td>
</tr>
<tr>
<td>4. Non-mobile non-rent</td>
<td>Possibly</td>
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</tbody>
</table>

This categorization gives us another way to think about the conceptual role of “source” in the multi-jurisdictional open economy setting. On efficiency grounds these categories require differential tax treatment. Moreover, the distinctions drawn by these categories are importantly related to geographical concepts, both because one needs to take account of differential mobility, which is fundamentally a spatial concept, and because one needs to take account of the identity of the preferred sovereign to collect the tax. This geographical aspect, however, does not run afoul of the basic category mistake argument. We need only be able to distinguish along the mobile/non-mobile line and the rent/non-rent line.
How might one take these very high level abstractions and bring them to bear upon the design of actual source rules? As a first step I propose that one could analyze the interaction between the source rules and the corporate income tax specifically. This narrowing of the inquiry makes sense because the distinction between rents/non-rents lies at the core of the suggested approach and it is plausible to suppose that at present a great portion of rents in international commerce are earned through the corporate form.

This is something of a departure from the common way of viewing the connection between source rules and the corporate income tax. Thus the relationship between the decision to maintain a classical corporate income tax and the big question of international tax base division has in the past been viewed largely in a structural sense. That is, one has a question about legal forms and whether the basic problem of division operates upon two legally distinct bases or upon a single base. The typical allocation of tax jurisdiction found in treaties accords well with the legal forms of a classical system insofar as the rules of division are premised on distinct corporate and individual bases. Preserving such division in a world of integration is possible but presents a series of technical problems.

What I would like to do here is take a somewhat different approach regarding the relationship between the inter-nation division of the tax base, the rationale for a corporate income tax, and the content of the source rules. Specifically, rather than analyzing the connection between base allocation and the corporate income tax as a structural question, the approach is to inquire for the independent justifications for the entity level tax and then pursue the source/inter-nation allocation question on that basis. This is important, I believe, because one can state different justifications for entity level taxes, and moreover it seems that the approach to source plausibly differs depending on the justification. Put another way, I suggest we

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18. See id.
need to understand the reason underlying entity level taxation first and from there one can analyze the nature of source taxation. If one approaches the inquiry in the other direction, taking source and distribution as a justificatory ground for entity level taxation in the first place then there will be no conceptual space for the approach to source to vary across different theories of the corporate tax. Although I think this is the right way to approach the problem it will not, unfortunately, yield clear prescriptive results regarding the content of the source rules. The problem is twofold. First, even within a given conception of the reason underlying entity level taxation the content of the source rule may be difficult to ascertain. Second, there is no unified view on the proper function of an entity level tax even within single jurisdictions, much less across the range of jurisdictions for which source rules will have operative effect.

In the discussion below I would like to take up two basic justifications for the corporate income tax and consider the implications for the analysis of source. Specifically, I will first consider the justification for the corporate tax as a tax on rents and second consider the justification for the corporate tax as a backstop to the individual tax. I should mention a few clarifying points before turning to that discussion. First, regarding the taxation of rents, one can readily observe that the non-distorting characteristics of a tax on rents is a poor justification for current instantiations of the corporate income tax, which frequently tax normal returns to capital as well.19 Thus in discussions of corporate tax reform one can view rents-based arguments as affirmative arguments to move to a rents only base, as under a cashflow tax or an ACE. My point is somewhat different. As my limited project here is to analyze source within the parameters of the system as it largely stands today (that is, with substantial taxation of normal returns to capital in the corporate sector), I am intent to analyze the role of source in cases where the rents base is embedded in the broader corporate base including both normal and supernormal returns. Second, regarding further possible justifications for the corporate tax

(particularly in the international case), two additional grounds are that the corporate tax can serve as a substitute for user fees for unpriced public goods and that the corporate tax can have desirable political economy aspects to the extent either that economic incidence may be difficult to trace or that legal incidence may be on non-voters.\textsuperscript{20} Regarding the public goods point I think for present purposes it is possible to collapse this into the discussion of rents as unpriced public goods should give rise to economic rent. Regarding the political economy points I do not further discuss this here as it does not provide a sound basis for analyzing the efficiency characteristics of source rules.

1. Corporate Tax as a Tax on Rents. Let’s begin with the case where one seeks to justify the corporate tax as a rents tax. We can then rely on the template introduced above to shed light on the desirable content of the source rules. As mentioned above I propose to analyze this not as if the corporate tax were an \textit{actual} rents tax but rather to consider the efficiency characteristics of the embedded rents piece. To facilitate analysis, though, I will break the discussion into two parts. I will first consider issues that arise were we to have easy access to the rents-only part of the base. Then I will turn to a consideration of the complications of separating out the rents-only part of the base within the confines of a comprehensive income base.

\textit{a. Analysis of Rents Part of the Base in Isolation}

Even with the simplifying assumption that we have ready access to the rents portion of the base, matters are not all that simple from the perspective of source. From an efficiency standpoint we will have eliminated the two categories of mobile non-rents and non-mobile non-rents. That simplifies matters somewhat, but we are still left with two difficult tasks for the source rules. First, ideally the source rules would distinguish between location specific rents and non-location specific rents. Second, we need some explicit sharing rule for the non-location specific rents.

\textsuperscript{20} See id. at 16-17.
Consider, then, the distinction between location specific and mobile rents. As we saw above the basic reason to draw a distinction here is because while it makes sense to tax the rent in both cases, there are good reasons on efficiency grounds to distinguish the two cases with respect to the taxing sovereign. Provisionally, it seems that at least some location specific rents should be taxed by the local sovereign on the grounds of creating good incentives for sovereigns to reap the rewards of investments that generate rents. It also would seem that non-location specific rents, as a class, are more susceptible to tax competitive pressures. Precisely because they are mobile, sovereigns can compete over them, driving tax rates to an inefficiently low level. Thus in this case (and probably only in this case) will it be desirable to write rules that stem tax competitive pressures. 21

So far, then, we have good reason to distinguish mobile from non-mobile rents but how should we actually do so? I think there is an initial conceptual puzzle here about whether it even makes sense to think about these two categories as coherent in a pre-legal sense. Do location specific rents and mobile rents exist as distinct categories prior and independent from our attempts to write rules defining the categories? The chief distinguishing feature between the two categories is that one is subject to tax competitive pressures, because mobile, and the other not. But it is difficult to construct a concept of tax competitive pressures until after one has defined source rules. Tax competition just is taking some action, the result of which is shifting the base to the competing jurisdiction -- that is, shifting the source determination. So we cannot really rely on the criterion of rents subject to competitive pressures versus those not as a criterion to write the source rules in the first instance without the exercise becoming a circular one.

A more promising route is to rely on the distinguishing feature that looks to whether the rent is a return on sovereign investment. This has the advantage that if we define the category in this way then the taxing right is clear. It should be allocated to only that sovereign which made

21. See id. at 22.
the investment. (Thus we could remove the qualification in the chart above stating a conditional preference for the local sovereign.) This seems conceptually sound in the way the tax competitive approach is not. But it is also a very difficult task. This is greatly aggravated by the fact that one must consider the source question of the rent on a net rather than a gross basis. That is, we need source rules for both gross income and deductions. This will put pressure on even seemingly non-controversial cases of local non-mobile rents. Perhaps the paradigm case is natural resources, which looks like it could generate a non-mobile rent. But on net basis assessment matters become complicated. Suppose that a sovereign has natural resources in the ground which at some point in time are not economical to extract. Then through some combination of technology developed in one jurisdiction, skilled services of individuals trained in a second jurisdiction, and low cost labor in the jurisdiction where the natural resource is located it becomes possible to extract the resource and earn pure economic profit. Is this a location specific rent? It would seem at least in part that it is. But if we are following the approach of defining location specific rents as those which reflect sovereign investments then this becomes nearly impossible to implement through a workable source rule. How exactly would one define the respective shares of these contributions? In theory, perhaps, the answer should be based on proportionate cost but there will be absolutely no access to such information.\footnote{One could further develop all kinds of difficulties here. Is the person who makes technological discovery the product of first class educational system or one-off genius. Is the cost contribution where the resource is located an opportunity cost? How would one go about defining that?} It would also flip traditional thinking on its head (not that this is necessarily a bad thing) insofar as systems generally approach the problem first with a rule for sourcing or allocating gross income and then associate taxpayer costs with this. A cost based approach here would source part of the net stream on the rent to jurisdictions that had incurred costs making this possible.

Suppose one could successfully establish some set of source rules that drew categories of location specific versus mobile rents. Now we would expect that tax competition could arise
with respect to the latter. From an efficiency standpoint the source rules would have done their job under the current framework by isolating this category of income. It requires distinct treatment because it will be subject to harmful tax competitive pressures. Thus a further function of the source rules here would be to achieve the distributional task of figuring out which country or countries would tax this. Presumably one way this could work would be to write source rules that definitively allocate the rent to various jurisdictions. With such source rules in place the tax competitive pressures drop away. But again the practical task of doing this is extremely difficult. Above one had a hard empirical task of linking jurisdictions that are responsible for the rents with the actual rents. Here one has the opposite problem. The category involves no such responsibility and yet it would be efficient to allocate the rent to one or more jurisdictions. Such allocation would seem, then, to be completely arbitrary and it is difficult to know upon what basis it would proceed. This approach too would be very far divorced from common conceptions of source. We are dealing here with a category of income which by definition has no geographical connection but we are to force it into a geographic box because this would seem efficient.

A final complication to observe here is that these categories of location specific rents and non-mobile rents are almost certainly not sharp and binary. After all what explains a completely mobile rent in this sense? Perhaps that the rent arises because of investments made in the private sector rather than the public sector? But will the private sector ever be wholly divorced from background conditions and investments by the public sector with which it coexists? This suggests one should think of this more as a continuum than discrete categories but that just complicates the definitional tasks further.

b. Analysis of a Comprehensive Base

The above discussion revealed substantial complications in writing source rules with the assigned task of separating location specific versus non-location specific rents. Here I want to
consider the complications that arise with a comprehensive base at the corporate level. The first point to note is that such a base still includes the mobile and non-mobile rents discussed above so one would still rely on source rules to draw this distinction, with all of the complications just noted. Further, it would now be desirable to (i) distinguish rents from non-rents and (ii) distinguish mobile non-rents from non-mobile non-rents.

Each of these tasks is difficult. Regarding the initial distinction between rents and non-rents, we know well how to design a tax that makes this distinction, namely a cashflow tax. Under the assumption of corporate level income taxes with a comprehensive base, where does this leave us? Because the cashflow tax draws the correct distinction, it is tempting to think about grafting this back onto a comprehensive income base. That is, even under a comprehensive income tax a taxpayer could calculate notional base under a cashflow tax and then subtract such amount from the actual base to get an approximation of the non-rents part of the base. This may be the best approach, but it has some obvious problems. These problems stem from the twin facts that countries do not apply pure income tax bases and countries do not in fact apply the same impure income tax bases. To the extent that an actual income tax base exempts some of the ordinary return to capital then the method of comparing the base under the income tax base and a notional cashflow base will understate the amount of actual economic rent. Moreover, to the extent that countries exempt different amounts of the ordinary return to capital then calculations under this back-out method will produce different results across countries. One cannot fix this problem by dividing the total base among countries and having each apply their imperfect income base to the respective quantities. Dividing up the aggregate base in this way would essentially require the existence of substantive source rules. But these are the very rules we are trying to give content to in the first place. To get around this problem of base mismatches under the income tax we would need taxpayers to calculate a notional pure income base on a coordinated basis. But now matters are beginning to seem a bit ridiculous.
Taxpayers essentially would be using three bases: the imperfect income base; the notional cashflow base; and the notional ideal income base.

These complications suggest that the notional approach is not a sound one. But the alternative is not very appealing either. The alternative would require the taxpayer to analyze all of the gross income and deductions recognized under the actual (impure) income tax and then apply general rules (call them source rules) which, by category of income and expense, distinguish rents from non-rents. We can imagine drafting some such categories without much difficulty, that is for those sectors that are highly competitive and where we expect no rents. Thus we could probably write the correct rule, for example, for bank deposit interest. But across the range of income and expense it will be very difficult to perform this exercise.

Aside from the notional approach and the categorization approach a third possibility might be to try to calculate through some formula the taxpayer's ordinary return on capital, treating the residual as economic rent. This does not seem a very appealing approach, however. Determining a generally applicable formula would be very difficult. Further, even if this produced a bottom line reliable number for net rent, this is not sufficient for the task at hand. As the discussion above demonstrated, one needs to understand the income and deduction flows as these may be split across various jurisdictions in complicated ways. For a calculated amount of ordinary return on capital and associated residual this would be consistent with any number of income and expense scenarios. We would need some other approach to identify these and it is not clear what such an approach would be.

These issues above all relate to the distinction between rents and non-rents. Under the basic paradigm suggested here, though, in the case where non-rents are actually in the base one needs to make a further distinction between mobile non-rents and non-mobile non-rents. That distinction is important because the former make up the standard base susceptible to tax competitive pressures and the latter do not. One could naively hope that this particular problem
would just disappear because even with comprehensive income tax bases countries should not be trying to tax mobile non-rents. But this does not describe the actual state of the world. As long as there is some home country bias we can expect countries to impose entity level tax on mobile non-rents (and quite well even in the state of the world where there is no bias). But even accepting this, there is good reason for countries not taxing on a residence basis to exempt this part of the base, which means it is desirable to have a source rule that distinguishes this part of the base from other parts of the base. Drafting rules that do this with any precision, though, will again be very difficult. One could make some initial cuts simply by drawing a capital-labor divide, but this is obviously very inexact. There will be cases of non-mobile non-rents for some capital income (ordinary returns to real estate for example) and cases of mobile non-rents for labor (returns to skilled labor, for example, where there are competitive labor markets for the skilled labor). With such distinctions, though, one could perhaps begin with an initial capital/labor distinction and graft on further categories to improve accuracy regarding the mobility (or not) of the non-rent part of the base.

2. **Corporate Tax as Backstop.**

If one conceives of the point of the corporate tax not as facilitating the collection of tax on rents earned through corporate form but rather as a backstop to the individual income tax, then one faces a new set of problems regarding source -- and, without really shedding many of the problems discussed immediately above regarding economic rents. As a first cut as one moves from the closed economy to the open economy it would seem that the fundamental task of source rules under a backstop theory would be to trace flows to ultimate shareholders. The source rules, at least at the corporate level, would assign the tax base to the “correct jurisdiction” -- that is the jurisdiction associated with the individual shareholder with respect to whom the backstop is necessary. This raises a whole set of problems regarding the design of such source rules.

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rules.

First, and most obviously, one has the practical problem of identifying the relevant shareholders. If it were a simple, or even a difficult but remotely feasible, task to associate income at the corporate level with ultimate shareholders in advance of actual profits distributions under contractual entitlements, then one would not really ever need to use a corporate tax as a backstop in the first place. That observation would hold true in the wholly domestic sphere. It is all the more applicable in the cross-border setting, where this sort of tracing would require information flows and sharing across channels that simply do not, and will not plausibly, exist. Not surprisingly, the sort of rules that would be required by such an approach look nothing like the source rules that have traditionally been in place.

Second, the type of practical problem just noted is aggravated once one takes account of distinctions between gross and net income and the way this relates to sourcing determinations. The way source determinations generally work is that one applies source determinations to gross income and then additionally to deductions. This is really logically required where systems define the base in various ways. Put simply, if one were going to source or allocate net income, then what base definitions would one use to determine net income in the first place? But once we graft this issue onto the question of what to do with the corporate tax as backstop and a potential tracing approach, this issue gets all the worse as neither a gross nor net basis approach seems at all workable. If one were to adopt a gross basis approach then this would require making source determinations with respect to gross income flows and deductions that might seem totally divorced from the actual cashflows. Imagine a corporation resident in one country with activities that give rise to income and expense in another country with widespread share ownership across, say, 10 third countries. Under a tracing approach the corporation would be required to trace gross income and expense to these shareholding jurisdictions (difficult information task all by itself) but then further to calculate different bases with respect to a
portion of each of these shareholder jurisdictions. A net basis approach, however, would be unworkable for the reason just mentioned. Under what base definitions would the corporation operate in order to reach net income?

Third, even if one views the best justification of the corporate tax as a backstop one must take account of the way the rents issue plays out differently in the open and closed economy. In the closed economy consider the case of an individual or individuals earning business income outside of the corporate form. On efficiency grounds one would want to design a tax that at least captured the rents. There will then be further base determinations regarding the non-rents portion of the base. In the multiple jurisdiction setting, though, matters look substantially different. Suppose again that we have an individual or individuals earning income outside the corporate form, with the individuals resident in one jurisdiction and the productive activities located in some other jurisdiction. Under the basic framework established at the beginning of the paper, there would still be sound reason to draw distinctions between rents and non-rents, across the mobile/non-mobile axis on efficiency grounds. My suggestion throughout is that one should see source rules ideally as grappling with precisely these distinctions. If this is true when individuals earn income cross-border outside of the corporate form, though, it is no less true when the activities are then placed inside a corporate box. But now we have a problem. If the income, when earned in corporate solution, is viewed as taxable at the entity level under a backstop theory and we use source rules in a way that is consistent with tracing to ultimate individual shareholders, then we are likely to generate two conflicting normative benchmarks for the source rules. There is no reason to expect that the results under source rules premised on tracing/backstop would look anything like source rules based on a rents justification of the entity level tax. But there is also no reason why we shouldn’t also be concerned with the rents aspect under a backstop theory.

3. Multiple, Simultaneous Theories of the Corporate Tax. The preceding two sections
have outlined numerous problems with defining sound source rules under either a rents-based theory of the corporate tax or a backstop-based theory. One can add one further observation, here, which is simply that matters are made more complicated by the fact that there is no uniformly accepted view at the governmental level of the basis for the corporate tax. The best that one could say is that there is an academic presumption that a rents-theory is a sounder justification of a corporate level tax than a backstop theory. But that academic presumption is based on evolving views of the relative desirability of individual income versus consumption taxes, which have not to date been fully incorporated into the real world policy space. This dynamic makes the framing of conceptually grounded source rules very difficult. For a given country a unified theory of the corporate tax would lead to quite difficult problems under the approach presented here. On top of that, though, we must layer two further complications: (i) given jurisdictions do not have a unified conceptual basis for the corporate tax and (ii) the view of these matters differs across various jurisdictions.

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Conclusion

What I have tried to set out in these comments is a way to think about a conceptual grounding for international source rules that goes beyond, firstly, the (problematic and oft-noted) difficulties with associating geographic place to income and secondly, the view of source rules merely as reflecting a bargained solution to power relations between jurisdictions over the tax base. Determining the geographic source of income in a conceptually sound way is a deeply difficult problem, but it does not founder on a category mistake and it is not impossible to make some incremental progress. At the very least one faces important doctrinal choices about whether to couple source determinations with associated allocation determinations or not. More ambitiously there is room to improve source rules on the margin by considering likely grounds of pre-legal consensus regarding geographic location of income from labor and income from
real capital. Finally, a far reaching modification to current approaches to source might seek to separate out different parts of the comprehensive income tax base, allowing efficient treatment of the various constituent components.