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A Defense of Source Rules in International Taxation

Mitchell A. Kane†

The concept of "source" is central to the functioning of the current international tax system. To the extent the "source" of income is meant to reflect the spatial location of income; however, many academic commentators have come to regard the concept as completely incoherent. Further, that incoherence is viewed as a partial explanation of the perceived artificiality and frailties of current instantiations of source rules. In this Paper I make three basic claims. First, it is in fact coherent to conceive of the source concept in terms of the spatial location of income. Second, most of the problems with current instantiations of source rules can be understood as reflections of fundamental complications in designing an income tax in a closed economy and thus have nothing to do with spatial indeterminacy. This observation allows for incremental improvement to source rules in the same fashion as one can make incremental improvement to a closed economy income tax. Third, from an efficiency perspective, a novel and ambitious way to approach source rules would be to use such rules to segregate rents from non-rents and mobile income from non-mobile income. Traditionally, scholars have viewed the efficiency characteristics of a rents-only tax as an affirmative argument for cashflow taxes over income taxes. Holding the existence of the income tax constant, however, source rules could theoretically achieve an efficient result on this dimension. The practical implementation hurdles, though, are substantial.
Introduction

The body of law generally labeled “international taxation” is widely perceived to be in shambles. International taxation encompasses both unilateral domestic law and treaty law on the taxation of transactions that implicate the taxing rights of more than one sovereign, and it is reasonably subject to the charge that it is unduly complex, highly manipulable, deeply inequitable, and hardly worth the attendant costs given the revenues that jurisdictions are actually able to raise under the system. These criticisms have recently reached something of a boiling point, as an arcane subject that was once the exclusive domain of trained specialists has taken on increased prominence in the popular consciousness. Thus, the highly effective tax planning strategies of prominent companies such as Apple, Google, and Starbucks have become front-page news.1 Throughout the summer of 2014, the U.S. Congress became somewhat obsessed with the problem of corporate inversion transactions, in which companies historically headquartered in the U.S. attempt to shed that geographical link because of potential tax savings.2 On the international stage, defects of the international tax rules have come to share G-20 agenda and communique space with other great international coordination challenges of the day, such as climate change.3


Complexity abounds here—in the law, in the organizational structures and transactions of the pertinent taxpayers, and in the details of whatever alternative might plausibly replace the status quo. One might expect, then, that the root causes of the perceived range of problems are likewise complex and within the ken of only the trained specialist. But this is not the case. The basic locus of frailty in the current system can actually be captured in just a few sentences, though as will become clear I reject certain aspects of the simple narrative sketched below.

It begins and ends with the two pillars of the extant international tax system: the residence principle and the source principle. These principles capture the jurisdictional bases under which sovereign states tax income from cross-border transactions. Consider an individual industrialist who lives in the United States and owns a factory in Canada. The United States could assert the right to tax the capital income of this individual taxpayer under the residence principle (i.e., based on the residence of the income’s owner), and Canada could assert the right to tax the same capital income under the source principle (i.e., based on the location of income production). Much of the historic challenge of the international tax system was to provide rules of priority designed to resolve residence-source conflicts in cases in which the principles accorded taxing rights to two sovereigns over the same income. Much of the current consternation over the international tax system is about perceived inadequate taxation of a highly porous tax base, even with the conjoined operation of the residence and source principles.

The holes in the tax base are thought to arise because the residence and source pillars themselves are crumbling. The weak point of the residence principle stems from the introduction of entities into the picture. As long as we are committed to entity-level taxes and as long as the bulk of international trade in capital, goods, and services occurs through entities, the residence principle will require rules that assign residence to entities. However, because entities are legal fictions, such rules will necessarily be arbitrary. Further, whatever rules are adopted, taxpayers will modify entity attributes in ways to achieve tax-favorable residence status.

The perceived weak point of the source principle (though a perception I will argue against) is analogous. It is difficult to write source rules that assign location to income. For example, where should one “source” royalty income arising from the license of a patent that is funded in one jurisdiction, developed in a second, and embedded in tangible property sold into a third? And once one writes such rules, taxpayers will predictably arrange affairs such that income is sourced to tax-friendly jurisdictions.
On this account, both the residence principle and the source principle are deeply broken. Perhaps they are sufficiently broken to wave the white flag of surrender. Regarding the residence principle, that might mean giving up on entities altogether and looking only to individuals, who have relatively more determinate and immutable residence, as suitable taxpayers. Regarding the source principle, that might mean giving up on source-based income taxation altogether, in favor of consumption taxes based on relatively inelastic factors such as the location of consumers.

Neither of these options is particularly appealing. Forgoing entity-based taxation produces familiar problems with individuals escaping tax by structuring income-earning activities through entities and would generally impose severe burdens on countries (typically developing countries) that rely disproportionately on entity taxes to fund the cost of government. Forgoing source-based income taxation would mark a drastic shift in existing negotiated equilibria, which would be vehemently rejected by countries (both developed and developing) that host substantial production activities, by virtue of which source-based taxing claims are currently asserted and accepted.

The basic point of this Article is to argue against a key aspect of the narrative just presented. Specifically, I contend that source rules can be a robust part of the international tax system and that such rules are not deeply flawed in the manner that has come to be commonly accepted. In order to sketch my thesis and state its consequences, I need to elaborate briefly on the commonly accepted criticism of source rules.

It is helpful here to juxtapose the residence principle and the source principle. The normative basis for the residence principle is not particularly mysterious. However one defines residence, the basic idea captured by the residence principle is that the existence of some requisite threshold political connection between a taxpayer and a state justifies the state’s tax claim over that individual. The source principle seems, at least initially, more problematic. What are we actually trying to capture when we write a source rule?

Scholars have grappled with the basic normative underpinnings of source-based taxation. The political connection between taxpayer and state that undergirds the residence principle does not exist for the source principle. Further, source-based tax claims seem to conflict with modern notions that income taxation should be progressive, thereby reflecting an ability-to-pay principle.

5. See, e.g., Roy Bahl, A Retrospective on Taxation in Developing Countries: Will the Weakest Link be Strengthened?, in TAXATION AND DEVELOPMENT: THE WEAKEST LINK 405, 421 (Richard M. Bird and Jorge Martinez-Vazquez eds., 2014) (noting that the corporate tax makes up a greater share of revenue collected in developing countries as compared to developed countries).

6. Throughout this Article the use of “normative” in connection with either the residence principle or the source principle is meant to refer to the justificatory basis for a sovereign’s assertion of a right to tax certain income.

7. As suggested above, implementing rules that establish this sort of political connection presents immediate definitional problems in the case of entities. But at least the core normative grounding of the residence principle (between individuals and states) is both clear and sound.
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rather than a benefits principle. Ability to pay should be assessed based on a taxpayer’s comprehensive income, not on portions of a taxpayer’s income that have been subdivided into different pots based on source. If an income tax were understood as justified in terms of payment for benefits rendered by a jurisdiction to a taxpayer, then there would be nothing problematic about splitting up a taxpayer’s income into different jurisdictional pots. But, as noted, benefits-based justifications for income taxes have largely been rejected. Additionally, any net basis income tax assessed on a source basis will do a very poor job of actually reflecting the magnitude of benefits accorded to the taxpayer by a particular jurisdiction.

In spite of the problems involved with the benefits principle, it would seem that source-based taxation must ultimately rest on some sort of benefits rationale, if only because there is no plausible alternative justifying the widely accepted source-based rules. Further, it would seem natural to think of those benefits in spatial terms (available with respect to activity conducted in one jurisdiction but not another), thereby giving us a way to understand the geographic location of income. On that story, one could non-problematically say that income sourced to a certain jurisdiction is geographically located in that jurisdiction in much the same way as an individual can be geographically located in a jurisdiction for purposes of applying a residency rule.

For example, suppose a jurisdiction enacts a source rule for rental income from real estate that ascribes “source” to the enacting jurisdiction when the real property generating the rental stream is located within the sovereign’s borders. Construing source of income rules in a geographic sense would be to say that the rental income is spatially in the jurisdiction where the real estate is physically


9. This outcome is driven by two factors. First, benefits are difficult to measure. Second, there is widespread commitment under international tax treaties that there should be non-discrimination between non-residents taxed on a source basis and residents taxed on a residence basis. But if the residents are not taxed under a set of rules grounded in a benefits rationale (they are not), then matching the tax treatment of non-residents to that of residents will naturally push outcomes away from what a pure benefits rationale would demand.

10. There have been attempts to articulate justifications for source-based taxation that overcome the sorts of difficulties described in this Introduction. The most prominent of these alternatives is the “market access” theory, in which source-based taxation is justified not by benefits conferred, but rather as a sort of price charged to non-resident taxpayers for entering the source jurisdiction’s market. See Stephen E. Shay, J. Clifton Fleming, Jr. & Robert J. Peroni, What’s Source Got to Do With It? Source Rules and U.S. International Taxation, 56 TAX L. REV. 81, 92 (2003). The chief merit of this sort of theory (over a more standard benefits rationale) is that it is supposed to give an answer to the criticism that the actual source base does not in any realistic way measure benefits conferred. Under market access, one would apply the logic of revealed preference, common in economics regarding the determination of individual preference structure. That is, if taxpayers enter the market, then the “price” must have been set at a tolerable level. Whatever one thinks of this justification, I would note only that it is possible to group it together with the broader class of benefits-based theories. That is, it is a justification for taxing non-residents on the grounds of a sovereign having offered something to those non-residents.

11. This is an accurate reflection of the current rule in place in the United States. See I.R.C. § 861(a)(4) (2014).
located in the same way that the underlying asset generating the income is located in the jurisdiction. Further, locating the income in such jurisdiction in a spatial sense would accord with an underlying benefits theory of taxation to the extent that the jurisdiction had accorded benefits within its sovereign borders that contributed to the earning of the rental income there.

Sensible as that description might be, it is largely rejected out of hand in contemporary international tax policy literature. Critics of such an approach might say that to attempt to ascribe geographic location to income in this fashion represents a type of "category mistake." The critics would argue that the geographic location of income is not a coherent concept because physical location is not a property that can ever properly be ascribed to income, much as Gilbert Ryle (who coined the term "category mistake") famously argued that substance could not properly be ascribed to mind, as under Cartesian dualism. Ryle observed that, when terms are part of the same logical category, it is possible to construct conjunctive or disjunctive propositions involving them. If the terms are not part of the same category, then asserting such propositions will lead us to conceptual error. Thus if "taxpayer" and "income" are not, in fact, in the same logical category, we will generate conceptual confusion by asserting something like, "a jurisdiction's authority to tax requires that either the taxpayer is in the jurisdiction (a residence theory) or the income is in the jurisdiction (a source theory)." Similarly, one would err by asserting that taxpayers and incomes bear the same sorts of characteristics, as in the claim that "taxpayers and income both have geographic location."

From what I can tell, Professors Hugh Ault and David Bradford were the first scholars to make the argument that "income" should not be understood in geographic terms at all. They contend that, to the extent we have constructed rules that attempt to ascribe geographic location to income, we have gone seriously astray as a conceptual matter. This supposed category mistake has been specifically identified as the culprit responsible for the shortcomings of the current particular instantiation of source rules.14

There are two aspects of Ault and Bradford’s argument. First, they claim that the source of income is not a coherent economic concept. Thus Ault and Bradford state, "The idea that income has a locatable source seems to be taken for granted, but the source of income is not a well-defined economic idea." The

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13. Id. at 11-12. Conjoining items of different logical categories will lead to nonsensical propositions. For example, Ryle offers the following illustration: "[A] purchaser may say that he bought a left-hand glove and a right-hand glove, but not that he bought a left-hand glove, a right-hand glove and a pair of gloves."
14. See David F. Bradford, The X Tax in the World Economy 22 (Princeton Univ. Ctr. for Econ. Policy Studies, Working Paper No. 93, 2003) ("I suspect that the ambiguity of the idea [of source] at the most fundamental level is a reason that sourcing rules are so controversial and arcane.").
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The basic idea underlying this claim is that the comprehensive 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.\textsuperscript{16} I should stress that this is an economic argument, in that the claim is that the discipline of economics has nothing useful to tell us about where income is located in a geographic sense. In other words, the economic concept of income cannot be coherently construed as involving a spatial component. One might refer to this as the “economic incoherence” claim, to distinguish it from the claim that immediately follows.

Second, Ault and Bradford claim that source rules are not properly understood as legal instruments that capture a factual predicate relevant to an underlying normative jurisdictional theory. The source rules, rather, are mere assertions of the right to tax, irrespective of any underlying normative theory justifying such right. Ault and Bradford state the point as follows: “One may speculate 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.”\textsuperscript{17} The distinction between an “ethical conception of sovereignty” and force majeure is as follows. A justification for source-based taxation appealing to the former would rely on the proposition that states have the legal right to tax income that arises within their sovereign borders. The task of the source rules would then be to describe the factual predicate for when income arises in the jurisdiction. This would be just like any other factual question about location that a legal rule might address—such as whether a person born in a foreign military installation counts as being born “in” a country for purposes of a citizenship determination.\textsuperscript{18}

The alternative—the “force majeure” view—is that placing the “source” label on income amounts to nothing more than an assertion by a state that it will claim the right to tax the income stream, notwithstanding the fact that the owner

\textsuperscript{16} Id. at 30-32. According to Simon’s classic statement regarding the concept that has come to be known as “Schanz-Haig-Simons” income, “Income may be defined as the algebraic sum of the market value of the rights exercised in consumption plus the change in value of the store of property rights between the beginning and end of the period in question.” Henry Simon, \textit{The Personal Income Taxation: The Definition of Income as a Problem of Fiscal Policy} 50 (1938). For a modern exposition of this fundamental description of the income tax base, see \textit{Edward J. McCaffery, Income Tax Law} 6-8 (2012).

\textsuperscript{17} Ault & Bradford, \textit{supra} note 15, at 32.

\textsuperscript{18} Consider the treatment of this issue by the United States. Under the Fourteenth Amendment all persons born “in the United States” are automatically U.S. citizens. Likewise under U.S. statutory law a person is a citizen at birth if “born in the United States, and subject to the jurisdiction thereof.” 8 U.S.C. § 1401(a). Neither the Constitution nor the citizenship statute directly mentions foreign military installations, but the condition regarding birth “in the United States” has been interpreted not to include birth on such a military installation for these purposes. See U.S. DEP’T OF STATE, FOREIGN AFFAIRS MANUAL vol. 7, § 1113(c)(1) (2009) (“Despite widespread popular belief, U.S. military installations abroad and U.S. diplomatic or consular facilities abroad are not part of the United States within the meaning of the 14th Amendment. A child born on the premises of such a facility is not born in the United States and does not acquire U.S. citizenship by reason of birth.”).
of the income stream does not satisfy the applicable residence criterion.\textsuperscript{19} On this account the state asserts the right to tax the income simply because it has the raw power to do so, not because such right is legitimized under some legal determination, such as the conclusion that the income is located in the jurisdiction under a source of income rule. This view follows from the category mistake argument, in the sense that the factual determination of income being located in a given jurisdiction (required under the former view) is conceptually incoherent.

The category mistake argument, along with its implications regarding economic incoherence and force majeure, has gained substantial traction in the international tax literature.\textsuperscript{20} Regarding economic incoherence, Edward Kleinbard has described the phenomenon of what he calls “stateless income.” Under Professor Kleinbard’s definition, “stateless income” is income that is subject to tax in a jurisdiction which is not the domicile of a group’s parent company, the jurisdiction where a company’s customers are located, or the jurisdiction where factors of production are located.\textsuperscript{21} Essentially, this is the phenomenon of income facing low or zero taxation when tax base is stripped from source countries and is not picked up in the tax base of any residence country. Professor Kleinbard lays the blame for the phenomenon in no small part at the feet of what he sees as vacuous source rules. Thus, he refers to source rules variously as “meaningless,” “largely artificial,” and “devoid of any conceptual foundation.”\textsuperscript{22} The argument is very much informed by the consequences of aggressive tax planning of U.S. firms under the current instantiation of rules on the taxation of international income, but the intellectual underpinnings appear to go back to Professors Ault and Bradford and their articulation of what I call the category mistake.\textsuperscript{23} Regarding the force majeure claim, Steve Shay, Clifton Fleming, and Robert Peroni have offered an extended development of the distinction between source of income as geographical determination and source of income as jurisdictional determination.\textsuperscript{24}
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In general I take the critiques embedded in the category mistake argument to capture the dominant view in current academic analysis of international tax policy in the United States. I also take the view embodied in the category mistake argument to be incorrect. The argument and its implications are the central target of my analysis in this Article.

My basic thesis is that the severe criticism of the source concept generally, and source rules in particular, that one finds in both prominent scholarship and the international tax policy space in the United States does not withstand scrutiny. There is a coherent way to understand source rules as legal rules designed to reflect factual predicates about the geographic location of income, contra the basic implication of the category mistake argument. If the thesis is defensible, there are two basic consequences to my analysis.

First, and most obviously, the argument has substantial consequences for the continuing normative authority underlying the claims of states to tax on a source basis at all. This is most immediately of relevance to developing countries, a category that I will take to include countries that are most dependent on source-based taxation for the simple reason that they are the jurisdictions that do not own a significant amount of the world’s capital. For these countries, I take the seeming rejection of the underpinning of source rules in current analysis to be of first order magnitude. Recall here the conceptual nature of those claims. It is one thing to say that legal questions of taxation are difficult or complex or unresolved or expensive to administer. (It would be astonishing if modern income tax systems did not generate that list of complications!) But it is quite another matter to say that rules are incoherent precisely because they lack any conceptual basis or underpinning at all. For if that is the claim, then there is no point in trying to make the rules better. That would be like trying to strengthen a building by adding structural supports on the ground floor, only to find that the building rests on a foundation of quicksand. Further, if the understanding of source is simply that it is an ex post label reflecting the raw power to tax, then developing countries (with far fewer resources and less clout) are not going to come out in a very strong position. The pervasive critiques of source-based taxation thus go to the very heart of the theoretical underpinnings of the way in which developing countries largely seek to tax income.

Although the basic bolstering of source taxation I undertake in this Article has greatest relevance for developing countries, it is also highly relevant for developed countries, which are themselves often large importers of capital with substantial interests in taxing capital income owned by foreign persons. One of the most high-profile fora for analysis of the frailties of the current international tax rules, including the operation of source-based taxation, is the Organisation driving source determinations. See Ault and Bradford, supra note 15, at 32; see also 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 subject to tax”).

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for Economic Co-operation and Development ("OECD") project on "base erosion and profit shifting" ("BEPS"). The project is an expansive one. The developed country membership of the OECD sometimes confronts base erosion from the standpoint of a residence country (e.g., where a controlled foreign corporation of a domestic entity is able to achieve deferral or exemption of income earned abroad) and sometimes from the standpoint of a source country (e.g., where a taxpayer makes deductible interest payments from the jurisdiction). In either case the issue is wound up deeply with questions of the proper limits of source-based taxation. Of course, one could take the project to be addressing an important and serious issue while still holding the denuded view of the "source" concept—that it is merely about ex post jurisdictional assertions of taxing authority. But if that were one's view of the world, then the whole project would have to be seen as a very odd one, to the extent that the BEPS working plan sets out a two-year timeframe to undertake what is essentially an analytical approach to the matter. If "source" is incoherent, then analysis of "base erosion" could be seen only as a very cynical exercise indeed, essentially laying a faux legal groundwork and justification for raw political exercises of power. At least for anybody who would like the project to be about more than that, it is an important initial step to have a sound theoretical underpinning for how "source" of income is at least a coherent concept subject to conceptual analysis.

This observation points to the second basic payoff to the line of argument taken up in this Article, which is that it supports the very possibility of legal analysis of source rules. It bears emphasis that, if the category mistake argument is correct, then there is really nothing that legal scholars have to say about improving the content of source rules. If source were properly understood to be about the geographic location of income, then lawyers could bring their analytical and drafting skills to the task of writing better rules to capture that location. But if the source rules are ex post descriptions of power only, then the question of content is essentially political rather than legal. It would then be next to impossible to say anything about the proper content and structure of a source rule on the basis of a priori legal analysis. The best that one could do would be 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 solutions to dealing with international distributional issues. The actual extent of any such modifications, however, would follow from the

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25. For an overview see ORG. FOR ECON. CO-OPERATION AND DEV., ACTION PLAN ON BASE EROSION AND PROFIT SHIFTING (2013).

26. The most likely limit on direct transfers will be political. That is, there will be an upper bound on politicians’ willingness to transfer domestic funds abroad for redistributive purposes. Cf. Michael P. Devereux & Peter Birch Sorensen, The Corporate Income Tax: International Trends and Options for Fundamental Reform, EUROPEAN COMMISSION ECONOMIC PAPERS NO. 264 at 20 (2006) ("[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).")

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actual underlying distributional preferences and limits on direct transfers—topics about which lawyers have little or nothing to add. On that picture of the world, there would be little to no room for lawyers to label a particular source rule as better or worse than any other.27

For these reasons the payoffs to my argument are substantial. To be clear, this does not mean my argument will solve the crucial international income tax base allocation issues of the day. The sorts of questions and planning opportunities that motivate concerns about base erosion will be largely untouched by my analysis. This is because nothing I say here can resolve the basic issue of the primacy of source versus residence taxation in a given circumstance. Nor does anything I say here diminish the fact that there are pervasive tax-competitive pressures pushing downward on both residence taxation (where jurisdictions fear the loss of tax residents, individual or corporate) and source taxation (where jurisdictions fear the loss of foreign-owned capital). Nor can my analysis, in suggesting that there is more to source-based taxation than raw power, remove the fact that power is surely important in the development and exercise of this mode of taxation. But for all of these limitations, a proper understanding of the conceptual basis of source rules remains essential, at least under the current framework, which is premised on the resolution of competing source and residence claims.

My argument in this Article has both a critical and an affirmative aspect. In Part I, I undertake a direct critique of the category mistake argument, understood alternately as an argument about economic incoherence and force majeure. Regarding the former, I suggest that any degree of economic incoherence is irrelevant, insofar as we should not expect the discipline of economics to shed any meaningful light on the basic distributional question addressed by source rules. Regarding the force majeure claim, I work through a series of thought examples designed to show that we can understand legal source of income rules as determining factual predicates relevant to an underlying normative theory of taxing jurisdiction.

Parts II and III cover my affirmative claims. In Part II I characterize source rules, construed as geographic determinations, as distributive instruments. I take this to be the agreed function of existing source rules, whether that function is achieved through force majeure or through my alternative depiction. In this part of the Article, I undertake three tasks. First, I demonstrate why I think it likely,
and defensible, that conditional on the adoption of income taxes, countries will gravitate towards an "origin" principle for both labor and capital income. Under such a principle, income would be sourced to the jurisdiction where it is produced. Second, I attempt to show that many of the common problems and trouble spots with current source rules ought to be understood as manifestations of deep analytical problems that arise even in wholly domestic tax systems, rather than as problems that arise with respect to the issue of ascribing geographic source to income. In particular, geographic source of income problems can often be reduced to a series of problems involving questions such as timing, the capital-labor divide, and calculation of the net income base. If that is correct, it would suggest both that the core problems are not about geographic indeterminacy and that one could make incremental progress in the design of legal source rules using our accumulated knowledge regarding analogous domestic tax problems. Finally, I describe a concrete example, regarding the adoption of section 865 of the Internal Revenue Code. This example demonstrates the type of analysis of geographic source of income rules that would follow under the approach I advocate.

In Part III, my premise is that, although source of income rules are currently best understood as distributional coordinating rules across jurisdictions, an alternate way to conceive of the function of such rules would be to consider their efficiency implications. Cross-border income has different implications for efficiency depending on two crucial variables: the mobility of the capital producing the income and the distinction between an ordinary return versus an economic rent. My claim is that, approached from this perspective, source rules could attempt to draw the relevant distinctions with respect to these two variables and categorize income accordingly. This suggests (consistent with Part II) that there are ways to approach source of income rules as coherently capturing geographic location. Although I suggest that this is a promising analytical frame for analyzing source rules, I also describe a range of obstacles to writing source rules in this way.

I. The Category Mistake Argument

According to the category mistake argument, the whole concept of source, understood as reflecting the geographic location of income, is incoherent. Although the use of the descriptor "category mistake" in this context is novel, I do believe it is an accurate depiction of existing views on the impossibility of construing source of income rules as reflecting the geographic location of income. I discuss below the two claims that follow from the category mistake argument—the economic incoherence claim and the force majeure claim—showing in each case that the argument does not dismantle the coherence of the source of income, as others have suggested.
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A. The Economic Incoherence Claim

The argument against source rules is very often cast in economic terms. For example, the central claim of Professors Ault and Bradford initially was that attaching a "locational label" to transactions that determine the income tax base is "an operation that is not itself based on a well-defined economic question." But this simply begs the question of why economics is relevant to the concept of source at all. My contention here is that, at least as currently construed, the basic function of the source principle (and the source rules that are supposed to reflect that principle) is to coordinate, alongside the residence principle, taxing claims of various jurisdictions. The issue is thus essentially distributional in nature: which country will receive which tax revenues? Because economic analysis is not suited to answer this question, the incoherence of source of income from an economic perspective is not a meaningful critique.

In spite of the expansiveness of the economic analysis of law, there are, of course, many instances in which economics will provide no assistance to the legal task at hand. To take a recent, prominent example, consider the question of how to define "marriage" for purposes of determining tax filing status under the Federal income tax. One could well say that marriage is not a coherent economic concept, in the sense that nothing in the discipline of economics can tell us whether the scope of the concept of "marriage" as reflected in legal rules extends to same-sex unions or not. Economics might have a lot to tell us about marginal incentives to enter certain unions, but that is a different sort of question. In other words, economic analysis might tell us something useful about whether an individual is likely to enter a marital relationship, conditional on the assumption that the state has afforded that option. But it lacks the analytical tools to delimit the class of marriage-eligible individuals in the first instance. The inability of economics to delineate "marriage" surely does not cast doubt on the entire enterprise of writing legal rules that seek to reflect the proper scope of that term in the tax system.

What one really wants to know here is what one is trying to achieve with a particular legal rule or concept and whether it makes sense to use terms in that rule that map onto various objects of reference. These objects might themselves be products of some legal rule or relationship (like "marriage"), or they might exist outside of the legal system (as would be the case with a tax rule related to "oil").

29. It is possible to conceive of source rules serving a different sort of function. In particular one could attempt to draft source rules with the primary aim of achieving economic efficiency. Although this has not been the historic conception of the function of source rules, I consider this possibility in Part III below.
We should ask then what we are attempting to accomplish with source rules. The answer to that question, at least under current instantiations of source rules, seems fairly clear. Source rules function as inputs to a broader legal process that coordinates competing sovereign claims to tax the same item of income. To go back to my simple rental income example from above, the source rule coupled with some rule ordering the priority of the source and residence claim will answer the question of which jurisdiction gets to tax the income.

One might reject the idea that answering or posing this question is the best way to approach international tax policy. Even so, I believe it is an accurate reflection of how countries view the issue and relevance of source rules at present. Accepting the basic function of source rules as essentially distributional rules across countries, one can readily see why economic analysis is unlikely to inform the required discussion. To elaborate, consider the various ways one could approach international tax policy through economic analysis. I think such approaches fall into three basic families.

First, there is the approach that analyzes the effects of the tax system on various taxpayer decisions, such as the location of capital, identity of ownership, or location of savings. This broad approach has fallen out of favor. I only want to observe that the content of source rules would not be determined by these welfare criteria, even for their defenders. This approach is concerned with marginal incentives in matters such as investment and savings, but the taxpayer should be indifferent as to which state receives the tax revenues, which is the central distributional role of source rules. For example, application of these welfare criteria will often depend on the relative treatment of domestic versus foreign source income, but it will not matter what actually goes into those two categories (as long as we get the relative treatment right).

Second, one could view international tax policy as presenting a global optimal tax problem—that is, as an optimization problem under a specified social welfare function mirroring the typical domestic setup. In a first-best world there would be no place for geographic source of income rules under such an approach. Optimal tax analysis is thoroughly individualistic, with the distributional problem conceived as one among individuals and not as one among nations. Any nation adopting such a framework would need to choose utility weights for the various individuals to be considered and then would enact optimal tax and

32. I discuss the basic approaches for thinking about the big questions of international tax policy from an economic perspective immediately below in the text. Regarding the narrower question of source of income specifically, in Part III of this Article I consider a very different approach to source rules, which would attempt to assess the efficiency characteristics of different streams of income rather than approaching the problem as essentially a distributional one. Of course, one will be tempted here to think about the problem as simultaneously about distributional and efficiency concerns. But I take this option to be off the table, as the ensuing discussion in the text about a global optimal tax policy should make clear.

33. For a general discussion of the approach and associated critiques, see Graetz, supra note 20, at 269-315.

transfer policy on that basis. In real-world settings there may be substantial constraints on both tax and transfer policy with respect to non-nationals. That is, nationals can be expected to resist paying taxes to their home country, only to have such funds either transferred to some foreign country or to have such funds spent by the home country on foreign beneficiaries. Thus a country that sought to approach international tax policy under a global optimal tax framework might have no choice other than to have some other sovereign use its tax and transfer powers to effect the desired distributions. Functionally, a source rule could operate as such a second-best method of effecting the inter-nation distribution, which itself would be a precursor to the desired distributions among individuals.\textsuperscript{35} Thus under this economically informed approach to international tax policy, there is conceptual space for a set of source rules viewed as inter-nation distributional mechanisms. Further, any approach to writing legal source rules that viewed the problem as about locating income in a geographic sense would indeed look quite odd and beside the point. Indeed, such an approach might look like a basic category mistake because the relevant set of considerations informing source rules in this sense would all be about the particular constraints on tax and transfer between a particular sovereign and a particular individual.

Even conceding these points, the relevance of economic analysis to the actual content of source rules in this sense is highly dubious. I would observe initially that nobody seriously approaches international tax policy as a global optimal tax problem. This surely reflects, at least in part, the fact that prescriptions would be hugely sensitive to assumptions about utility weights of non-nationals, which could range anywhere from complete parity with nationals for the cosmopolitan to zero (or even negative) for the arch-nationalist. Further, even if one made some simplifying assumption about the utility weighting for non-nationals, it is extremely difficult to see how such analysis, which is already arising in a second-best framework, could ever hope to inform the content of real-world source rules. The complexity of the problem is almost beyond imagination. One would have to take account of the multitude of dynamic effects following from the manner in which other countries' policies affect the global distribution of resources. In addition, one would presumably need to maintain a distinct set of source rules with respect to each other sovereign. This is because source rules, viewed as second-best distributional tools, should be sensitive to the actual constraints on direct transfers from the sovereign to the individual (consider, for example, the range of different constraints on transfers from the U.S. to the individual nationals of the U.K., Russia, Iraq, and China). Because the whole point of the source rule in this framework is to achieve a second-best distributional result, there is no reason to limit the source inquiry to a question of distribution between nation states. The analysis would have to take account of

\textsuperscript{35}. See supra note 26 and accompanying text.
other potential governmental sources of redistribution such as sub-national governmental units.

The third way of approaching international taxation through economic analysis is to view international tax policy from the standpoint of national welfare (possibly, but not necessarily, understood in terms of optimal tax theory) coupled with game theoretic considerations reflecting how other countries respond in a dynamic setting to attempts to maximize national welfare. This is likely the prevailing approach at present, at least for academic audiences. Source rules as distributional rules across countries seem potentially relevant here, insofar as the associated distributional effects will certainly bear on national welfare. But this is too weak a link to ground substantive analysis because national welfare considerations will underdetermine the content of source rules. In other words, economic analysis might, depending on one’s normative framework, be of use in determining the national welfare consequences of a particular instantiation of source rules (along with the accompanying distributional consequences) but will not be able to tell us much of anything about what underlying distributions across countries should look like at the end of the day.

To sum up where we are on the economic incoherence argument, the category mistake argument embodies a claim that geographic source of income is an incoherent economic concept. That is, the discipline of economics has nothing helpful or useful to say about the question of where income is located in a geographic sense. I agree with that central point. It is simply not a particularly important claim because there is no reason to think that economics should have anything useful to say about the normative distribution of revenue across countries, which is the central point of legal source of income rules (at least as currently conceived) in the first place.

B. The Force Majeure Claim

The second aspect of the category mistake argument reflects the idea that source rules cannot properly be understood as identifying the geographic location of income in a way that would be relevant to an underlying normative theory of source-based tax jurisdiction. If one assumes that source rules are not part of a normative theory, they would be reduced to mere labels that accompany the assertion of tax jurisdiction under a force majeure rationale. A state asserting tax jurisdiction under such a rationale would ultimately be basing its claim on considerations of administrability only. In other words, states could be expected to tax non-residents on their income in cases where the tax is administrable. Considerations of administrability here would encompass both the ability to

36. For a recent prominent example see Daniel N. Shaviro, FIXING U.S. INTERNATIONAL TAXATION 143-77, 186-90 (2014) (arguing in favor of a national welfare perspective and explicitly taking account of other countries’ policy reactions to the setting of U.S. policy).
collect information relevant to determination of the tax base in the first instance, as well as the existence of enforcement mechanisms in the event the non-resident fails to pay any tax due. Income of a non-resident arising in instances where a tax is administrable (e.g., where the nonresident owns local property about which the state can obtain information and on which the state can enforce a lien in the event of nonpayment) would simply be deemed local "source."

I undertake here a series of thought experiments that are meant to call this analysis into question. What ties these examples together is that they seem to evoke intuitions about the international distribution of the tax base that are not grounded simply in administrability. Rather, the intuitions are related in some way either (i) to concepts of territoriality and fairness, aside from administrability, or (ii) to concepts about coherence of the overall tax base, even if that means including items that have some territorial link to a sovereign which is not the administratively superior taxing authority.

Although I won't attempt a causal explanation about what might form the basis of such intuitions, I do think the most obvious candidate has already come to the fore in the Introduction: the benefits principle. If one finds taxation of non-residents defensible under a benefits rationale, then to the extent that benefits are territorially limited (they usually are) and sometimes divorced from the administrability of a tax (they can be), the plausible intuitions I describe in my examples are unsurprising.

The precise claim I question here is that any understanding of source of income rules as reflecting the geographic location of income is incoherent because geographic location of income is not a coherent sort of claim one can ever make about the existing natural and legal order. It would be as if lawyers sat down to write a set of rules contingent on ascription of feelings to tables. Perhaps "happy tables" would benefit from accelerated depreciation while "sad tables" would not. Because tables do not bear ascriptions of emotion in the natural world, any legal rule relying on such ascription would itself be incoherent because of the underlying category mistake.

One way to think about category mistakes in this sense is to ask whether a given legal rule is constrained by facts in the world. Rules about "happy tables" or "sad tables" are not constrained in this way, as there are simply no underlying facts in the world to perform the constraining function. A category mistake argument about location of income would assert that the situation with geographic source of income rules is parallel because they are not constrained by facts about the world related to the location of income. Location of income, then, would be different from common phenomena, about which we might write a legal rule.

Rules about the location of people come immediately to mind. Imagine a legal rule that said a person would be treated as located in the United States for any day during which the person is located in Russia. A country such as the United States would not be precluded from writing such a rule, and the rule would not be meaningless. However, the rule is constrained to some extent by
facts about the world (which pre-exist the legal rule). One can be initially suspect of the rule and critique it on the ground that it is a horrible reflection of what we all understand the location of individuals to mean. But there is no issue of category mistake here because physical location is exactly the sort of property that we believe individuals can bear.

If the force majeure claim is correct, then source of income rules would not be constrained by facts about the world. The constraints, rather, would flow only from considerations of sovereign power and administrative issues related to enforceability. To be clear, this is not an economic argument. It is, rather, about categorization. The argument says, in essence, that facts about the world relating to the location of income cannot constrain legal rules about the location of income because ascriptions of location to income in advance of the articulation of the legal source rule are incoherent.

Note here that, when I speak of constraints that precede the articulation of the rule under consideration, I have in mind both facts about the wholly natural (non-legal) world and facts about the world that relate to the existing legal order. That second sort of constraint is crucial. It is also coherent because we very rarely analyze the coherence or meaningfulness of a legal rule in complete isolation from existing parts of a legal order that are taken as fixed. I cannot rebut the claim that, if we stripped away every aspect of the existing legal order, then source of income rules would be entirely unconstrained. But nor do I need to rebut that claim.

This idea that source rules are unconstrained (other than by power and enforcement issues) has, of late, been put in terms of natural law. Regarding the source concept, Wolfgang Schön has observed that “there is no natural law of income allocation.” I agree with Schön, but this does not tell us anything about source in particular. There is no natural law of source because there is no natural law of anything pertaining to the international tax rules.

On this point, one might fruitfully compare source rules with residence rules. Of course, there is no natural law of residence either. Consider, for example, the rules in the United States for determining whether an alien is resident or non-resident. Under these rules, for purposes of determining physical presence in the United States under a so-called “substantial presence” test, a day spent in the United States in the year preceding the current tax year counts as one-third of a day. We have here an arbitrary rule that is clearly a manifestation of positive law unconstrained by any notion of natural law. But this still leaves open the possibility, as I have just suggested, that residence rules are constrained by our simple understanding of facts about the world since they rely on concepts

37. By “natural law” here I mean simply some norm which has the authority of law independent of its instantiation as positive legal rule.
Defense of Source Rules in International Taxation

of physical presence of individuals. The interesting and important question is whether source of income rules are constrained in the same manner.

There are a couple of ways to get at that point. All proceed by thought example and probing of intuitions. This is because the nature of the inquiry is to evaluate hypothetical rules and ask if there would be some constraint on the rule. My example of the U.S.-Russia residence rule is a case in point. Although it is constrained by the real world, I can assert that the rule would rankle. I hold that intuition and I suspect that others would as well. I will make similar claims about source of income rules below, though I will, admittedly, have little to add for readers who find the examples unconvincing.

The methodology of my inquiry reflects a basic limitation on trying to answer any question about whether a given legal rule is subject to constraints. The problem is that one’s answer to such a question will depend crucially on what is taken to be fixed—that is, on what is available as a possible constraint in the first place. That sort of question (at least for any legal positivist) is necessarily arbitrary to some extent because one could always peel away additional layers of the existing legal order and posit a world in which those layers do not yet exist.

My approach is to imagine nation states that have already adopted income tax systems in isolation coming together to negotiate source of income rules from scratch. Source rules, here, would function as coordinating mechanisms that, in conjunction with residence rules and a set of rules of priority, assign primary taxing authority to a single jurisdiction. Thus at a very general level one can consider potential constraints on legal source of income rules by thinking about the potential constraints on such coordinating mechanisms.

Were such a hypothetical bargaining game actually to take place, it seems quite plausible to me that certain allocations would be off the table. Proposals regarding such allocations would be met with suspicion analogous to the suspicion that would greet the rule treating a person as being present in the United States for any day in which he or she is physically located in Russia. I have in mind here what seem to be intensely local items of income, that is, the sorts of items that do not seem to cause many actual problems under current instantiations of source rules.

Imagine, for example, unskilled personal services that are performed entirely within the geographic boundaries of a single jurisdiction. A source rule that sought to locate such income in some jurisdiction other than the place of performance would, I think, be considered incorrect. It probably would not be bargained over in my example. Critics of this position might contend that, if constraint exists here, it is about administrability only, which would bring us right back to the force majeure claim. Under such a view, the local services will be sourced to the jurisdiction of performance because that is the jurisdiction that can tax such part of the base. Of course, I cannot rule out such a possibility. On the other hand, as is typical with such exercises, neither can the critic be certain or prove that any practical constraints are merely about administrative ease or enforceability. And one can elaborate on the hypothetical in ways that would
seem to ease the administrative concerns without really cutting against the intuition that there is another constraint at work.

For example, one could imagine a source rule for services that sources the income to a jurisdiction other than that of performance in cases where the income is sourced to the jurisdiction of a parent company owning the subsidiary that nominally employs the person rendering services. In such a case it may well be feasible to insist on a tax collection responsibility on the part of the parent company. Even so, it seems that such a rule would operate under some constraint in the hypothetical bargain—that it either would be rejected out of hand or at least disfavored over a rule of source tied to location of service provision (even assuming equal administrative ease of collection).

One can come up with other examples that are at least suggestive of the idea that there seem to be some constraints on the content of legal source rules that transcend issues of administrability and relative power across jurisdictions. Consider, for example, the case of immigrants coming into a country. Suppose that a country receiving immigrants had a practice of assessing an extra tax on people at the border before stamping passports based on the theory that income from services performed by the immigrant in the jurisdiction of origin over, say, the prior five years would be "sourced" to the new country and thus taxed by the new country. The country might well have the power to enforce such a claim (assuming it is a sufficiently desirable location to enter) and could well execute the claim with relative administrative ease (by for example requiring five years of old tax returns as part of any initial visa application). But it seems to me that such a rule would rankle in the way my hypothetical residence rule described above would.

Even if one thinks this is really all about jurisdictional power and administrative feasibility, observe that at the very least this assertion of the right to tax the earlier earned services income on a theory of source would seem to be an aggressive assertion of tax authority. It would seem far-reaching, in a way that taxation of services income of the immigrant in the new country, after he or she had entered but before he or she had established the requisite physical presence to satisfy the jurisdiction’s residence criterion, would not. But if one concedes even that, then it would seem one must acknowledge the prospect of some constraint on the source rules. For if there were no such constraint, on what would we base the intuition that one assertion of source-based tax seems more aggressive or far-reaching than the other? If there were no such constraint, then all assertions of source-based tax that could be collected with equal administrative ease or cost would stand on an identical footing. I surmise that many would not find the various cases to stand on identical footing in this way.

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40. This general rule of taxing services income in the jurisdiction of residence is embodied, for example, in Article 15.1 of the OECD model tax treaty. See OECD, MODEL CONVENTION WITH RESPECT TO TAXES ON INCOME AND CAPITAL (2014) [hereinafter OECD Model Convention].
Consider one final thought example. Suppose a resident of the United Kingdom books a flight from New York City to London, with a layover in Iceland. Assume further that the person buys an instant win lottery ticket in the airport in New York and puts the ticket in his pocket. During the layover the person scratches the ticket and it turns out to be a big winner. What if Iceland has a rule that sources winnings from instant win lottery tickets to Iceland if the holder of the ticket plays the game (that is, scratches it off) in Iceland? If the Icelandic authorities discover the ticket during a security check and seek to assess the tax, having both the power and ability to enforce the assessment, what would the likely reaction be? As above, I would like to suggest there seems to be some constraint on this, in the sense that the United States would likely object to this assertion of source-based tax authority.

I believe this example reveals an important general point about the nature of source taxation as it relates to the category mistake argument. One could make the argument that a jurisdiction in the position of the United States would be the correct jurisdiction to tax the lottery ticket if the jurisdiction has given deductions for gambling losses on the same lottery game. In terms of accurate measurement of income at the global aggregate level, it is often necessary to consider both deductions and income together. This reveals something important about how administrability concerns relate to source determinations. Here, one likely has the intuition that the income from the lottery ticket should be sourced to the United States, even if Iceland has the superior administrative capacity with respect to this particular item of income. The idea is that the sourcing of the item of income derives from administrative considerations regarding other income and deductions but not regarding the item of income itself. This would give us some sense in which the source determination regarding that item of income is not itself about issues of administrability. At least with respect to that item of income, it would not seem correct to say that the source rule is jurisdictional only, as argued by the force majeure claim.

Supposing, then, that there is some conceptual space for legal source rules which is not about exercise of power, this reopens the door to analytic inquiry into the content of source rules. It is to that task that I turn in the remainder of the Article.

II. Geographic Source of Income as a Distributional Concept

In this part of the Article, I offer an affirmative account of how international tax source of income rules can be understood as constructs designed to capture the geographic location of income. The analysis is entirely grounded in the existing conception of the function of source rules: source rules operate as distributional rules. (This is equally true under the force majeure account and the

41. For example, the United States allows taxpayers to deduct gambling losses up to the amount of gambling gains for the taxable year. See I.R.C. § 165(a), (d) (2014).
account that I offer.) This frame can be contrasted with that in Part III, in which I will offer a very different, inspirational conception of source rules, which would view their basic function as allocative. The common theme is that in each part I argue that source of income rules could be understood as coherent legal rules that take the geographic location of income as their subject.

This Part II, which adopts a distributive frame, has three sections. The first section builds on the idea introduced above that source rules do seem to be constrained by geography. Here I attempt to describe where such a constraint might come from and what it involves. The premise is that the decision to impose an income tax entails practical considerations that will push towards coordination around an “origin” principle (pertaining to the location of income production) rather than a “destination” principle (pertaining to the location of income consumption) for both labor income and capital income. Once that constraint is in place, individual source determinations can be understood in a geographic sense.

The second section addresses the question of what to do about the various claimed breakdowns and difficulties in the extant source rules. The standard story is that these breakdowns are a reflection of the underlying incoherence of source of income as a geographic constraint. I offer instead a novel counter-narrative. My claim is that a range of difficult issues with source rules manifest deeper problems in the construction of a comprehensive income tax base, which arise equally in a closed economy. These foundational problems go to core issues such as the labor-capital divide, the proper definition of deductible expenses, and timing. This claim has two implications. First, if the conceptual problems arise in a closed economy, they could not be driven by geographic indeterminacy. Second, the route to better source rules would be to call upon the same tools used to shore up the income tax base in the closed economy, as opposed to abandoning hope that better source rules are possible.

The third section takes up the example of the adoption of section 865 into the U.S. Internal Revenue Code, which relates to source rules for personal property sales. The point of this example is to give some sense of what an analytical assessment of source rules would look like if, as I argue, the origin of income is a constraint and the treatment of closed-economy complexities is relevant.

A. The Origin Constraint

My basic premise in this Part is that the function of legal source rules is distributive: they coordinate claims by various jurisdictions to tax base. Such coordination is not arbitrary, but occurs against the backdrop of some sort of constraint. The idea is that coordination of claims to a tax base—that is, claims over the primary right to tax income—can work in the same spatial way that we coordinate claims to physical resources. For example, if we ask, “Which nation has the right to extract the oil within the territorial boundaries of Saudi Arabia?”
we do not think that this is a difficult question to answer. We also think it is perfectly natural, indeed required, to answer that question by reference to territorial or spatial concepts.

We can understand coordination of income taxation working in a similar way, even though it is rather more difficult to see how. Observe that the position that takes geographic source of income to be an incoherent concept would seem to view the distributive coordination issue as a pure, unconstrained 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 in which to locate income, which would attempt to transcend positive law determinations, would simply be a huge waste of time.

If the situations are in fact parallel, then in the same way it is meaningless to say that the United States' "drive on the right rule" is better than the United Kingdom's "drive on the left rule," it would be senseless to critique one set of source rules as superior or inferior to another in their accurate reflection of the true geographic location of income, so long as they served their coordinating function. One might, of course, critique or approve of the distributional consequences of one set of source rules or another (e.g., on the grounds that tax base is being awarded to a wealthy country rather than a poor one), but then "source" as a geographic phenomenon is playing no role in the discussion, as one could simply talk about the distributional consequences across sovereigns directly.

My basic suggestion is that source rules should not be analyzed as pure coordination games in this sense. The idea is that, within the bounds of an income tax, we observe some likely fixed or determinate aspects of the rules. These aspects operate as constraining forces. Moreover, those constraining forces relate crucially to the source of income, understood (contra the basic claim of the category mistake argument) as a phenomenon about the geographic location of such income.

If I may push the driving analogy one step further, it is like the case in which everybody has already coordinated around a rule of drive on the right with two-way traffic, and given that decision, there is good reason to coordinate around a rule stipulating that one-way traffic in a traffic circle should move in a counter-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 the fact that making everything a left turn in a drive-on-the-right system is a slower

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42. Note that in the international tax system, the absence of coordination can lead to multiple jurisdictions claiming primary authority to tax the same income but can also lead to no jurisdiction asserting a claim to tax an item of income.
and more dangerous way to move traffic will lead to a further coordination around the counter-clockwise result.

I believe a similar dynamic is at play with source rules. Given a decision to have an income tax at all, certain approaches to source will seem preferable to others. Further, as I argue in this Part, one will be able to understand the preferred approach as having an important geographic component. This means that source rules will be subject to both critique and improvement, even when they are satisfying the bare coordination function. Ultimately the prospect of critique and improvement must rest on the fact that there is some connection between the normative underpinnings of the source-based tax (which, as noted, I assume to be some version of a benefits theory) and the location of income, understood in a geographic sense. The analogous normative constraint in the traffic circle example is the assumption that we value efficiency of movement and safety.

The basic class of problem I am concerned with, then, is one in which (i) coordination is important (flow of traffic/international tax jurisdiction); (ii) given certain fixed design features, the logic of coordination will suggest the superiority of certain other design elements (a drive-on-the-right rule for two-way traffic generates a preference for counter-clockwise traffic in a traffic circle/ a choice of an income tax generates a preference for an origin principle); and (iii) the suggestion of the superiority of these further design features cannot be divorced from some underlying normative commitments (minimizing traffic accidents and maximizing the efficiency of traffic flow/a benefits principle grounding territorial taxation).

Because my focus is on the connection between source and an income tax, we can begin by separating out the labor component and the capital component of a comprehensive income tax base. The type of constraint I have in mind works a bit differently across these two components of the base.

To assist in the analysis consider the following simple example. Suppose an individual resident in some jurisdiction, call it Home, performs labor services in period 1 in Home with value of \$100. Further, suppose the individual consumes \$80 of this in Home and saves \$20. The \$20 of savings is deployed in an investment, say rental real estate in another jurisdiction, call it Foreign. In period 2 the investment produces \$2 of net income, and the individual liquidates and consumes in Foreign the \$20 of original capital investment (ignoring depreciation for simplicity) and \$1 of the capital income, with the remaining \$1 invested in a new investment in Foreign. In period 3, this further investment produces an additional 10 cents of net income, and the taxpayer liquidates and consumes the \$1 capital investment as well as the 10 cents of income, all in Foreign. To summarize:
Observe first that I do not mean, by splitting items across Home and Foreign, to assume the answer to the distributional inquiry addressed by the source determination. I mean only to describe, as a factual matter, where the labor was performed, where physical capital was deployed, and where actual consumption occurred. Under a pure income tax base we would have $100 of tax base in period 1, $2 of tax base in period 2, and $0.10 of tax base in period 3. By contrast, under a cashflow consumption tax we would have $80 of tax base in period 1, $21 of tax base in period 2, and $1.10 of tax base in period 3.

We can now think about the labor income and capital income components of a comprehensive income tax base from a geographic source of income perspective. My strategy here is to adduce the range of basic conceptual possibilities and then to narrow this range based on likely real-world manifestations of a comprehensive income tax.

1. Labor Income

Regarding the labor income component of the example above, we could make an initial distinction between what might be called a supply-side approach and a demand-side approach. A supply-side approach would focus on attributes of the performer of the labor services. A demand-side approach would focus on attributes of the consumer of such services. From within a supply-side approach, there are two further conceptual possibilities. Specifically, one could base the source of income determination on an origin basis (i.e., where the person performs the labor) or on a destination basis (i.e., where the laborer consumes the labor income).

To map these categories onto the example, a supply-side origin approach would source all $100 of the labor income to Home on the theory that this is where all of the labor was performed. A supply-side destination approach would source $80 of the labor income to Home and $20 to Foreign based solely on the jurisdiction in which the proceeds of the labor income were consumed. Finally, application of a demand-side theory would depend on the location of the purchaser of the labor services. That purchaser could be in the same jurisdiction as the provider of the services but does not necessarily need to be since some
services may be provided remotely by electronic communication. Thus if the purchaser of the labor services were located in Home, then all $100 would be sourced to Home; if the purchaser of the labor services were located in Foreign, then all $100 would be sourced to Foreign.

There is nothing about the conceptual structure of a comprehensive income tax base that necessarily pushes us towards one of these three approaches over another. That was precisely the point of Ault and Bradford’s original articulation of what I have called the “economic incoherence” claim. Thus in the example above there is nothing of a conceptual nature that would preclude sourcing all $100 of the labor income to Home (under an origin principle) or would preclude sourcing $80 of the labor income to Home and $20 of the labor income to Foreign (under a destination principle).

There is, however, an important constraint relating to timing of information that militates in favor of an origin principle in this example. The $20 of unconsumed labor income is taxed in period 1 under a comprehensive income tax but in period 2 under a cashflow consumption tax. Therefore, implementing the income tax base will favor seeing information about source for all $100 of labor income in period 1. With an origin principle, this information is available, as all $100 of labor value has been performed. By contrast, under a destination principle, one does not have all of the relevant information in period 1 because some of the labor earnings are not consumed until later.

This is obviously not an absolute conceptual bar to using a destination principle. Within the bounds of an income tax, one could give a deduction for non-consumed labor earnings, source the associated income under a destination principle when consumed, and then make a time value adjustment through an interest charge in the period of consumption to give the same economic effect as having levied the tax in the period of labor performance. But this is an unwieldy approach. There may be a lag of many years between the earning of labor income and its consumption. Thus, within the bounds of a supply-side approach, there is a strong argument for adopting an origin principle—much like the argument for adopting a rule that traffic in a traffic circle should move counter-clockwise in a drive-on-the-right system.

This still leaves the possibility of a demand-side approach. Although a demand-side approach, like a supply-side destination theory, is grounded in consumption, it does not suffer from the same frailty mentioned above. Under a demand-side approach, the proper result in a case in which the purchaser of the labor services is in Foreign is to source all $100 of labor income to Foreign in period 1. Thus we do not have the inter-period information problem just described. However, there are other practical constraints that favor a supply-side approach rather than a demand-side approach. Specifically, the income tax will impose legal incidence on the performer of labor services, not the consumer. This means that supply-side theories are likely to have substantial informational
advantages over demand-side approaches. 43 That is, there are informational gains to be had from having the jurisdiction where the legal taxpayer is physically located (as under a supply-side approach) assume the primary source taxation right. For example, it should in general be much easier for the jurisdiction where the taxpayer is located to conduct audits to determine the true amount of labor supplied and the compensation paid for such labor.

Source taxation has historically generally endorsed a supply-side theory. To see this, one must consider cases in which labor is performed in one jurisdiction but consumed in another. This would arise with the remote provision of services, as where an attorney offers legal advice by telephone to a client in a different country. Under the OECD Model Convention the jurisdiction of labor demand would be unable to tax income from such remote provision of services under a source theory because the provider of services would have no “permanent establishment” therein. 44 While there has been some pushback against this result in recent years, nothing about this reaction calls into question the basic mode of analysis presented here (which is grounded in informational advantages). 45 That pushback reflects, I think, the simple fact that technological advances have made the remote provision of services far more feasible than it once was. Now that services are increasingly provided remotely, jurisdictions of labor demand have lost tax base that they were once able to reach under a supply-side source theory applied to locally provided services.

It is possible that remote provision of services could become so pervasive that we would see a rewriting of the equilibrium that currently exists. That is, countries may come to see the informational costs of applying a demand-side approach as worthwhile in light of the distributional benefits. But that is consistent with my overall theme here. Countries get channeled into particular structural commitments regarding source of income. From there, we can see the rules as both geographically determined and constrained. The rules are determined because, under a demand-side theory, we can usually physically

43. This does not mean that the concept of source reduces to considerations of administrability only (as in the position I critique in the Introduction). For further discussion of this point, see infra Part II.A.3.

44. This follows from article 7 of the OECD Model Convention, which provides that “[p]rofits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein.” Prior to amendments made to the OECD Model Convention in 2000 the same result would have arisen under now-deleted article 14 relating to independent personal services. Under that article, in a remote delivery of services case the jurisdiction where such services were consumed would not be able to tax labor income in the absence of a “fixed base” therein. See OECD, COMMENTARIES ON THE ARTICLES OF THE MODEL TAX CONVENTION 250 (2010).

45. See, e.g., FERNANDO TONANII & ALEXANDRE BARBOSA, INT’L BUREAU OF FISCAL DOCUMENTATION, CORPORATE TAXATION: BRAZIL 26 (2014) (“The majority of Brazilian income tax treaties generally follows the wording of article 7 of the OECD Model. Nonetheless, in some circumstances, tax authorities are reluctant to apply article 7 of the Brazilian income tax treaties, as for example in the case of outbound payments for services to non-residents without a permanent establishment, where article 21 (Other Income) is usually applied instead (article 21 in treaties signed by Brazil normally does not follow the OECD Model, but grants the taxing rights to the source country).”).

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locate the consumer. They are constrained because countries cannot tax in a way that conflicts with the basic structural commitments in isolated cases, even if they administratively can do so, without violating the bounds of accepted source-based taxation.

2. Capital Income

Now consider the capital income portion of the base. For capital income we could once again draw a distinction between a supply-side approach and a demand-side approach. The analysis of the supply-side possibility is somewhat different from that just discussed, however, reflecting the basic distinctions between capital and labor. Specifically, there are three basic possibilities for sourcing capital income under a supply side theory. One could look to: 1) the jurisdiction in which the productive capital is located (analogous to the origin principle discussed above with labor); 2) the jurisdiction in which the owner of the capital consumes the capital income at issue (analogous to the destination principle discussed above with labor); or 3) the jurisdiction in which the capital owner is located. Note that we get three supply-side possibilities rather than two because it is possible to deploy capital remotely in a way that it is not possible to deploy labor remotely (at least in a society that does not permit slavery).

Much as in the case of labor income, forces would seem to push towards adopting an origin principle from a supply-side perspective. A destination approach would generate the same sorts of inter-period problems that we have seen. To call on the example introduced above, suppose a decision has been made to source the labor income in period 1 under an origin principle. This would provide a strong reason not to adopt a destination principle for capital income in period 2. If we did have a destination principle, then we would have to be able to distinguish between consumption of labor income and consumption of capital income, which would be difficult and completely arbitrary. What if the taxpayer splits her $21 of consumption across jurisdictions? Of course, we would need to take account of the $20 of embedded labor income that has already been taxed and then have an allocation rule about whether the consumption in any given jurisdiction was funded out of previously taxed labor income or not previously taxed capital income. This would be complicated. One also has the very same problem as one does with labor income under a destination principle: the income tax will be structured to tax all of the $2 capital income in period 2, but we don’t have information about all $2 yet because some of it is saved.

The alternate possibility under a supply-side approach is to look to the location of the saver or owner of the capital income. Thus in period 2 we could look spatially at where the owner is located. This does not have the same problems as the destination sourcing approach, but it seems like there are other factors pushing against it. Specifically, the premise of this whole discussion is that jurisdictions are bargaining over tax entitlement where the tax claim is not based on residence. But if we write a source rule that defaults to residence, this
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is not so much a source rule as it is a rejection of the source-based claim altogether.

Finally, a demand-side theory applied to capital income faces the same sort of informational hurdles as it does when applied to labor income. That is, the jurisdiction of demand is physically remote from the factors producing the capital income, thereby complicating issues of audit and measurement. This is not to say that such an approach is impossible. Indeed, it has become popular of late to advocate for this type of approach.\textsuperscript{46} That said, one can understand—and observe—the forces that seem to have pushed sourcing determinations towards a supply-side origin principle for both the labor income and capital income components of the income tax base.

3. Administrative Constraints and Geography

Before concluding this section, I should add an important clarification. My overall thesis relies on the idea that source determinations can be understood as reflecting something about the geographic location of income rather than as mere labels that a jurisdiction attaches to income that it has the raw power to tax. Admittedly my analysis also uses the idea of administrative realities (such as informational hurdles that make it difficult to apply a destination principle to labor income that is saved and consumed in future years) to generate the basis for some constraints on the content of source rules. However, the key aspect of the position that I espouse is that the administrative realities generate certain structural commitments (such as an origin basis), which in turn have a \textit{geographic} dimension. Moreover, that geographic dimension relates to underlying normative commitments such as an understanding that the jurisdiction asserting source-based tax on an origin basis has accorded benefits to the taxpayer. Thus, under my approach, administrability concerns favor an origin basis for the labor income tax and from there the task is to write rules that determine the geographic location of the production of labor income. Attempts to then tax labor income according to a source theory where the production is \textit{not} located within the sovereign’s borders would thus offend the rule. It would be a coherent claim under my approach to say that a sovereign that attempted to tax income in this sense was acting outside the bounds of appropriate source-based taxation, insofar as it was seeking to tax foreign source income of a non-resident. By contrast, under the more typical approach (grounded in the category mistake argument), such a claim would not be coherent. If there were circumstances in which it was administratively feasible to tax labor income that was produced extra-territorially by a non-resident, then the jurisdiction that sought to tax such income would, by construction, be taxing domestic-source income.

\textsuperscript{46} See, \textit{e.g.}, Alan J. Auerbach, Michael P. Devereux & Helen Simpson, \textit{Taxing Corporate Income}, in \textit{DIMENSIONS OF TAX DESIGN: THE MIRRLEES REVIEW} 837, 882-88 (Stuart Adam et al. eds., 2010).
B. Enduring Problems with Source Rules and Complexities Under a Closed Economy Income Tax

We should take stock of where we are in the argument. So far I have attempted to show that there are good reasons for countries to coordinate around an origin principle for source taxation both with respect to labor income and capital income when one is dealing with a comprehensive income base. Further, one can understand such an origin principle in a geographic sense, which opens the door to analytical determinations of better and worse source rules, to the extent they accurately capture, or not, the relevant geographic criterion. This does not mean, of course, that we have ready answers to the more difficult problems of source taxation. To this point, the discussion has been an exercise in carving out space for a conceptually sound approach to geographic source of income rules in the face of the category mistake argument. I turn now to the question of what to do with difficult questions of source taxation.

The basic claim in this section is that a range of problematic issues in source taxation should be understood as manifestations of deeper problems that arise under an income tax, even within a closed economy. This opens the door for incremental improvement of source rules, to the extent that one can locate the deeper conceptual problem at issue and then call upon accumulated learning in dealing with such problems.

There are three broad categories of problems in a system that has coordinated around an origin principle for both labor income and capital income. First, one has the problem of applying an origin principle to capital income (i.e., determining where the capital is actually located). Second, there is the problem of applying an origin principle to labor income (i.e., determining where the labor is actually performed). Third, there is the problem of determining which category income falls into (i.e., determining whether it is labor income or capital income that is being sourced).


My basic claim in this Part II.B. is that common source problems reflect deeper problems that arise in a closed-economy income tax. In this section’s discussion about locating capital, the closed economy complexities that come to the fore are (i) the problem of how to allocate deductions to different categories or items of gross income (where there is tax relevance because the different categories or items receive different tax treatment) and (ii) the problem of how to draw the line between debt and equity for purposes of determining deductibility under a corporate income tax of putative interest paid by a corporation.

Perhaps the greatest challenge under the framework I am trying to develop in this Paper is what to do about the sourcing of income that arises from intangible assets. Above I have tried to adduce reasons that would channel
sovereigns towards coordinating around an origin principle for sourcing capital income. Interpreted as the location of capital deployment, this presents no immediate problem for tangible capital. But what to do about intangible capital, which by definition has no physicality and would thus seem impossible to analyze meaningfully in a geographic sense? For reasons that will become clear, it is useful to distinguish between non-financial intangible assets (broadly, what we could think of as intellectual property) and financial intangible assets (largely debt giving rise to interest payments and corporate stock giving rise to dividends).

a. Non-Financial Intangible Assets

The first point to observe here is that it is possible to give geographic coherence to intangible assets so long as we consider the category to cover assets that have some legal basis or protection. This would cover legally recognized assets that have a statutory basis (such as patent or copyright) or private contractual mechanisms that benefit from legal enforcement. If this is the category with which we are concerned, it is possible to associate the income from the intangible asset with the territorial basis of the associated rights generating the income.\(^\text{47}\) Thus a royalty on a copyright for Canadian rights non-problematically generates income that can be geographically tied to Canada. This seems to be the common understanding that is in fact embodied in the basic approach to royalty income under the OECD Model Convention, which draws a distinction between the source state (where royalties “arise”) and the residence state where the royalties are beneficially owned.\(^\text{48}\) Intermediary jurisdictions which merely receive royalties and then pay them on count neither as source nor residence states in this sense.

An alternate possibility for geographically locating income from non-financial intangible property would be the jurisdiction in which the intangible asset is developed or created. However, the value of such creation should reflect the combination of some labor inputs in that jurisdiction (which can be located under the labor origin principle) and other intangible capital inputs (which can be located under the principle just noted that looks to the jurisdiction where such intangible receives legal protection). Assuming adequate compensation for these inputs, the jurisdiction in which the intangible is created will typically attract a substantial portion of the tax base with respect to the intangible.

But so far this gives us only a way to think about gross income from intangible assets in a spatially bounded sense. Under an income tax we will need to calculate net income from a particular source and thus must take account of deductions. This generates a substantially more complicated problem because

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48. OECD Model Convention, article 12.1.
expenses are not nearly as directly tied to an asset as is income. That is, it is generally much easier to determine which asset income derives from (a patent payment, for example) than it is to determine with which asset an expense should be associated (whether the inventor’s costs associated with building a lab should be tied to one invention or another, both of which were generated in the lab). This sort of issue can generate great difficulties when it comes to sourcing net income from intangible assets in the international context. The complexity of associating deduction with gross income gets the ball rolling. The taxpayer’s incentive to locate gross income in low tax jurisdictions and deductions in high tax ones will only serve to greatly aggravate the problem.

Consistent with my overall theme in this Part, though, I would note here that the problem one confronts in assigning proper source to net intangible income is not at the core a problem of geographic or spatial indeterminacy. At least once we have a sound approach to locating gross income, as I suggest above we do, then the nature of the sourcing problem here can be understood as merely a species of a more general problem of associating income and deduction even in wholly domestic systems. For example, taxpayers will in general have powerful incentives to tie intangible development costs to assets for which there will be more rapid depreciation or amortization. There should be no conceptual bar to applying whatever approach is adopted to solve the wholly domestic problem in the international case as well.

As an aside, I should note here that there is a series of problems regarding the taxation of intangibles which are sometimes grouped together with critiques of source but which in fact implicate questions about the extent of residence-based taxation. These issues thus run orthogonal to the source problems under discussion here. For example, tax administrators frequently confront difficult problems related to the migration of ownership of intangibles through the transfer of assets to low tax jurisdictions at artificially deflated prices. This is not a source problem, however, and the possible solutions (exit taxes, taxes on controlled foreign companies, transfer pricing regulations) are about the contours of residence-based taxation. Similarly, a lower than desired aggregate tax result may arise when a deductible royalty payment is made from a source country that bears low (or zero) withholding taxes under the terms of an executed tax treaty. If the residence country applies a foreign tax credit approach with respect to the royalty income and allows cross-crediting, then there may be zero residence country tax collected. Some scholars see here obvious evidence of the frailties

49. For example, in the United States this problem is addressed in a body of highly technical, complex regulations. See Treas. Reg. § 1.861-17 (2011).

50. A good example of how this plays out in the domestic context is the body of U.S. regulatory law on the question whether a taxpayer must capitalize rather than expense the amount paid to acquire or create intangible assets. See Treas. Reg. § 1.263(a)-4 (2004).

51. Under a cross-crediting regime, the taxpayer is able to use excess foreign tax credits from some other relatively high-taxed foreign income to offset any residual residence country liability on the relatively low-taxed foreign source income.
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of the source concept as an international tax base allocation mechanism. But the breakdown here is not in the source concept. Again, source is a coordinating mechanism, and when countries agree on the source determination (as in this example), it is difficult to say the coordinating mechanism is failing. The deeper cause for the non-taxation of income here lies in the approach of the residence country to its residence-based taxing authority, specifically in its application of the foreign tax credit. One could address the problem by restricting the availability of credits to offset tax on the income, which is conceded to be a foreign source royalty. The ambiguity or puzzle here is not in the scope of source-based taxation, but rather in the scope of residence-based taxation. The general form of the problem asks what residence countries should do about foreign source income that faces low foreign taxes. That's a difficult problem but not one that implicates the ambiguities of geographic source.

b. Financial Intangible Assets

We can now consider the problem of financial assets. Financial assets and non-financial intangible assets have different spatial characteristics. With the distinct category of financial assets I mean to separate out those instruments the value of which may ultimately be dependent on tangible assets. Thus the value of a home mortgage loan held by a bank on its balance sheet will depend on the value of the underlying physical asset that secures this loan. This is a crucial distinction because it provides a meaningful basis for source determinations at the end of the chain of financial intermediation, much like the rule for protection of intellectual property gives some way to understand gross income from non-financial intangible assets in a geographic sense. The two chief items of income from financial assets for sourcing purposes will be interest and dividends. I consider the interest case first as it presents a somewhat greater range of issues.

The most important context from the standpoint of source rules is the case in which local activity is debt-financed, giving rise to interest payments to a

52. See generally Kleinbard, supra note 21.
53. The extent to which avowed critics of the source concept disagree with this statement is unclear. For example, Professor Kleinbard gives a particular, non-conventional meaning to source. Specifically, he defines the "source" jurisdiction as the jurisdiction in which income is included or deducted. See id. at 752 n.123. Thus, if a U.S. person receives deductible interest from a foreign affiliate, which is denominated "foreign source interest" (under section 862(a)(1) of the Internal Revenue Code), Professor Kleinbard would denote this as "U.S. source interest" in the sense that the U.S. is the jurisdiction where the payment is included in income. Id. The technical denomination of the income as "foreign source" under the Code does not change where the item is taxed; rather, it simply makes matters worse by increasing the availability of U.S. foreign tax credits, which in general are limited by the amount of the taxpayer's "foreign source income" under the Code. Thus although the critique is phrased as a critique of "source," it would seem, in fact, to be a standard critique of the balance between residence- and source-based taxation, since the interest is includible in the U.S. on the basis of residence, not source. The residence criterion for corporations is admittedly artificial, but this is a failing pertaining to the residence concept, not the source concept.
54. If the value of the financial asset is driven by some intangible asset at the end of the chain of financial intermediation, then one can fall back upon the discussion of intangible assets from above to provide a meaningful geographic criterion.
nonresident taxpayer. This is a ubiquitous problem in international tax planning, covering for example the case of “debt pushdown” strategies to local affiliates that have physical capital in the local jurisdiction unambiguously creating local source gross income. The sourcing determination for interest in this sort of case is relevant because the local jurisdiction can expand its base by denying a deduction that is allocated to the local source gross income precisely in virtue of the fact that the recipient is a nonresident. This is the basic form of interest deduction denial under thin capitalization rules for debt finance. Or, the jurisdiction can expand its base by attaching local source to the interest income in the hands of the non-resident and assess tax on that basis, typically through a withholding tax on the outflowing interest payment. The mechanisms are different, but the base expansion aspect of each is tied to a source determination in the same way.

Suppose jurisdictions with real local economic activity are thought to reach too little tax base in this type of circumstance. The blame is often laid at the feet of the source rules, suggesting that a geographic source determination for a spatially nebulous item such as interest is artificial in any event. I suspect that arguments that assert the fundamental conceptual weakness of the source concept as a general matter are often not general claims at all but actually are very much grounded in the particular problems that arise when the concept is applied specifically to deductible payments to holders of financial capital.

It is true that in the above-described circumstance the jurisdiction could reach more base by denying more deductions (that is, by expanding rules on denial of local source interest deductions paid to non-residents) or by extending the reach of inclusions for interest received by non-residents. But the fact that there is a problem of inadequate base and the fact that the problem could potentially be redressed through modification of the source rules does not stand as a general indictment of the source concept. It is far from clear that it even stands as an indictment of the source concept in this particular circumstance.

Again, consistent with one of my basic themes in this Paper, the issue here could be seen as a manifestation of a more fundamental issue in the design of income tax systems even in a closed economy. That fundamental issue is simply what deductions ought to be allowed from a properly defined income tax base, particularly for interest. Thus one faces in essence the identical problem in determining the debt-equity line under a domestic corporate income tax. That is a notoriously difficult problem to solve, but nobody would think that the problem


56. Professor Kleinbard, for example, describes the norms that define geographic source of income as “largely artificial constructs” and justifies that claim based on the sourcing of interest specifically. Kleinbard, supra note 21, at 750-52. See also Michael J. Graetz, A Multilateral Solution for the Income Tax Treatment of Interest Expenses, 62 BULL. FOR INT’L TAX’N 486, 489 (2008) (offering the observation that “as is well known, the ‘source’ of income is not well grounded economically” as a prelude to an extended discussion of interest expense).
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has anything to do with the geographical locatability of interest payments.\textsuperscript{57} Much the same can be said for the basic fact pattern under discussion here. Having determined an appropriate amount of gross local source income (a determination which does have a geographic basis, stemming from the physical location of real capital generating the income), the question is simply what amount of deductible interest expense is allowable against such income. The mere fact that the cross-border case may allow one to incur third party lending from non-local affiliates and then push an artificial amount of debt into the local affiliate does not make for a more difficult problem than in the domestic case. In the domestic wholly owned corporate case, one similarly faces no market constraints on the formal labeling of an interest in the company as debt because the sole owner is entitled to all economic returns regardless of label. Thus the wholly domestic debt-equity line of authority must deal with the full range of inflated leverage ratios as well.\textsuperscript{58}

Turning now to dividends, the fact that dividends, unlike interest, are non-deductible under a classical corporate income tax (i.e., one that attempts to levy one level of tax at the corporate level and a second level of tax at the shareholder level) makes for a simpler analysis. It is true that one faces a set of complications with sourcing dividends as a decision must be made about how much to trace

\textsuperscript{57} As evidence of the difficulty of the general problem consider the history of section 385 of the Internal Revenue Code, which grants authority to the Treasury to promulgate regulations on the determination of whether an interest in a corporation should be considered debt or equity. This section was first enacted in 1969. Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487 (1969). In an accompanying committee report the Senate Finance Committee observed, "In view of the uncertainties and difficulties which the distinction between debt and equity has produced in numerous situations other than those involving corporate acquisitions, the committee believes that it would be desirable to provide rules for distinguishing debt from equity in the variety of contexts in which this problem can arise." S. REP. No. 91-552 (1969). Although the Treasury issued proposed and final regulations in the early 1980's, these were withdrawn before ever taking effect. Further, the Treasury has to date still not successfully written final effective regulations on the topic. For a general discussion of the common law approach to the problem of distinguishing debt from equity and a fuller history of section 385, see Joint Committee on Taxation, Present Law and Background Relating to Tax Treatment of Business Debt, JCX-41-11 (July 11, 2011).

\textsuperscript{58} Note that there are further problems that can arise with cross-border interest payments in which source rules may be at issue. However, these problems are best understood as questions about the proper scope of residence-based taxation. There are two sorts of problems I have in mind here. First, if a residence jurisdiction includes cross-border interest income in the base of a resident but then grants foreign tax credits (in virtue of the income being denominated as foreign source), then the source determination will have operated to curtail the residence country base. But this is entirely analogous to the issue of low-taxed foreign source royalties discussed above. This problem implicates a difficult question about residence country tax policy; it does not implicate a breakdown in the source concept. Second, a jurisdiction from which interest is paid might denominate the interest as domestic source so that it can withhold on the payment precisely because it is concerned about resident taxpayers who have artificially routed money out of the country only to lend it back to a domestic borrower (so-called "round-tripping"). Using the conjunction of a "source" determination plus a withholding tax (possibly called off if one can prove to the payer that the investor is not in fact a resident) may or may not be effective to solve the round-tripping problem. I would observe that once again there is no issue of residence-source coordination here. Rather, this is really an instance of collecting tax on domestic source income of a resident but about which it is difficult to get information. I put this sort of problem to the side as it does not implicate the coordination of overlapping claims to tax base, which I take to be the central distributional role of source rules.
through to underlying activities of a corporation paying dividends. At one extreme one can have an entirely formalistic rule that looks only to the residence of the payor, no matter what real activity is ultimately funding the dividend. At the other extreme one could attempt to trace dividends back to the return on real assets that ultimately funds their payment. These are difficult questions, but they do not call into question the basic substantive grounding of the source concept. It seems fairly clear that, on a substantive analysis of the source of a dividend payment, one should look to the real returns at the corporate level. To the extent that one does not look through, this reflects typical tradeoffs in drafting tax rules between administrability and substantive accuracy. But I do not see that it calls the basic coherence of source rules into question.

2. Locating Labor Under an Origin Principle

In this subsection I discuss the closed-economy income tax complication that I take to be relevant to the sourcing of labor income. The particular closed economy complexity that I focus on here relates to timing issues under an income tax that adopts discrete accounting periods.

This is a substantially easier problem to analyze than the case of capital because labor, taken to be a function of an individual, is necessarily spatially bounded in a way that at least intangible capital is not. Still, the location of labor under an origin principle can present some difficult problems. The structure of those problems tracks what we have just seen regarding capital income to some extent. Specifically, the issues that arise with gross income versus net income are subject to a different analysis.

Consider gross income first. If labor services are of relatively low and constant value, sourcing determinations will present no particular issues. With level income, one can apply a sourcing rule that is proportionate by time. Thus an individual who has $1000 of gross income and works half of the time in one jurisdiction and half of the time in another jurisdiction can have her income sourced accurately under an origin principle by applying a simple fifty-fifty allocation. But what if the value of services is variable? Then a straight time basis rule of apportionment will get the answer wrong.

This precise issue arose in the United States in a series of cases involving hockey players who spent part of their time in Canada and part of their time in the United States. In *Stemkowski v. Commissioner*, the Second Circuit apportioned a hockey player’s income based on the number of days of training camp, regular season, and playoffs spent in either the United States or Canada. Arguably, the value of services performed in these various circumstances is not level, and thus a straight rule of time apportionment is not completely substantively accurate. The adopted rule, however, was closer to the conceptual ideal than the one urged by the taxpayer, which would have given equal

59. 690 F.2d 40 (2d Cir. 1982).
weighting in the apportionment formula to days in the off-season, which presumably had non-zero, but low, value to the team.

Current regulations reflect a similar dynamic. Thus there is a default time basis rule for compensation paid to employees.60 This reflects an assumption that the value of labor services provided by employees is likely to be relatively level over time. By contrast, this presumption does not apply to entities or independent contractors, reflecting the greater possible variance in the value of their services.

Proposed regulations would apply an “event basis” sourcing rule that would source income from performance of a particular event to the location of that event.61 This rule is meant to deal with the situation of artists and athletes who may spend time in preparation for an event outside of the country in anticipation of performance at an event therein.62 The events basis rule would not take account of preparation time. This is a departure from a time basis rule, reflecting the fact that straight application of such a rule would apportion too much income to the relatively lower value services performed in preparation for the event.

My observation on this dynamic is a simple one. The issues are complex but they are not complex because of any issue with spatial indeterminacy. The problem here, rather, is one very familiar to domestic tax policy. Specifically, we confront a tradeoff between the administrative complexity of more accurate valuation approaches and the administrative ease of proxy rules, which are simpler to apply even if they are, by definition, inaccurate.

Thus in the context of sourcing gross income, it is not difficult to state the conceptual ideal under an origin principle. The source rule should ascribe appropriate value for actual services rendered in a given jurisdiction. In a case in which a contract covers services of variable value, then the conceptually correct approach would be to consider what the bargained-for result would have been if there had been separate agreements for each jurisdiction. This is a complicated exercise. A rule of time basis apportionment overshoots the mark in one direction (ascribing equal value to services of variable value). An events basis apportionment overshoots the mark in the other (ascribing zero value to services of positive value). Still, there is nothing mysterious about this dynamic, and the problem presents no fundamental challenge to the issue of source taxation of labor services under an origin principle.

Turning to net income, we face a different sort of problem, though also one that can be likened to standard problems in domestic tax systems. A basic issue arises here where there is a temporal split between skill accumulation and the delivery of services. In circumstances in which an individual devotes substantial time and expense to the accumulation of human capital, it may seem that basic application of an origin principle to labor services does not achieve the correct allocation across jurisdictions. For example, consider a professional, such as a

62. See id.
lawyer, who incurs substantial expense by training in one jurisdiction and then later delivers services in another jurisdiction. Under a straight application of a place of performance/origin rule it may look like the jurisdiction of service performance is capturing too much tax base, as gross income is not reduced to reflect expenses incurred in earlier years.

But once again this reveals no underlying flaw in source taxation. Rather, it reflects a simple timing issue that arises in wholly domestic systems. That is, human capital is notoriously difficult to capture accurately in an income tax system. On one view it would be necessary to capitalize and amortize costs, an approach that presents complicated issues of cost recovery over many years.63 Alternately, it has been argued that human capital should be taxed as a wealth transfer at birth (or on an ongoing basis to reach similar economic results to the case where the wealth transfer had been taxed at birth).64 None of these approaches is without complication. My point, as above, is simply that these are not complications of geographic indeterminacy. They are, instead, problems of a net income base in instances in which expense and associated income are separated in time.

3. Labor Income Versus Capital Income

In this third subsection I take up the issue of the distinction between labor and capital income. The relevant closed economy complexity should be easy to understand here as it relates simply to the basic divide between labor and capital under an income tax.

Assuming one can obtain a reasonable resolution to the two problems discussed above, one faces a further problem, which is determining the line between labor income and capital income. This is crucial because, even though both may be sourced under an origin principle, the location of associated labor performance and capital deployment may not be in the same jurisdiction. In such cases, the categorization of the income as labor or capital will be determinative of the source determination.

This type of conflict often presents itself along the margin between royalty income and services income, where the issue is whether a taxpayer has capital income from the return on royalty-generating intellectual property or rather has labor income from the performance of services. To illustrate, it will be helpful to refer to a recent case from the United States. In Garcia v. Commissioner, the taxpayer, a professional golfer, had entered into an endorsement contract with a golf equipment company.65 The contract was in part for activities that unambiguously constituted personal services (namely, the requirement to use the

63. See William Vickrey, Agenda for Progressive Taxation 122-26 (1947).
company's products while playing in professional golf tournaments) and in part for activities that unambiguously related to royalties for the use of the taxpayer's property rights in his name and image.\(^{66}\)

One of the key questions at issue in the case was the allocation between these two types of payment as they received different tax treatment under the applicable double tax convention.\(^{67}\) The bulk of the payments under the contract presented no question of source because they would have been U.S. source in any event. That is, they related either to performance of services in the United States or to rights to use the taxpayer’s name and image in the United States. If, however, the distinction were between services performed in the United States and the right to the name and image outside of the United States, then the characterization issue would squarely present the relevant sourcing concern along the labor income versus capital income axis. Indeed, there was some amount of income under the contract related to use of the taxpayer’s name and image outside of the United States. With respect to that element of income, there was no claim on the part of the United States that it was taxable (insofar as it was foreign source).\(^{68}\)

The key point I would make with respect to this example is that, although the allocation issue in Garcia was contentious and clearly difficult for the court (which ultimately produced a result that departed from all of the submitted expert approaches), the difficulty had nothing to do with complications related to the determination of geographic source of income. The difficulty, rather, focused entirely on the complexity of solving the valuation problem: how much the services were worth versus how much the image was worth in circumstances where the court doubted that the contractually stipulated allocation across the two categories reflected reality. (Although the parties were contracting at arm's length, it appeared that the allocation mattered only to the taxpayer and not to his contractual counterparty).\(^{69}\) By contrast, the actual source determinations were fairly simple: were services performed in the United States or not? Were rights to the taxpayer's image and name used in the United States or not?

More generally, it is worth observing that the deep issue under consideration here relates to the question of mixed income—cases where it is not clear how to divide income between labor and capital. That dividing line can have immense consequences under domestic law in closed-economy applications of an income tax. For example, it implicates the difference between permissible assignments of income-producing property versus impermissible assignments of income from property.\(^{70}\) Thus in Helvering v. Eubank the Court confronted the

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66. Id. at 144-48.
67. Id. at 158-63.
68. See id. at 149 n.12.
69. Id. at 151 (indicating that counterparty's CEO had stated the allocation was "irrelevant" to him).
70. That basic distinction was articulated in two Supreme Court cases decided within a few years of one another. In Blair v. Commissioner, 300 U.S. 5 (1937), the Court held that a father's
issue whether the assignment of contingent rights to life insurance renewal commissions should be treated as non-assignable services income (i.e., the commissions themselves) or as an assignable property right. This is much the same line as between services income and property confronted in Garcia.

The line between capital and labor can also represent the difference between ordinary income treatment to the taxpayer or capital gains treatment. Not surprisingly, this is also a much-contested issue under wholly domestic law. To take a recent prominent example, consider the controversy surrounding whether the "carried interest" of hedge fund managers is ordinary or capital in character.

The overarching theme should, by now, be plain. Complications that arise in the application of source rules can typically be understood as reflections of more general and basic difficulties that arise in the application of an income tax in wholly domestic circumstances. Such complications do not call into question the fundamental conceptual coherence of geographic source of income as a crucial component in allocating the income tax base across countries. Further, this means that the path to more robust, analytically sound source rules lies in part in thinking about the way the various problematic fault lines and complexities (deductibility of expense, timing, labor versus capital) have played out over time in the wholly domestic context.

C. An Example

The discussion so far has been relatively abstract. Here I take up a concrete example. My goal here is to show what a substantively grounded analysis of source rules, which calls upon the important distinctions highlighted in Part II.B above, would look like. This is a drastically different sort of methodological approach than one would follow if one really accepted conceptual incoherence of source rules and the force majeure view of the matter.

Consider the amendments to the Internal Revenue Code in 1986, which introduced section 865 into the Code. Prior to this legislative amendment, gains assignment of his beneficial interest in a trust constituted a valid assignment of property for tax purposes, with the effect that the assignees became owners of the beneficial interest and taxable thereon. By contrast, in Helvering v. Horst, 311 U.S. 112 (1940), the Court held that a father’s gift of interest coupons detached from a coupon bond constituted an assignment of income, rather than property, for tax purposes and thus would be taxable to the donor rather than the donee under the general authority of Lucas v. Earl, 281 US. 111 (1930), which held tax effect would not be given to anticipatory assignments of income.

Note that there is some judicial authority in the United States explicitly taking the position that the capital gains versus ordinary income line for domestic purposes is not necessarily determinative of the line between sales and royalties under the international provisions of the Code. See, e.g., Rohmer v. Commissioner, 153 F.2d 61 (2d Cir. 1946), aff'g, 5 T.C. 183 (1945). I would observe, however, that the distinctions drawn have nothing to do with geographic determinacy or indeterminacy in the cross-border cases. Further, the line of authority has been questioned in academic commentary for introducing unnecessary complexity into the tax law. See Harvey P. Dale, Withholding Tax on Payments to Foreign Persons, 36 TAX L. REV. 49, 73 (1980).

from the sale of intellectual property were sourced under a “title passage rule.” In other words, income would be sourced to the United States if title on the sale passed in the United States but would be sourced outside the United States if title did not pass domestically. That result had been roundly criticized as arbitrary and as failing to reflect in any meaningful way the location of value creation related to the intangible property. Under the newly introduced section 865, by contrast, gains from the sale of intangible property would be sourced under a residence of the seller rule so long as the payments were not contingent, and under the royalties sourcing rule (that is, by place of use) so long as the payments were contingent.

How should one analyze the merits of such a change? Under a force majeure view, the analysis might look something like this. The prior rule, which allowed one to source gain from a “sale” under a title passage rule 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 merits of the rule modification would be analyzed based on the distributional and administrative consequences of removing or curtailing taxpayer discretion and applying, in this case, a uniform place of use standard. If one preferred the distributional consequences of the status quo (taking account of possibly dynamic moves by other countries) and the approach was administrable, then that would be the favored result.

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 problem discussed above. From that perspective, both the source rule based on the residence of the payor for fixed price sales and the place of use rule for royalties have some sense, at least as imperfect proxies. (By contrast, a title passage rule seems to have little or no connection to the location of income under the origin constraint discussed above.) Specifically, 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 royalties

74. See Lokken, supra note 47, at 253.
75. See I.R.C. § 865(d) (2014).
76. For the avoidance of confusion, note that “source” rules can invoke concepts of residence—such as sourcing income based on the residence of the payor or the payee—without thereby becoming “residence” rules within the source-residence dichotomy that pervades international tax analysis. The distinction is that residence rules ascribe an attribute (i.e., “residence”) to a taxpayer (individual or corporate), while source rules ascribe an attribute (i.e., “source”) to an item of income rather than to a taxpayer.
77. The legislative history makes it clear that this was the underlying thought behind a residence of the seller rule. The House Report states, “Because the residence of the seller generally is the location of much of the underlying activity that generates income derived from sales of personal property,
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 underlying goals of these admittedly imperfect approaches 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 in the United States that are embodied in zero-basis intellectual property that can be transferred for exploitation abroad for consideration of either a $100 fixed sum or a contingent stream that will pay either $200 or $0 with equal probability. It would seem “correct” to treat the latter case 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. In other words, because of the contingency the payment will be sourced under section 865(d) in the same fashion as a royalty and thus sourced 100% foreign in this hypothetical.

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.

I should conclude this Part with a final, broader observation. Just because we can analyze a source rule, such as that in section 865, in the way just presented, should we? That is, some readers may at this point be convinced of the logical possibility of a coherent conception of source rules about geographic location of income but nonetheless find the force majeure account normatively appealing.

If the amendment of a source rule is in the national interest in a distributive sense, and a country can administer it and get away with it, why not adopt the amendment? Why do we need further analysis? Scholars will differ in their views on this question, but I think the proper way to frame the issue is to ask at what

the committee believes that sales income generally should be sourced there.” H.R. REP. No. 99-426, at 360 (1985).
level of generality we should assess the national interest. There is an embedded normative commitment in my analysis, which I am not shy about admitting. It is that the basic normative underpinning of the analysis rests on the general desirability of coordination across jurisdictions and that such coordination should build upon a defensible normative justification for source taxation (and residence taxation, though that’s easier) in the first instance. My view is that source rules are meant to accomplish that goal and that, conditional on the adoption of income taxes, the coordinating rules will have a sound, natural tendency to be based on an origin principle. From there, the task of legal analysis should be to write rules that capture factual inputs demanded by the normative theory justifying source tax. The task should not be to think about the national interest on an item-by-item or transaction-by-transaction basis. Some source rules—applied in a geographically coherent way—may not be in a given nation’s interest across a range of transactions and taxpayers. But maintenance of the overall coordinated system could well be in the national interest, in spite of this.

III. Geographic Source of Income as Efficiency Concept

In Part II I analyzed source rules as reflections of the geographic location of income given what I take to be the extant agreed function of the source rules. In other words, I have attempted to achieve a coordinated approach from a distributive standpoint. In that analysis there were no efficiency gains or losses to be reflected. Indeed, as I argued in Part I, the discipline of economics is ill-equipped to tell us anything about these underlying distributive questions.

The method in Part III is to take a different approach to source rules that would still involve coordination but in which the focus would be on efficiency. The point of including the analysis here is twofold. First, I take the conception of source rules to be of independent normative merit. That is, one could certainly take the position that a justifiable goal of source rules would be to promote efficiency on a global basis. Second, because the account involves a concept of source rules that would aim to describe the geographic location of income, the discussion bolsters my basic thesis in the Paper that it makes sense to think of the geographic location of income, contra the category mistake argument. It can make sense under existing normative commitments, as in Part II, and it can make sense under alternate conceivable normative commitments, as in this Part III.

This Part has two sections. First, I describe the way in which cross-border income, and tax competition associated with it, can be described as arising in four different categories. Each category suggests a different role for source rules, again understood in a geographic sense. This categorization lays the groundwork for what a system of source rules would need to accomplish if the normative commitment were grounded in efficiency. The second part deals with various real-world complications that would arise in segregating the tax base in this fashion. I have more problems than answers here. The bottom line is that implementing this approach to source alongside real-world instantiations of
corporate income taxes would be very difficult. However, I hope this Part will at least generate discussion about the desirability of following the type of approach I outline here and about the ways in which one might try to solve the various problems I have identified.

A. Categories of Income

The efficiency-based analysis that I offer here reflects the fact 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 in which 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 with jurisdiction over the location of the rent 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 from 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 because the fact that the rent is non-location-specific means there is no ready connection between the rent and prior sovereign investment. 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. One could fruitfully think of this category as involving firm-specific, non-location-specific rents, where source taxation is difficult because of the mobility of the rent and residence taxation is difficult because of the mobility of the firm.

The third category covers income from what we can think of as mobile non-rents. This would cover income that reflects a normal return to capital—for example, from deploying capital in a routine manufacturing operation—that could be earned in any jurisdiction, or at least a range of jurisdictions. In that

78. There are complexities associated with demarcating this category, which I take up below. But the general idea is that the rent embodies an above-normal return that can only be earned in a particular location. The canonical example is a rent from natural resource extraction. If the rent is “location-specific,” we could also say that it is “non-mobile,” which is simply to reflect the fact that it can only be earned in that particular location. By contrast, a return that is “mobile” for these purposes is simply one that could be earned, without diminution, in another jurisdiction.

79. See Green, supra note 8, at 30; Charles E. McLure, Jr., Substituting Consumption-Based Direct Taxation for Income Taxes as the International Norm, 45 NAT'L TAX J. 145, 149 (1992).
case we are in the standard tax competition case. Economic theory has generally suggested that jurisdictions not tax in this case as the incidence of the tax will simply be shifted to non-mobile factors. This is what is generally thought of as the zero capital income taxation result for the small open economy.\footnote{For the seminal paper on this issue, see Peter Diamond \& James Mirrlees, \textit{Optimal Taxation and Public Production I: Production Efficiency}, 61 AMER. ECON. REV. 8 (1971); Peter Diamond \& James Mirrlees, \textit{Optimal Taxation and Public Production II: Tax Rules}, 61 AMER. ECON. REV. 261 (1971). This consideration may be countered where there are political constraints on raising necessary revenue from local factor inputs.}

The fourth category covers income from 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 there is 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:

<table>
<thead>
<tr>
<th>1. Non-mobile rent</th>
<th>Is Tax Desirable?</th>
<th>Who Should Tax?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes</td>
<td>Preference for local sovereign</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>2. Mobile rents</th>
<th>Yes</th>
<th>Indeterminate</th>
</tr>
</thead>
<tbody>
<tr>
<td>3. Mobile non-rents</td>
<td>No</td>
<td>N/A</td>
</tr>
<tr>
<td>4. Non-mobile non-rent</td>
<td>Possibly</td>
<td>Indeterminate</td>
</tr>
</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 because one needs to take account of differential mobility, which is fundamentally a spatial concept.

To be clear, the distinctions drawn above between rents and non-rents are familiar in the expansive literature on tax competition.\footnote{See supra notes 79, 80.} What is new is the suggestion that we might think about using the "source" concept, \textit{within} the bounds of a comprehensive income tax, to separate out the relevantly different parts of the tax base. More typically, scholars have taken the range of efficiency characteristics above as reason to gut the comprehensive income tax in favor of taxes that use a curtailed base reaching only rents.\footnote{See, e.g., McLure, supra note 79.} Supposing that option is not on the table (at least in the near term) because of the associated revenue losses to
national governments, then the interesting and relevant policy question is whether one could, as a technical matter, segregate these portions of the base from within the operation of a typical comprehensive income tax.

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. Further, I propose to analyze the corporate tax as if the underlying purpose is to impose a tax on rents. This is not the only possible justification for a corporate tax, but it is the one that aligns with the categorization I have sketched above and the one that is most relevant to the role of source rules.

B. Corporate Tax as a Tax on Rents

Consider the case where one justifies 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 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 would 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.

1. Analysis of Rents Portion 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 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.

Consider, then, the distinction between location-specific and mobile rents. As we saw above the basic reason to draw a distinction here is that, although 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 so that sovereigns are incentivized to make 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 possibly only in this case) it will be desirable to write rules that stem tax-competitive pressures. 85

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 to and independently 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 it is 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 distinction between rents subject to competitive pressures versus those not subject to such pressures 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 of 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 the sovereign that made 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 a way the tax-competitive approach is not.

But it is also a very difficult task because 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

85. See Devereux & Sarenseen, supra note 26, at 22 ("However, since some rents earned by multinational companies are internationally mobile, as companies can relocate from one country to another, national governments acting in their own interest are likely to choose a lower tax rate on rents than would be optimal from a global perspective.").
paradigm case is natural resources, which looks like it could generate a non-mobile rent. But on a net basis assessment, matters become complicated. Suppose that a sovereign has natural resources in the ground that at some point in time were 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. 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 income. A cost-based approach here would source part of the net stream on the rent to jurisdictions that had incurred costs making this possible.

My goal in this Part is to think about efficiency concerns. But note that if we successfully established some set of source rules that distinguished location-specific from mobile rents, we would expect that tax competition could arise with respect to the mobile rents. Thus we would also need a distributional rule to figure out which country or countries would tax this. This would likely present a series of challenges because we lack the sort of normative commitments that could ground the sort of distributional frame assumed in Part II. That is, precisely because the rent is mobile, it is difficult to make normative claims that it "belongs" to a certain jurisdiction, even though tax by some jurisdiction would be efficient.

2. Analysis of a Comprehensive Base

The above discussion revealed several 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. Further, it would now be desirable to (i) distinguish rents from non-rents (because from an efficiency perspective the former should be taxed in full and the latter should be taxed at most only in part) (ii) distinguish mobile non-rents from non-mobile non-rents.

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86. One could further identify all kinds of difficulties here. Is the person who makes a technological discovery the product of a 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?
Defense of Source Rules in International Taxation

(because from an efficiency perspective the former should not be taxed, whereas the latter might be appropriate to tax).

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 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, 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 its 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 unduly complex. Taxpayers essentially would be using three bases: the imperfect income base, the notional cashflow base, and the notional ideal income base.

The alternative to a notional approach also generates substantial complexity. 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 source rules that, by category of income and expense, distinguish rents from non-rents. We can imagine drafting some such categories without much difficulty, at least 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

87. Under a cashflow tax, the taxpayer would be allowed to deduct capital expenditures currently. On the assumption that the taxpayer can invest the tax savings resulting from that deduction and earn a normal rate of return, then that return essentially offsets the tax cost of any normal return generated by the capital expenditure. For a further discussion of the way a cashflow tax treats rents versus non-rents, see OECD, FUNDAMENTAL REFORM OF CORPORATE INCOME TAX 155-56 (2007).
ordinary return on capital, treating the residual as economic rent. This also presents various complications.

Determining a generally applicable formula would be 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.

The issues discussed 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 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 difficult. One could make some initial cuts simply by drawing a capital-labor divide, but this is 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.

Conclusion

What I have tried to do in this Article is to think about a conceptual grounding for international source of income 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 ex post labels to raw exercises of power. As described at the outset, establishing a sound conceptual basis for source rules is crucial for developing countries, which have historically relied disproportionately on source taxation, and for developed countries, which increasingly perceive their tax bases to be stripped by non-
resident taxpayers. Determining the geographic source of income is a deeply difficult problem. There are, no doubt, instances in which current source rules draw unjustified distinctions and reflect substantial arbitrariness. Further, regardless how much effort we put into the matter, the problem of adducing spatial location for intangible items, such as financial assets and intellectual property, will always remain a complicated endeavor. The risk, though, is that scholars and policymakers let the difficult cases obscure the fact that source rules remain coherent at their core.

For all of the complexities and difficulties surrounding source rules, I have attempted to argue here that there is a conceptually sound way to understand geographic source of income. The concept does not founder on a category mistake, and it is not impossible to make some incremental progress. Specifically, there is room to improve source rules on the margin by considering likely grounds of consensus regarding geographic location of income from labor and capital under an origin principle, coupled with analysis of fundamental problems under a closed economy income tax on issues such as timing and the capital-labor divide.

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. I offer this observation as an invitation to scholars to think through the complexities identified above with respect to separating out the various aspects of an income tax base along the margins of mobility/non-mobility and the normal/supernormal returns to capital.