

The criterion for source of income and the relationship between net and gross income

ASATSUMA Akiyuki
 Doctor of Law (University of Tokyo)
 More condensed version of an abstract

Why I studied source of income?

There are many discussions on how to tax income (especially international business income) in the future when business environments are changing due to the development of information and communication technology. However, there have been serious inconsistencies on how to find or to decide source of income. For example, when a person gets income derived from a certain patent right with different manners, findings of the source of income are different. If the person has licensed the patent right and now gets royalty income, then the source of the royalty income is decided looking at the payers. Roughly speaking, the importing country is the source country of the royalty income. On the other hand, if the person has utilized the patent right, produced the commodities, exported them, and now gets business income, then the source rule concerned with sales income will be applied. Although the source rule of sales income is complex, it is generally looking at the earners. Roughly speaking, the exporting country is the source country of the sales income.

There have also been serious inconsistencies on how to tax royalty income and business income. The tax base of royalty income is gross income and the tax base of business income is net income.

The purpose of my doctoral thesis is studying (1) how can we understand the relationship between gross taxation and net taxation, (2) how we image the source of income and what is the root of such inconsistencies above, and (3) what problems are there in the current taxation.

Of course, I cannot write down the whole parts of my doctoral thesis now. I show the implications from my doctoral thesis and explain them briefly.

- (1) Tax bases of net and gross income are similar.
- (2) Inconsistencies of source rule are derived from the difference of remarkable points: origin principle type vs. destination principle type.
- (3) The defect of “no taxation without PE” rule: geographical allocation of income and personal allocation of income are sometimes confused.

Tax bases of net and gross income are similar.

Usually, business income is taxed in net basis by source countries and capital income is taxed in gross basis by source countries. Traditionally, this difference of source-based taxing method is explained from the view point of tax administration, and I don't say that the explanation is wrong. However, I also emphasize that, in economic substance, source-based tax bases of net income and gross income are similar in some cases. For example, let's compare the source-based taxation of allocated business

income of a partnership and the source-based taxation of dividend income from a corporation. In the former situation, a nonresident partner is taxed in net basis, and in the latter situation, a nonresident shareholder is taxed in gross basis. However, if we ignore an issue of double taxation of corporate-shareholder level because this kind of double taxation is not originated with international taxation, tax bases are similar: the former's tax base is business profit of the partnership (if the nonresident partner is considered to have a PE in the source country) and the latter's tax base is also business profit of the corporation.

In both situations, something of the partnership or of the corporation seems to be understood as source income of the country where the partnership or the corporation is located. I call it as "fruits of business."

What is "fruits of business"? The figure bellow shows an image of "fruits of business."

earnings		
[1] payments to residents (including nonresidents' domestic PEs)	[2] payments to nonresidents (excluding nonresidents' domestic PEs)	
	[3] dividends, interests, royalties, rents, and etc.	[4] sales income, service fee, and etc.

This line makes division between domestic source income and foreign source income.

When a business entity, which is a partnership or of a corporation in examples above, makes payments ([1] in the figure) to residents (including nonresidents' domestic PEs) of the same country, deduction is required in order to preclude accumulation of taxation. When payments ([2] in the figure) are made to nonresidents (excluding nonresidents' domestic PEs), the problem is what is deductible and what is not. Under the widely accepted current rules, [3] type payments subject to tax as capital income (such as dividends, interests, royalties, rents, and etc.) are not excluded in deciding the country's source income, and such payments do not erode the country's tax base (unless otherwise a tax treaty provides). On the other hand, [4] type payments subject to tax as business income (such as sales income, service fee, and etc.) are excluded in deciding the country's source income, and such payments erode the country's tax base.

Gross basis taxation on nonresidents' [3] type income (capital income) means that the source country imposes tax on the amount, equal with {(earnings of the partnership or the corporation) minus ([1] type payments) minus ([4] type payments)}. Although nominally it is gross basis taxation on nonresidents, it can be considered as an alternative to net basis taxation on residents' business profit, because the parts of [1] and [4] are already deducted at the stage of resident payers. The part of [3] in the figure is an image of "fruits of business."

Inconsistencies of source rule are derived from the difference of remarkable points: origin principle type vs. destination principle type.

Roughly speaking, the line between [3] and [4] in the figure limits the country's source income. The left side of the line is the country's source income, because, although the part of [1] is deducted from the tax bases of resident payers, the most (if not all) part of [1] is taxed as income of resident recipients in the country; the right side of the line is not the country's source income. What is the criterion of this line

drawing?

Unfortunately, this line drawing has inconsistencies. Historically, the line between [3] and [4] is explained by passive/active dichotomy. It is said that dividends, interest, royalties, and rents are passive income; sales income and service fee are active income. It is also said that the former is not business and the latter is business. However this explanation is not correct. For example, when a nonresident bank makes a loan and gets interest income, the bank certainly does business regardless whether the bank has a branch in the source country or not. For another example, there is little rationality in an explanation that lease transactions and sales transactions are different therefore rent income maintains the nature of the country's source income and sales income loses the nature of the country's source income.

The part of [3], which I call as "fruits of business," resembles "added value" of the resident payers. Not only dividend payments but also interest payments are not deducted from the tax base of the source country, and dividend payments and interest payments are not deducted also in calculation of added value. However this resemblance is not perfect. Royalty payments are not deducted from the tax base of the source country, although royalty payments are deducted in calculation of added value. Roughly speaking, "fruits of business" is similar to added value, but exceptions of royalty payments are significant in the discussion below.

The remarkable points of source rules of so-called "active" income and "passive" income are different. Source rule of active income looks at earners and source rule of passive income looks at payers. To some extent, this difference can be justified because sales income is included in the earners' added value and dividend or interest income can be explained as the payers' added value. However royalty income can not be explained as the payers' added value. Under the current tax system, source rules of sales income and dividend or interest income can be said as origin principle type and source rule of royalty income can be said as destination principle type.

Which is right: origin or destination? Logically, there is no answer or both answers are true: we can say that economic value is born because of the activities of suppliers and we can also say that economic value is born because of the demand. Therefore it is not the matter of logic; it is the matter of arrangement.

Traditionally, it has seemed that origin principle type source rules are general and destination principle type source rules are exceptional. Recently, however, it also seems that people do not kick away destination principle type in business environments with the development of information and communication technology. There are some arguments that importing countries should be given some taxing rights on cross-border transactions, and these arguments can hardly be justified without an image of source of income based on destination principle type.

The defect of "no taxation without PE" rule: geographical allocation of income and personal allocation of income are sometimes confused.

As I said, traditionally seems to be general. "No taxation without PE" rule is consistent with this source rule based on origin principle type in most cases; however it makes inconsistencies in some cases.

Geographical allocation of income and personal allocation of income are different. For example, if Mr. X, who is a resident of Y country, has land in Z country and he earns income from the land, then the income has source in Z country but the income is attributed to Mr. X.

However we sometimes confuse geographical allocation of income and personal

allocation of income. The current PE-taxation system has some elements of personal allocation of income, because the source country has taxing rights only on the income attributed to PEs and “attribution” is the matter of personal allocation.

“No taxation without PE” rule can not be appropriately applied in some cases of “personal” transfers of income by means of contracts. Typical examples are covenants not to compete. For example, P corporation, who is a resident of Q country, makes a contract with R corporation, who is a resident of S country. Under the contract, P can not do business in S country and R makes payments to P in compensation for the P’s duty not to compete. Usually the payment from R to P is derived from the R’s business in S country, so we might have an image that the income is allocated to S country from a geographical view point. However, if P has no PE in S country, S has no taxing right. In this example, personal allocation of income destroys geographical allocation of income because of “no taxation without PE” rule.

I summarize my doctoral thesis as follows: Traditionally, source rule based on origin principle type seems to be general, but source rule based on destination principle type can also be an alternative in legislative discussions in the future. Regardless whether we adopt origin or destination principle type, the future source rule should be consistently designed based on origin or destination. Next, the current source-based tax rules have confusion between geographical allocation of income and personal allocation of income; we should reconstruct the relationship between geographical allocation of income and personal allocation of income in the future.