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Source as a Solution to Residence

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ARTICLE

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Adam H. Rosenzweig 471

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Volume 17 | *2015* | *Number 6*

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Volume 17 | *2015* | *Number 6*

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// FLORIDA TAX REVIEW
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SOURCE AS A SOLUTION TO RESIDENCE

Adam H. Rosenzweig[*]

ABSTRACT

The choice between source-based and residence-based taxation has defined the terms of the debate for the international tax regime since its inception in the early 1900s. As an economic matter, residence taxation has generally been considered superior to source taxation. Recently, however, source taxation has begun to receive increasing support from both policy-makers and academics alike, especially as the concept of residence has come under attack as losing any significance in the modern, globalized world. Regardless of one's preference in this debate, the terms of the debate seem to be set—source versus residence as two opposing poles for all purposes.

The thesis of this Article is that the construct of source and residence as two competing and irreconcilable doctrines is largely incorrect as a legal matter. Rather, both source rules and residence rules can and should be thought of solely as instrumental tools to divide taxing authority in a globalized world with mobile capital. Under this approach, there is no reason why "source" rules as a doctrinal matter need to be used only for "source" taxation as an economic matter, or that "residence" rules as a doctrinal matter need be used for "residence" taxation as an economic matter. Instead, the source rules as a doctrinal matter can actually be used to solve the problems of the residence rules as a doctrinal

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matter. Put differently, source and residence as doctrinal rules can converge into a single concept in the modern global economy.

If it is true that residence as a conceptual matter has become increasingly meaningless in the globalized world, tying the doctrinal rules of residence to the doctrinal rules for source can better effectuate the ultimate goals of the international tax regime. This Article introduces a proposal to define the residence of entities as domestic for purposes of US tax law based on the source of the income of such entities. In its most simplistic form – an entity would be a US Person if it earns over a threshold amount of US Source income. Of course, such an approach would prove more complex than such a simple statement, but the basic premise holds. The Article then demonstrates how such an approach could be used to resolve two of the most difficult and pressing issues confronting the modern US international tax regime: corporate inversions and offshore hedge funds.

TABLE OF CONTENTS

I. **INTRODUCTION** 473
II. **THE ROLE OF SOURCE AND RESIDENCE AS LEGAL DOCTRINES** 476
A. *Framing a Normative Case for Residence Taxation of Entities* *477*
B. *The False Dichotomy Between Source and Residence as Legal Doctrine* *482*
III. **RESIDENCE AND SOURCE AS INSTRUMENTAL TOOLS IN INTERNATIONAL TAX LAW** 489
A. *A Brief Summary of the US Rules for Source and Residence* 489
B. *The Crisis of Residency in the Global Economy: Using Source to Solve Residence* *495*
C. *Source-Based Residence as Self-Help Coordination* *500*
1. *Minimizing the Exercise of Residence Tax over Foreign Source Income* *501*
2. *Nowhere Corporations and Self-Help Source Taxation* *502*
3. *Source-Based Residence and Formulary Apportionment* 504
IV. **SOURCE AS A SOLUTION TO RESIDENCE: THE PROPOSAL AND EXAMPLES** 505

A. *Source as a Solution to Residence: The Proposal for Corporations* ... 507
1. *Defining Residency for Corporations* ... 507
2. *Example: Corporate Inversions* ... 514
B. *Source as a Solution to Residence: The Proposal for Partnerships* ... 519
1. *Defining the Residency of Partnerships* ... 519
2. *Example: Offshore Hedge Funds* ... 523
V. **CONCLUSION** ... 526

> *"[W]orldwide taxation without deferral—or, as a close substitute, territoriality with tough CFC rules . . . put increased pressures on notions of residence, since that is what would ultimately define liability."*[1]

> *"Morality can't be a guiding principle for international taxation."*[2]

I. INTRODUCTION

One of the core assumptions underlying the modern international tax regime involves the distinction between source and residence. The debate between source and residence defined the competing sides of the emerging international tax order in the early 1900s. As the twentieth century progressed, the debate over source and residence taxation dominated the area of public finance. More recently, however, an increasing number of countries have been moving to source-based territorial tax regimes as the concept of residence for entities has come under attack as losing any significant meaning in the increasingly globalized economic world.

As a result, a tension seems to be emerging. As an economic matter, the default for the past century has been that residence taxation is superior to source taxation in almost every respect,[3] but that source taxation is necessary as a matter of enforcement and, to a lesser extent, as a matter of fairness for

1. INT'L MONETARY FUND, IMF POLICY PAPER: SPILLOVERS IN INTERNATIONAL CORPORATE TAXATION at 38–39 (May 9, 2014) [hereinafter "2014 IMF Report"].

2. Lee A. Sheppard, *BEPS as an Opportunity*, 2014 TAX NOTES TODAY 191-3 (Oct. 1, 2014) (quoting Manal Corwin).

3. *See, e.g.*, Johannes Becker & Clemens Fuest, *Source versus Residence Based Taxation with International Mergers and Acquisitions*, 95 J. PUB. ECON. 28 (2011) ("One of the most powerful theorems in literature on international taxation . . . is that residence based taxation is superior to source based taxation.").

capital importing countries. In recent years, there has been a move towards adopting territorial regimes—at least among most OECD member states. This shift is often seen as a rejection of residence taxation in favor of source taxation. While this is sometimes defended in economic terms,[4] it is typically defended in terms of tax competition and, to a lesser degree, technical and enforcement issues. Regardless of one's preference in this debate, the terms of the debate seem to be set—source versus residence, two opposing poles for all purposes.

The thesis of this Article is that this construct of source and residence as two competing and irreconcilable concepts is largely incorrect as a legal and doctrinal matter. From this perspective, both source rules and residence rules are merely instrumental tools to be used to divide tax authority among countries in a globalized world with mobile capital. Under this approach, there is no reason why "source" rules as a doctrinal matter need to be used only for "source" taxation as an economic matter, or that residence rules as a doctrinal matter need be used for residence taxation as an economic matter. Correspondingly, the concepts of source and residence as doctrinal rules fail to have any normative content in light of the realities of the modern, global economy.

Instead, this Article will propose a new legal and doctrinal approach to international tax: using the source rules to solve the problems with the residence rules. If it is true, as the literature suggests, that residence as a doctrinal concept is becoming increasingly meaningless in the globalized world, and that the world is moving towards increasingly source-based regimes, tying the concept of residence to something with more substance makes sense. Rather than do so by tying to some separate benchmark, such as public trading or shareholder base, this Article proposes to do so by linking residency to source of income. In its most simplistic form—an entity would be a US Person if it earns too much US Source income.

Of course, such an approach would prove more complex than such a simple statement—but surprisingly, perhaps not much more. In fact, the most difficult part of using source as a solution to residence is overcoming the traditional labels of source and residence as mutually exclusive economic concepts. Once this step is taken, defining US status based on US source can capture both the intuition and the mechanics of the income tax remarkably well. Deciding what is "too much" US Source income and whether these "US Persons" should pay US tax is a more complicated issue, but the basic premise holds—the source rules can be used to solve the residence problem.

Using source as a solution to residence can provide multiple benefits not available with other approaches: (1) it equalizes the residence rules for corporations and partnerships, thereby minimizing the distortions at the choice of entity margin; (2) it minimizes the exercise of sovereign power over foreign

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4. *See id.*

source income of residents because, by definition, no resident entity would earn more than half of its income from foreign sources; (3) it minimizes the avoidance of residence rules due to reincorporation or other tactics by tying the definition directly to the place of underlying business activity; and (4) it minimizes the ability of individuals to hide behind entities to avoid the individual ability to pay based tax.

It is important to note that this Article is not intended to serve as a normative defense of an income tax generally, of an income tax on corporations as entities, of a particular normative argument for the international tax regime, or of any particular alternative international tax regime that could be developed through multinational agreement. Rather, this Article assumes that the United States has an income tax that turns, in part, on the residency of corporations and partnerships, and wants some form of tax on the income of corporations or investors in partnerships that exploit US public goods, markets, or both, as a descriptive matter.[5] Similarly, this Article considers only the concept of residency in the context of the tax treatment of entities and not individuals. In part this is because the treatment of individuals in the international tax regime has been addressed in the literature already and in part it is because the policy considerations underlying the normative concerns driving this analysis apply primarily with respect to entities.

Part II of this Article will describe why and how the source rules can be used to address the residence rules. In particular, Part II will describe how a number of the perceived problems in the international tax law—from corporate inversions to offshore hedge funds—can more accurately be thought of as manifestations of the false doctrinal dichotomy between source rules and residence rules. Part III will demonstrate how some of the perceived weakness of both the source and residence regimes, in particular that they are easily manipulable and can be exploited by multinational corporations to avoid tax—can actually be a strength when tying together source and residence rules as a single, unified doctrinal concept. Those readers familiar with US international tax rules or the development of the modern international tax regime may prefer to skip these sections and proceed directly to Part IV, which discusses implementation of the proposals in more detail.

Part IV will introduce a proposal for how to implement a source-based residency rule for corporations and partnerships and use two examples to flesh out the proposal. Under this approach, any corporation—regardless where organized or managed—would be considered a US corporation in any year in which over fifty percent of its gross income is US source income. This, in turn, raises a number of implementation issues that will be discussed as well. In particular, the proposal will rely substantially on a combination of existing

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5. As recently noted by the IMF, residency will prove crucial to both a worldwide tax system and a territorial tax system with strong anti-abuse provisions. *See* 2014 IMF Report, *supra* note 1.

passive foreign investment company rules and the S Corporation rules to implement this new regime, recognizing that corporations can indeed have income over and under the threshold in particular years and to attempt to prevent abuse. Part IV will then explain how the proposal applies to determine the residency of a partnership. Under the proposal, the residency of a partnership would turn, in part, on the source of income generated by the partnership and, in part, on the identity of the partners in the partnership (assuming the corporate residency rules described above are implemented). In this way, true passive investment vehicles for foreign individual investors can remain foreign but funds actively managed through the United States would be within the US tax net. Part IV will then demonstrate how these rules could be used to prevent two of the most troubling and intractable difficulties of the US international tax regime: corporate inversions and offshore hedge funds.

II. THE ROLE OF SOURCE AND RESIDENCE AS LEGAL DOCTRINES

The modern international tax regime appears headed for a major realignment. The basic premises underlying the "flawed miracle"[6] of the modern international tax regime appear to be breaking down, as evidenced by the Base Erosion and Profit Shifting project of the Organization for Economic Cooperation and Development and the increasing push towards worldwide formulary apportionment, on the one hand, and the second-wave of US corporate inversions and offshore hedge funds, on the other.

For the most part, each of these problems is considered independent of and separate from the others, with each legal problem having its own legal response. If US companies can invert by meeting the 20 percent ownership threshold, the answer must be to raise the threshold. If offshore hedge funds can invest and do business in the United States without paying any tax, the answer must be to impose withholding taxes on the investments of offshore hedge funds. If multinational companies with significant intellectual property can siphon off the income from the intellectual property to countries like Ireland using transfer pricing, the answer must be to switch to formulary apportionment.

While any one of these approaches may be correct as a matter of law or policy, what is often missing is the larger question of whether a particular taxpayer should be within the taxing power of a country at all.[7] This, in turn,

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6. Reuven S. Avi-Yonah, *The Structure of International Taxation: A Proposal for Simplification,* 74 TEX. L. REV. 1301, 1303 (1996) [hereinafter Avi-Yonah, *Simplification*].

7. There has been some discussion of this issue in the context of international law, however. *See* Allison Christians, *Tax Advice for the Second Obama Administration: Putting the Reign Back in Sovereign*, 40 PEPP. L. REV. 1373 (2013) [hereinafter Christians, *Sovereign*].

derives from the justification for the income tax regime adopted in that country in the first place. This Article is agnostic as to the ultimate normative goals of the US international tax regime. Rather, the purpose of this Article is to demonstrate how the legal definitions of residence and source can be used to achieve whatever normative goal of the regime is preferred. To do so, however, requires adopting some normative goal of the US international tax regime for purposes of discussion. This next section will discuss a framework of a normative case for worldwide taxation for certain entities with some threshold, minimum connections to the United States.

A. Framing a Normative Case for Residence Taxation of Entities

Ability to pay has, for the most part, served as the primary normative justification for the modern US income tax regime.[8] Ability to pay is determined without regard to source of income, meaning that an ability to pay based tax regime would tax all income from whatever source.[9]

Crucially, however, ability to pay does not proscribe *who* should pay a tax. Rather, some minimum threshold connection to a country is typically justified before imposing ability to pay taxation on a particular taxpayer.[10] If a taxpayer does not meet that threshold, ability to pay taxation is considered inappropriate. Rather, a country may tax the income of such a taxpayer that is sourced within that country, but only that income, under the theory that such income must have benefited from the country in some manner.[11] Taken together, the primary difference between ability to pay taxation and benefit taxation in the international context is the taxation of foreign source income: resident taxpayers are taxed based on ability to pay and thus take into account foreign source income while non-resident taxpayers are taxed based on

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8. *See* J. Clifton Fleming, Jr., Robert J. Peroni & Stephen E. Shay, *Fairness in International Taxation: The Ability-to-Pay Case for Taxing Worldwide Income*, 5 FLA. TAX REV. 299, 307-308 (2001) [hereinafter Fleming, Peroni & Shay, *Fairness*].

9. *Id.* at 311.

10. *See* J. Clifton Fleming, Jr., Robert J. Peroni & Stephen E. Shay, *Perspectives on the Worldwide vs. Territorial Taxation Debate*, 125 TAX NOTES 1079, 1093 (Dec. 7, 2009) [hereinafter Fleming, Peroni & Shay, *Perspectives*] ("[I]ndividuals substantially connected to the United States should have their net incomes taken into account in determining how the income tax will allocate the fiscal burden of the U.S. government. And, if an individual has such a connection, it seems clear that her entire net income must be considered, regardless of whether it is derived from U.S. or foreign sources."); *see also* Michael S. Kirsch, *Taxing Citizens in a Global Economy*, 82 N.Y.U. L. Rev. 443 (2007) [hereinafter Kirsch, *Taxing Citizens*].

11. *See* Reuven Avi-Yonah, *International Tax as International Law*, 57 TAX L. REV. 483 (2004) [hereinafter Avi-Yonah, *International Tax As International Law*].

benefits and thus do not take into account foreign source income. Put differently, taxpayers should only pay tax to fund US public goods if they are exploiting those public goods to some minimum extent, either by consuming them directly or exploiting the markets generated by them.[12]

The ultimate normative question in defining residence for tax purposes, therefore, turns almost exclusively on whether a country should exercise its taxing power over the foreign source income of a taxpayer. Ability to pay applies a form of horizontal equity analysis to the issue: two identical taxpayers in terms of number of dollars earned should pay the same US tax regardless where the income is earned. Under this approach, a US person earning $1 million in the United States would pay the same tax as a US person earning $1 million in Germany (subject to double tax relief).

For individuals, the law attempts to implement this goal under one of two approaches. First, an individual could be subject to a worldwide tax regime based on ability to pay if that individual is a citizen or legal permanent resident of that jurisdiction. This is a legal status definition of residency. Second, an individual could be subject to worldwide tax based on physical presence. In other words, at some point an individual has been physically present in a country for a sufficient amount of time to justify imposing tax on that individual in the same manner as a citizen or legal permanent resident. This is a real activity test as opposed to a legal status test. The United States has adopted both of these tests in defining US resident status for individuals, although citizenship-based taxation has begun to receive increased criticism.[13]

The difficulty with extending this analysis to entities is that entities ultimately do not bear the incidence of any tax imposed on, or collected by, them. Instead, a tax on entities (or determined based on the residence of entities) is borne ultimately by some constituency of that entity, whether it be the owners, the employees, or the customers. Thus, a residence-based tax regime for entities primarily can be justified as a backstop to a residency-based tax regime for individuals rather than as its own ability to pay tax. In other words, imposing the taxing power of the United States on US resident entities is justified to prevent individual US residents from avoiding the residency-based tax regime simply by forming a legal entity.[14] Alternatively, the

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12. *See* Stephen E. Shay, J. Clifton Fleming, Jr. & Robert Peroni, *The David R. Tillinghast Lecture: "What's Source Got to Do With It?" Source Rules and U.S. International Taxation*, 56 TAX L. REV. 81, 91 (2002) [hereinafter Shay, Fleming & Peroni, *Source Rules*].

13. *See, e.g.*, Michael S. Kirsch, *Revisiting the Tax Treatment of Citizens Abroad: Reconciling Principle and Practice*, 16 FLA. TAX REV. 117 (2014) [hereinafter Kirsch, *Revisiting the Tax Treatment*].

14. In addition, some have also argued that the corporate tax serves as an indirect tax on foreign investment in a US trade or business. *See, e.g.*, Daniel Shaviro, *The David R. Tillinghast Lecture: The Rising Tax-Electivity of U.S. Corporate Residence*, 64 TAX L. REV. 377, 402 (2011) [hereinafter Shaviro, *Rising Electivity*].

residence tax could be thought of as a backstop to source taxation by preventing individuals from using entities to avoid source tax in the country of source.[15] Either way, the important point to emphasize is that entity residence tax on entities cannot be analyzed on its own but only based on whether it is serving its purpose as a backstop to some underlying ability to pay based tax.

Since it is impossible to know with certainty who bears the incidence of an entity-level tax, and in what proportions, this is inherently a second-best approach. While this means that any residency-based tax regime for entities will necessarily be both over- and under-inclusive, in that it could impose tax on entities owned solely by non-US residents or could indirectly impose tax on labor instead of shareholders, the ultimate question is whether this result is better or worse from a policy standpoint as a second-best matter than permitting US residents to easily avoid US tax simply by forming a legal entity.[16]

The definition of entity residence must therefore be examined through this lens. Defining a corporation as a domestic corporation is the same as exercising the power to tax the foreign source income of the corporation. Defining a partnership as a domestic partnership subjects the partnership and its owners to US information reporting and tax accounting compliance rules, as well as potentially subjecting foreign partners in the partnership to US net income tax.

From this perspective, the relevant issue is whether these results are a good idea as a matter of implementing the broader tax policy of the United States. In turn, the definition of residency should be structured so as to accomplish these goals. If a particular definition of corporate residency permits US individual taxpayers to avoid the individual ability to pay based tax with ease, the definition should be changed to include that entity within the definition.[17] If a particular definition ends up primarily imposing tax on the foreign source income of foreign individuals, the definition should be changed to exclude that entity from the definition.

The difficulty with defining residency for entities is that the most straightforward way to define residency—physical presence—is not available, simply because legal entities cannot be physically present in the same manner

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15. *See* Omri Marian, *The Function of Corporate Tax-Residence in Territorial Systems*, 18 CHAP. L. REV. 157 (2014) [hereinafter Marian, *Corporate Tax-Residence*].

16. *See* Fleming, Peroni & Shay, *Fairness*, *supra* note 8. This is also one reason why proposals to tie the definition of corporate residency to the taxation of the ultimate individuals bearing the incidence of the tax can prove quite difficult to implement in the real world.

17. *See* Edward D. Kleinbard, *The Lessons of Stateless Income*, 65 TAX L. REV. 99, 158–60 (2011) [hereinafter Kleinbard, *Lessons*].

as individuals.[18] Rather, some other connection to a country sufficient to justify the taxation of an entity as a backstop to the individual residency tax regime must be considered. As with individuals, there are two potential approaches to do so: legal status or actual activity. The United States currently uses a legal status test alone for entities, sometimes known as the place of incorporation rule. But there is no reason that residency could not be defined by substantive activity instead, such as primary place of management, primary place of operations, residency of the owners of an entity, or some other connection to a jurisdiction.[19]

From this perspective, the ultimate normative question in establishing the definition of entity residence (as distinct from whether a country should adopt a residence-based tax at all) must ultimately turn on the following question: when has an entity established sufficient connections with a country to justify imposing that country's taxing power over the entity's foreign source income?[20] In other words, entity residence has no independent normative meaning in itself for international tax purposes. Rather, it is purely an instrumental tool used to achieve the underlying goals of the broader worldwide tax regime of a particular country.[21]

It is important to note that using minimum connections with a country to define the residence under an ability to pay regime is not the same as imposing a benefit theory based tax on entities, notwithstanding that the minimum connections used may indeed arise from benefits derived within a particular country. Benefit taxation, for the most part, has been rejected as a basis for a broad-based income tax on the theory that benefits from public goods are too inchoate and difficult to value to form any realistic base for an income tax. Ability to pay solves this problem by disregarding actual benefits and looking only to relative ability to pay. In turn, however, ability to pay does not define the community subject to the tax. In the words of Michael Kirsch:

> The threshold question is whether ability-to-pay analysis should adopt a worldwide perspective, which would consider the relative incomes of all individuals worldwide, or whether it should adopt a national perspective, looking only at the incomes of members of U.S. society (however defined).

18. *See* Michael J. McIntyre, *Determining the Residence of Members of a Corporate Group*, 51 CAN. TAX J. 1567 (2003) [hereinafter McIntyre, *Corporate Group*].

19. *See, e.g.,* Shaviro, *Rising Electivity, supra* note 14; *see also* George K. Yin, *Stopping Corporate Inversions Sensibly and Legally*, 144 TAX NOTES 1087 (Sept. 1, 2014) (discussing the use of location of customers to define residence of corporations).

20. *See* McIntyre, *Corporate Group*, *supra* note 18.

21. *See* Omri Marian, *Jurisdiction to Tax Corporations*, 54 B.C. L. Rev. 1613 (2013) [hereinafter Marian, *Jurisdiction*].

> Commentators who have addressed this issue have generally concluded that, for both practical and theoretical reasons, U.S. tax policy should take a national perspective.[22]

Correspondingly, since entity taxation serves solely as a second-best form of imposing an ability to pay tax regime on individuals, it would be inappropriate to use benefits theory concepts to determine the residency of an entity for tax purposes. Rather, the question comes down to what minimum connections to a country are sufficient for that country to impose worldwide, residence-based taxation on that entity as a backstop to the ability to pay based individual income tax. From this perspective, residence of shareholders would seem to make the most sense if the entity tax is intended to be an indirect tax on shareholders. As discussed above, however, since it is unclear whether the incidence of any entity tax falls on shareholders, this argument is incomplete, at best.

As a result, the only question at issue in defining the residence of entities as a legal matter turns on whether a country wants to exercise its taxing power—including not only the power to impose tax but also the power to impose reporting obligations or withholding obligations—over the foreign source income of certain entities as part of the larger normative goals of its overall income tax regime. While this might seem like an odd framing of the international tax regime,[23] the United States has been implementing such an approach in the context of payroll withholding, where foreign employers with no US trade or business can be obligated to withhold or comply with information reporting for wages paid to US employees.[24]

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22. *See* Kirsch, *Taxing Citizens*, *supra* note 10, at 480.

23. *See* Joshua D. Blank & Ruth Mason, *Exporting FATCA*, 142 TAX NOTES 1245 (Mar. 17, 2014) [hereinafter Blank & Mason, *Exporting FATCA*] ("The principal criticisms have been that FATCA is not only unilateral, but also extraterritorial.") (footnotes omitted).

24. Reg. § 31.3401(a)-1(b)(7):

> The term 'wages' includes remuneration for services performed by a citizen or resident . . . of the United States as an employee of a nonresident alien individual, foreign partnership, or foreign corporation whether or not such alien individual or foreign entity is engaged in trade or business within the United States. Any person paying wages on behalf of a nonresident alien individual, foreign partnership, or foreign corporation, not engaged in trade or business within the United States . . . is subject to all the provisions of law and regulations applicable with respect to an employer.

See also T. Scott McMillen, *When Parachutes Cross the Border– International Aspects of Section 280G,* CORPORATE TAXATION (May/June, 2012), 39 WGL-CTAX 24.

To clarify, the question of whether a country is justified in exercising its taxing power is not the same as the question of whether it should exercise that power or how to do so. Countries of source generally have the power to impose tax on interest paid from those countries,[25] but the United States has unilaterally decided not to exercise that power in many cases.[26] The United States claims the power to tax the worldwide income of its residents,[27] but chooses not to exercise that power over certain foreign earned income.[28] The United States claims the power to tax the income of investors actively managing investments within the United States but chooses not to impose tax on investors managing investment for their own account, regardless of how much activity occurs within the United States.[29]

This is an important point to emphasize because the question of whether to impose the taxing power of a country over particular items of foreign source income is often confused with the larger issue of whether foreign source income should be taxed at all, especially in debates over fundamental reform of the US international tax system. Regardless of the resolution to any fundamental international tax reform, defining the residency of entities will remain relevant, if not crucial.[30] The remainder of this Article will focus solely on the issue of how and when the United States *can* impose its taxing power as a legal matter—including tax liability, reporting obligations, or withholding obligations—over the foreign source income of entities, and not whether or when it *should* do so, or at what rate.

B. The False Dichotomy Between Source and Residence as Legal Doctrines

While almost every aspect of the international tax regime has come under question as of late, the two fundamental underlying conceptual bases for international tax—source and residence—typically have not.[31] Almost since the beginning, source and residence have been seen as the two opposing poles of any international tax order.[32] To this end, the tax experts of the League of Nations in 1923 adopted an approach in their report on international taxation

25. *See* Avi-Yonah, *International Tax as International Law*, *supra* note 11.
26. I.R.C. §§ 871(h), 881(c).
27. *See* Cook v. Tait, 265 U.S. 47 (1924).
28. I.R.C. § 911.
29. I.R.C. § 864(b)(2)(A).
30. *See* Marian, *Corporate Tax-Residence*, *supra* note 15.
31. *See, e.g.*, Yoram Keinan, *The Case for Residency-Based Taxation of Financial Transactions in Developing Countries*, 9 FLA. TAX REV. 1, 3–4 (2008) (“Upon the issuance of the League of Nations Report in 1923, two generally recognized regimes for international tax have emerged – residency (or global) and source (or territorial).”).
32. *See, e.g.*, Avi-Yonah, *Simplification*, *supra* note 6.

in which individual items of income were allocated between the countries of source and the countries of residence.[33]

For the most part, economists have analyzed the efficiency of the international tax regime under this framework. Beginning with the most simplified model of international tax—the two state, one taxpayer, one period model—for there to be an international tax question there must (by definition of the model) be a state where a business resides and a state in which it operates that differ from each other.[34] This makes sense as an economic matter, because if one country was both the country of source and the country of residence, then the issue would reduce solely to one of domestic tax. Thus, for there to be an issue of international tax, at least in the economic models, there must be two separate countries—one in which the economic activity occurs (the country of source) and one in which the owner of the economic activity resides.[35]

For example, if a company was formed in France, owned and funded only by French residents, operated exclusively in France, and acted solely within France, there would be no international tax issue. Once the same company also operated in Germany, or Japan, or the United States, however, the question of international tax arises. From this perspective, the economic issue becomes what form of international tax would create the least distortions to the decision of the French company to operate in the other country. This question led to the development of the now familiar "alphabet soup" of neutralities, such as "capital export neutrality" (CEN), "capital import neutrality" (CIN), "national neutrality" (NN), and the more recent "capital ownership neutrality" (CON), as efficiency guidelines for balancing the claims to tax by the country of source and the country of residence.[36] These acronyms were used as shorthand for considering different margins upon which the tax law of two countries could act to distort the decisions of taxpayers.[37]

Traditionally there was consensus for the most part among economists that, described in this manner, residence taxation was superior to source taxation as a theoretical matter.[38] The idea was that residence taxation

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33. *See* Hugh J. Ault, *Corporate Integration, Tax Treaties and the Division of the International Tax Base: Principles and Practices*, 47 TAX L. REV. 565, 568 (1992) ("Under [the League of Nations] approach, items of income were classified and then assigned to either the residence jurisdiction or the source jurisdiction.").

34. *See* Michael Keen & David Wildasin, *Pareto-Efficient International Taxation*, AMER. ECON. REV., Mar. 2004, at 259 [hereinafter Keen & Wildasin, *Pareto-Efficient*].

35. *See, e.g.*, *id.*

36. *See* Shaviro, *Rising Electivity*, *supra* note 14.

37. *See* Jane G. Gravelle, *International Corporate Income Tax Reform: Issues and Proposals*, 9 FLA. TAX REV. 469 (2009) [hereinafter Gravelle, *Tax Reform*].

38. *See, e.g.*, Gravelle, *Tax Reform*, *supra* note 37, at 477 ("In neither the efficient nor the optimal system is there a justification for territorial, or source-based

minimized the distortions to investment across national borders and thus maximized the efficiency of the worldwide regime.[39] Correspondingly, source taxation was generally considered a necessary evil in a world with non-coordinated national tax regimes rather than a theoretically superior method for taxing capital income.[40] While this conclusion has come under scrutiny in recent years,[41] the basic framework has not: there is a country of source and a country of residence, and the primary issue in international tax turns on allocating the power to tax between the two in a way to maximize efficiency on some margin.

Despite this economic consensus, no country has adopted a "pure" residence- or source-based entity tax regime; rather, all countries have incorporated some combination of source-based and residence-based entity taxation.[42] For these purposes, the source and residence rules tend to have two conceptually distinct uses—for example, residency tax can be used to reflect the intent of a particular jurisdiction to exercise that jurisdiction's taxing power over a particular taxpayer while source tax can be used to provide a practical basis to collect tax generated on passive-type income within the economy of a particular jurisdiction but difficult to collect once paid.[43] In other words, source taxes—especially on passive income—have been justified as a backstop to residency taxes,[44] on the theory that once a payor of passive-type income within a country makes a payment to a foreign person located in a foreign jurisdiction, the source country effectively loses the ability to meaningfully track the income or impose tax. Consequently, the source country must impose a source-based tax at the time of payment on the payor over which it exercises jurisdiction.[45]

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taxes."); *see also* Mihir A. Desai & James R. Hines, Jr., *Evaluating International Tax Reform*, 56 NAT'L TAX J. 487 (2003).

39. This result was introduced primarily by Peggy Musgrave. *See* Gravelle, *Tax Reform*, *supra* note 37, at 479 n.26.

40. *See* Keen & Wildasin, *Pareto-Efficient*, *supra* note 34.

41. *See* James Hines, Jr., *Reconsidering the Taxation of Foreign Income*, 62 TAX L. REV. 269 (2009).

42. *See* Avi-Yonah *Simplification*, *supra* note 6.

43. *See* Shay, Fleming & Peroni, *Source Rules*, *supra* note 12, at 116.

44. *See, e.g.*, Reuven S. Avi-Yonah, *International Taxation of Electronic Commerce*, 52 TAX L. REV. 507 (1997) [hereinafter Avi-Yonah, *Electronic Commerce*].

45. Given this role for source-based taxation, it makes sense that tax treaties have been used to shift the default back towards a more residence-based model. If two countries are willing to agree how to divide the tax base between them and to cooperate on administrative matters between the competent authorities of the two countries, the countries would no longer need source-based tax as a backstop. The difficulty with the tax treaty model is that not every country is necessarily a good fit to be a bilateral tax treaty partner with any one particular country, leaving the default as the regime for

This (admittedly vastly oversimplified) summary of the modern international tax regime has begun to be challenged on a number of fronts. First, the idea that a country cannot track income once it leaves a jurisdiction has come under attack. The Organization for Economic Cooperation and Development has continued to push for increased international sharing of information and cooperation on tax collection among all the states of the world, not just OECD member states. This has led to a proliferation of Tax Information Exchange Agreements and Action Items in the recent Base Erosion and Profit Shifting project on sharing of information and cooperation on tax matters.[46] In addition, the United States unilaterally adopted the Foreign Account Tax Compliance Act which imposed tax reporting requirements on non-US financial institutions to report tax information on potential US taxpayers to the United States or face significant US tax consequences with respect to the institution's US based assets and business.[47] Both of these developments have fundamentally challenged the assumption that once a payment—such as interest on a bank account—is made to a recipient outside the country, the country can no longer trace the income or impose tax.[48] Correspondingly, the theoretical support for source-based taxation as a backstop to residence-based taxation has decreased as well.

At the same time, in the real world there has been a meaningful shift away from the strong assumption in favor of residence-based entity taxation as the foundation of the international tax regime. In more doctrinal terms, this has been represented by the remarkable shift among OECD member states (other than the United States) from nominally worldwide taxation to nominally territorial taxation. This move, most recently reflected by the corporate tax reforms adopted in countries such as Japan, has been pointed to by some as evidence of the breakdown of residence-based taxation as the foundation of the international tax regime.[49]

As a result, some have recently contended that residence taxation is, in reality, a backstop to source tax; in other words, entity residence is necessary

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those countries. *See* Adam H. Rosenzweig, *Thinking Outside the (Tax) Treat*y, 2012 WIS. L. REV. 717 (2012).

46. *See, e.g.*, John L. Harrington, *Automatic Information Exchange: Did the Dog Just Catch the Bus?*, 143 TAX NOTES 101 (Apr. 7, 2014).

47. *See* Blank & Mason, *Exporting FATCA*, *supra* note 23.

48. *See* Christians, *Sovereign*, *supra* note 7, at 1396 ("[FATCA] is an assertion by the U.S. that it not only has the jurisdictional authority to trace its resources no matter where in the world they are located, but that it also has the capacity to do so. If these assertions are correct, then it cannot be said that the U.S. is defeated by globalization or technological change as a matter of either legal reach or practical capacity.").

49. *See* Edward D. Kleinbard, *Stateless Income's Challenge to Tax Policy, Part 2*, 136 TAX NOTES 1431 (Sept. 17, 2012).

to ensure the use of entities to avoid source taxation.[50] This might seem odd at first because territorial regimes are nominally source-based tax regimes. The reason for residence taxation, however, is to prevent taxpayers from using shell companies or other maneuvers to avoid source taxation by artificially changing the source of the income. Thus, residency can be used as a backstop to source, making residency crucial even in a nominally territorial regime.

Taken together, from this perspective it is important to note that the labels "worldwide" and "territorial" have little meaning in and of themselves, and that, as a result, comparing national tax regimes based solely on labeling them "worldwide" or "territorial" also has little meaning.[51] Rather, a territorial regime with a minimum foreign tax and a passive income anti-abuse regime could look strikingly similar to a worldwide regime with a foreign tax credit and subsidiary-based deferral.[52] The mere fact that the United States nominally has a worldwide tax regime and Japan nominally has a territorial tax regime does not, in itself, say anything about the relative residence or source basis for the regime. Either way, what matters is that residence as a conceptual matter is important regardless if a country has adopted a nominally worldwide or nominally territorial regime. In turn, the definition of residence for entities needs to take into account this role in the broader tax regime.

As this brief summary demonstrates, the international tax regime is facing a number of difficulties, and some might say insurmountable challenges, resulting in a myriad of proposals to change the system. The proposals range from the technical—raising the section 7874 threshold to 50 percent—to overhauls of particular rules—such as switching from transfer pricing to formulary apportionment—to the fundamental reform—such as adopting a territorial tax regime or creating a multinational institution to enforce tax norms.

Yet, the one baseline assumption that has not seemed to receive much attention throughout this debate has been the basic dichotomy between source, on the one hand, and residence, on the other.[53] Many have pointed out that a switch from a worldwide regime to a territorial regime could well solve the residence definition problem, but only at the cost of putting increased pressure of the definition of source.[54] Others have pointed out that a formulary

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50. *See* Marian, *Corporate Tax-Residence*, *supra* note 15.

51. *See* Omri Y. Marian, *Meaningless Comparisons: Corporate Tax Reform Discourse in the United States*, 32 VA. TAX REV. 133 (2012) [hereinafter Marian, *Meaningless Comparisons*].

52. *See, e.g.*, 2014 IMF Report, *supra* note 1, at 38.

53. *See, e.g.*, *id.* at 10 ("At its core, a key issue in assessing any international tax arrangement is how it divides the rights to tax between source and residence countries.").

54. *See, e.g.*, Paul R. McDaniel, *Territorial vs. Worldwide International Tax Systems: Which is Better for the U.S.?*, 8 FLA. TAX REV. 283 (2007) [hereinafter McDaniel, *Tax Systems*].

apportionment method could well resolve a number of problems with the existing source rules, but potentially at the expense of sacrificing the taxing power over resident corporations.[55] This core dichotomy between source and residence has thus remained throughout, from the most technical proposals to the most fundamental overhauls.[56]

While the literature has begun to make compelling arguments against the traditional notion of the superiority of residence taxation over source taxation—whether as a theoretical and practical matter—the terms of the debate still seem to be made within the context of the source-residence dichotomy. If residence taxation is not working, then switch to source, and vice versa. The literature has yet to explain, however, why the choices seem to come down between source and residence in this manner. Rather, most proposals in the international tax arena tend to situate themselves between these two concepts as competing poles.

But why? Why has the dichotomy between source and residence proven so resilient when almost every other aspect of the modern international tax regime has come under criticism, if not attack, in the last two decades? This has proven true even while the concepts of both source and residence have been increasingly criticized as meaningless in a globalized world.[57]

This Article proposes that the reason lies in a fundamental mistake of conflating *economic* concepts of source and residence with *doctrinal* concepts of source and residence. Perhaps this is because the economic concepts of source and residence are so fundamental to public finance theory that it is generally assumed that the concepts are equally important in legal doctrine. Perhaps this is because source and residence provide a common framework and terminology for those involved in the debate to work with as a means to compare and contrast proposals. Perhaps it is due solely to myopia. Regardless, this Article will attempt to delink the economic concepts of source and residence from the legal concepts of source and residence. Doing so can result in a striking conclusion—*both* source and residence rules can be thought of as simply instrumental tools in the international tax regime's toolbox to be used to achieve the desired normative goals of the regime. No more, no less.

As noted above, the economic concept of source and residence traditionally are defined in terms that are mutually exclusive. Framed in this manner, it makes sense that source and residence as legal doctrines would be treated as mutually exclusive as well. In the real world, as with most things, however, the issue is not as clear. What if a company is owned primarily by US investors, is incorporated in the United Kingdom, is primarily managed in

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55. *See* Avi-Yonah, *Simplification*, *supra* note 6.

56. *See, e.g.*, Bret Wells & Cym Lowell, *Income Tax Treaty Policy in the 21st Century: Residence vs. Source*, 5 COLUM. J. TAX L. 1 (2013) [hereinafter Wells & Lowell, *21st Century*].

57. *See* Marian, *Jurisdiction*, *supra* note 21.

France, and primarily has its employees and tangible assets in China? What is the country of residence for these purposes? What is the country of source?

The movement towards treating residence rules as merely an instrumental tool in a larger toolkit of the overall international tax regime, and not as a core defining feature of that regime, has represented a fundamental shift in thinking about how to develop an international tax regime.[58] Yet less has been said about treating source rules equally as instrumental tools in the international tax toolbox. Since neither source nor residence have independent normative content, however, there is no reason that they could not both be treated as instrumental tools to achieve a particular desired result in an overall international tax regime.

This is precisely why the legal concepts of residence and source—which are doctrinal tools used to build a comprehensive, integrated, international tax regime—should be delinked from the economic concepts of residence and source—which represent opposite poles of tax regimes within economic models. From a doctrinal standpoint, every country with any form of residency-based entity tax regime—whether it be the primary regime, the default regime, or a backstop to a source-based regime, must have some definition of residency for entities.[59] This could be a rule, or a standard, or a rule with an anti-abuse backstop, or a standard with a rule-based safe harbor, or some other approach. Regardless, the law must draw a line somewhere—some corporations or partnerships are within a country's residency net and some are not.

Once the law begins drawing lines, however, the law itself creates incentives for taxpayers to change their behavior at the margins of that line. In turn, the law must balance not only achieving the ultimate underlying normative goal for the income tax in deciding where to draw the line, but also where drawing the line would minimize distortions, evasion, or avoidance at the margins.[60] While the law has tended to address these two goals—defining residency and policing the line—as distinct, once it is accepted that source and residency are purely instrumental they need to be combined into a single, second-best analysis to best achieve the ultimate goals of the tax regime. Under this approach a country should identify a normative goal for its international tax regime and then develop legal definitions of both residence and source that achieve that goal working together, even if those definitions do not look anything like the economic concepts of residence and source.

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58. *See* DANIEL N. SHAVIRO, FIXING U.S. INTERNATIONAL TAXATION (2014).

59. *See* Kleinbard, *Lessons*, *supra* note 17; Marian, *Jurisdiction*, *supra* note 21.

60. *See* David A. Weisbach, *Line Drawing, Doctrine, and Efficiency in the Tax Law*, 84 CORNELL L. REV. 1627 (1999).

III. RESIDENCE AND SOURCE AS INSTRUMENTAL TOOLS IN INTERNATIONAL TAX LAW

A. *A Brief Summary of the US Rules for Source and Residence*

For the most part, the United States uses a formalistic definition of residence for entities. The nice thing about this approach is that it provides a clear, bright line. Under section 7701(a)(4), a corporation is domestic (and thus a US resident) if it is formed under the laws of the United States, a state thereof, or the District of Columbia. Under section 7701(a)(5), a corporation is foreign (and this not a US resident) if it is not domestic. Similar rules apply for partnerships. This is the so-called "place of incorporation" rule.[61]

The rules for source of income in the United States are more complicated. This makes sense as an initial matter, since the source rules apply on an item-by-item basis while the residency rules adopt a bright-line, all-or-nothing approach. For purposes of simplicity, this Part will only discuss a handful of the source rules as examples. First, dividends paid by a domestic corporation are considered US source. Dividends paid by a foreign corporation, however, are foreign source only if the paying corporation does not earn more than 25 percent of its income from sources within the United States. If the paying foreign corporation does earn more than 25 percent of its income from within the United States, the dividend is treated as US source in a pro rata amount of the US source income of the paying corporation, effectively a look-through rule.[62]

The dividend sourcing rule demonstrates two of the many ways to source income: (1) based on the identity of the payor and (2) based on the location of the underlying business activity. Another approach is to source the income based on legal status, which looks not to the identity of the payor or the location of the business activity but rather to the primary place of legal protection. For example, royalties on patents are typically sourced in the jurisdiction issuing the patent regardless of the identity of the owner of the patent or the payor of the royalty.[63] In other words, royalties on a US patent are US source even if they are paid by a foreign corporation. Conversely,

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61. *See* Marian, *Jurisdiction, supra* note 21. There are some exceptions to this rule, however. The major exception is section 7874(b), which treats an inverted foreign company as a US resident even though it is legally formed in a jurisdiction outside the United States. *See* Omri Marian, *Meaningful Corporate Tax Residence*, 140 TAX NOTES 471 (July 29, 2013). Another exception is section 269B, which considers a foreign corporation with a majority of its stock stapled to the stock of a domestic corporation as a domestic corporation.

62. I.R.C. § 861(a)(2).

63. I.R.C. §§ 861(a)(4), 862(a)(4).

interest on debt is almost always sourced based on the identity of the payor regardless of the location of the underlying business generating the revenue to pay the interest.[64]

Establishing the three primary means of sourcing—(1) identity of payor, (2) underlying business activity, or (3) legal status—can help understand some of the more complex sourcing rules used in the Code. For example, the default rule for sourcing the gains from sale of property is based on the identity of the seller.[65] Thus, property sold by a non-US person is non-US source.[66]

This default rule is defined in the exceptions, with the largest exception being the sale of inventory exception. The sale of inventory as an initial matter is sourced based on the location of the sale, which for these purposes is typically defined as the place of the passage of title.[67] Thus, a non-US person selling a widget with title passing in the United States generates US source income on the gain from the sale.

These two rules are then subject to even more exceptions. One exception applies to inventory sold by non-residents with the title passing outside the United States but made through a US office. In this case, the gain from the sale would be US source notwithstanding that the title passed outside the United States.[68] This exception is then broadened by applying to sales made by certain agents within the United States on behalf of non-residents.[69] Another exception provides that the sale of intellectual property in which the price is contingent upon the use of the intellectual property will be treated as a royalty for purposes of sourcing the gain rather than a gain from the sale of property.[70]

Another exception applies to self-produced inventory. With respect to self-produced inventory, the Code bifurcates the gain from the sale into two

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64. I.R.C. § 861(a)(1). This rule was adopted in the Tax Reform Act of 1986 as part of a broader reform, including the adoption of the branch profits tax, before which there was a form of look-through rule for sourcing interest. *See* STAFF OF THE JOINT COMM. ON TAXATION, GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986*,* at 916-923 (1987) [hereinafter, JCT, TAX REFORM ACT OF 1986].

65. I.R.C. § 865(a).

66. Crucially, however, these rules contain their own definition of resident for these purposes, which look to the "tax home" of a taxpayer and not just that taxpayer's residence. I.R.C. § 865(g). Thus, the definition of resident can differ under section 865, at times, from the general rule for residence under section 7701. While this example applies to individuals, it demonstrates how source and residence can be used together instrumentally to achieve particular results, rather than rely on some inherent definition of these rules.

67. I.R.C. § 865(b).

68. I.R.C. § 865(e)(2).

69. I.R.C. §§ 865(e)(3), 864(c)(5).

70. I.R.C. § 865(d).

parts: (1) the gain attributable to the production and (2) the gain attributable to the sale.[71] Taxpayers are permitted to use one of three methods to bifurcate the gain for these purposes, for example through a 50-50 safe harbor.[72] Once the gain is bifurcated, each is sourced separately very roughly the gain attributable to production is sourced based on the location of the assets used in the production while the gain attributable to the sale is sourced based on the place of the sale.[73]

Deductions also need to be sourced for multinational businesses. The general rule for sourcing of deductions is that each item of deduction needs to be allocated to a particular item of income and then, once allocated, apportioned between US and foreign source in as close to the same manner as possible as the related item of income.[74] The general idea behind linking the sourcing of deductions to the sourcing of income is to prevent a company from artificially shifting deductions attributable to foreign source income into the United States to offset the US tax on US source income (or to increase foreign source income for US taxpayers so as to increase the ability to utilize a foreign tax credit).

The law recognizes that certain items of deduction cannot be traced and apportioned to specific items of income, however, because money is fungible. For example, it is impossible to determine whether borrowed proceeds of a multinational company were used in a US business or a foreign business, because a tracing rule would permit taxpayers to artificially allocate borrowed proceeds to their highest tax use and free up other money to be used in the other line of business. As a result, a special rule for sourcing of interest on debt applies, apportioning the interest in accordance with the relative basis of the assets of the business.[75] While this may not reflect the relative value of the business lines, it does provide an objective factor upon which to allocate interest deductions.

The residence and source rules interact with each other to determine the US tax liability of a particular taxpayer. US resident taxpayers are subject to US tax on their worldwide income, meaning there is no difference from an income standpoint as to the source of the income. US resident taxpayers still care about source of income because the foreign tax credit can only be utilized by US resident taxpayers against US tax on foreign source income.

Conversely, non-US resident taxpayers are typically only taxed by the United States on US source income. This can arise in two ways. First, non-US residents are subject to a 30 percent withholding tax on their US source fixed, determinable, annual or periodic (FDAP) income (primarily interest,

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71. I.R.C. § 863.
72. Reg. § 1.863-3(a).
73. Reg. § 1.863-3(c).
74. Reg. § 1.861-8.
75. Reg. § 1.861-9T.

dividends, rents, and royalties), subject to lower rates available by treaty.[76] Second, non-US residents are subject to net US income tax on their income effectively connected with the conduct of a US trade or business (ECI).[77] Once again, source plays an important role here, since effectively connected income is defined separately by source.[78] With respect to FDAP-type income, such income is ECI only if it derives from assets used in the conduct of the US trade or business, effectively a tracing rule.[79] With respect to most other income, the income is ECI if it is US source regardless of where the underlying assets are located.[80]

Most readers of this Article will likely already be quite familiar with these rules. The purpose of this summary is not to educate readers about these rules, but rather to frame the discussion about the doctrinal approach to source and residence rules within the Code. Under the law currently, residence serves as a form of threshold for the source rules. Whether and to what extent a taxpayer cares about the source of a particular item of income turns exclusively on whether that taxpayer is a US resident or a non-US resident. The source rules, by contrast, label individual items of income based on some underlying factor for that item of income justifying a US source-based tax regime.[81] This explains why the rules vary so much from item-to-item, such as the look-through rule for dividends paid by foreign corporations, the bifurcation rules for self-produced inventory, and the royalty rule for contingent sales of intellectual property, and the US office and dependent agent rules for sales of inventory, among others.

The passage of title test for sourcing gains from sale of inventory provides a bright-line rule for sourcing such gains, a rule that at least one famous court case ruled has real economic substance and thus should be respected.[82] More specifically, the idea behind the passage of title test is that economic risk of loss is borne by the owner of the title, and thus it would be inappropriate to treat a sale as having occurred before title is actually transferred. Absent this rule, it would be possible to source a gain from the sale of inventory in one country while having the risk of loss borne in another.

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76. I.R.C. §§ 871(a), 881(a).

77. I.R.C. §§ 871(b), 882(a). This is also deemed to include gain from sales of US real property. I.R.C. § 897.

78. I.R.C. § 864(c)(1)-(4).

79. I.R.C. § 864(c)(2).

80. I.R.C. § 864(c)(3). This is sometimes known as the "residual force of attraction" rule. *See , e.g.*, Anthony P. Polito, *Trade or Business Within the United States as an Interpretative Problem Under the Internal Revenue Code: Five Propositions*, 4 HASTINGS BUS. L.J. 251 (2008).

81. *See* Fred B. Brown, *An Equity-Based, Multilateral Approach for Sourcing Income Among Nations*, 11 FLA. TAX REV. 565, 574–85 (2011).

82. *See* A.P. Green Exp. Co. v. United States, 284 F.2d 383 (Ct. Cl. 1960).

For example, assume a business in Germany sells a widget to a buyer in the United States. The US buyer presumably does not want to take title to the widget until it is actually received in the United States. This would make the gain US source income, however. So the German seller asks the buyer to transfer title in Germany before shipment to make the gain foreign source. But what if the ship transporting the widget sinks? If the US buyer already owns title to the widget, the US buyer loses. If not, the German seller loses. Notwithstanding potential tax savings, presumably the US buyer would not agree to have title pass in Germany before receiving the widget.

Yet, the US office exception overrides the passage of title test even when the passage of title test has real economic consequences. Presumably, the idea behind the US office test is that sales made within a US office have a sufficiently high connection to the United States that the gain should be treated as US source regardless where title in fact passes. In other words, the United States has decided that the economic substance of the transaction occurs in the United States *notwithstanding* that title passes outside the United States.

Perhaps this is because the law assumes that the use of a US office indicates a greater exploitation of US markets and infrastructure than sales made from offices outside the United States, or perhaps because the United States provides legal protection and infrastructure for the operations in the US office. Regardless, what is important for these purposes is that the US office rule is a source rule and not a residency rule. No matter how many activities a non-US corporation has in the United States or how many offices it uses to conduct sales in the United States, it remains a foreign corporation for residency purposes. Thus, if the United States wants to exercise its taxing power over this business, it must do so through the source rules as it has already conceded residency taxation over this entity.[83]

What has arisen is a patchwork of rules, exceptions, counter-exceptions, and anti-abuse provisions, each intended to achieve the "proper" result within the framework of the dichotomy between the source and residence rules. As currently embodied, therefore, the residency rules and the source rules—at least for entities—tend to be determined independently of each other, but only have meaning once combined.

Looked at from this lens, a fair amount of the complexity embodied in the source rules can begin to make more sense. The United States uses a bright-line, and thus effectively elective, all-or-nothing definition of entity residence. Under this approach, an entity either is a US resident or is not, which in turn determines which basic tax regime the entity falls under. Domestic corporations pay tax on their worldwide income, regardless of source, and are entitled to a foreign tax credit (subject to limitations) on their foreign source

83. The United States imposes both gross and net income tax on foreign corporations, but each requires some concept of sourcing of income to limit the tax only to US source income, with some minor exceptions.

income. Foreign corporations only pay net US income tax on income effectively connected with the conduct of a US trade or business and a gross income tax on non-effectively connected FDAP income (subject to reduced rate by treaty). Domestic partnerships must file annual tax returns, provide information returns to their partners, and withhold on all US source FDAP and ECI allocated to foreign partners. Foreign partnerships only need to file annual tax returns in limited circumstances, are not required to provide information returns to all partners, and need not withhold on US source FDAP. Determining residency determines the tax regime.

By contrast, the United States uses a single set of source rules to determine eligibility for the foreign tax credit and also for applying gross-based source taxes. The source rules look to, among other things, the underlying profits funding a payment, the source of legal protection, the identify of payor and payee (depending on the circumstances), and the market into which it sells. Source rules tie the US tax consequences of an item of income to some underlying substantive content of that item of income. In other words, the source rules represent the fundamental policy choice of the United States over what is potentially "in" the US tax net and what is not.[84]

Taken together, as a simplified representation meant solely to assist in order to organize the conceptual analysis, the source and residency rules could be thought of as making up a grid, of sorts, with four potential tax consequences:

Corporations		
	US Source	*Non-US Source*
US Resident	*Net Income Tax without FTC*	*Net Income Tax with FTC*
Non-US Resident	*Net Income Tax (ECI) or Gross Income Tax (FDAP)*	*No US Income Tax*[85]

Partnerships		
	US Source	*Non-US Source*
US Resident	*Withholding and Information Returns*	*No Withholding; Information Returns*
Non-US Resident	*Withholding on FDAP; limited information returns*	*No withholding; no information returns*

84. *See* Christians, *Sovereign*, *supra* note 7; Fleming, Peroni & Shay, *Perspectives*, *supra* note 10.

85. On rare occasions, foreign source income could be treated as effectively connected with the conduct of a trade or business. I.R.C. § 864(c)(4).

The problem with this approach to international tax is that combining two independently defined rules—in this case source and residence—can result in unexpected consequences or unintended incentives. If the normative goal is to impose net income tax on a specific item of income, why permit a different result simply by allowing a taxpayer to choose a different box in the grid? Permitting taxpayers to manipulate results in this manner results from having two, separate doctrinal rules that operate independently but rely on each other to achieve their ultimate goals. In other words, once it is established that source and residence as legal concepts only have meaning once interacted with each other, the law can, and should, combine the doctrinal definitions of source and residence to achieve specific desired normative goals rather than continue to pretend that source and residence are conceptually distinct doctrinal concepts that have independent meaning.

B. The Crisis of Residency in the Global Economy: Using Source to Solve Residence

Corporate residency has effectively become elective.[86] US corporations can change their residency with impunity.[87] US controlled hedge funds can escape US tax altogether by simply pretending to be foreign.[88] From the sound of the current state of the debate, the US international tax rules seem to be facing an existential crisis.

Yet, when looked at more closely, the crisis seems to boil down to one of two themes that have permeated international tax law in recent years: (1) the need to broaden the definition of residency to capture more entities within the residency-tax regime or (2) the need to change from a residency-based tax regime to a source-based regime.[89]

For example, in response to the perceived ineffectiveness of US residency rules, many have proposed changing the definition of US residency for corporations to a test with more "substance"—such as defining residence based on the primary place of management of the corporation or the place of public trading.[90] While it is true (as a tautology) that changing the US

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86. *See* Shaviro, *Rising Electivity*, *supra* note 14.

87. *See* Kleinbard, *Lessons*, *supra* note 17.

88. *See* Lee A. Sheppard, *News Analysis: Neither a Dealer Nor a Lender Be, Part 2: Hedge Fund Lending*, 108 TAX NOTES 729 (Aug. 15, 2005) [hereinafter Sheppard, *Neither a Dealer Nor Lender*].

89. *See, e.g.*, Shay, Fleming & Peroni, *Source Rules*, *supra* note 12; Michael J. Graetz, *The David R. Tillinghast Lecture: Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies*, 54 TAX L. REV. 261 (2001) [hereinafter Graetz, *Inadequate Principles*].

90. *See* Marian, *Jurisdiction*, *supra* note 21.

definition of residency from the place of incorporation test to the primary place of management test will prevent what are perceived as abuses involving the place of incorporation rule, it is not clear that doing so will achieve what proponents of such a rule ultimately want—to impose residency-based taxation on these entities.[91] If the goal is to prevent corporations from using tax havens to artificially reduce tax, therefore, perhaps simply switching to a place of management test may not be effective.

Some point to such results as evidence that residency taxation is simply not workable in the modern economy. Instead, the argument goes, the United States should adopt a territorial (that is, source-based) tax regime for entities.[92] Many proponents of this approach point to the recent adoption by Japan and the United Kingdom of a mostly territorial system from a mostly worldwide system as proof that this is a good idea. Many claim that the change is necessary to enhance the "competitiveness" of US corporations in the global economy.[93] The argument provides that foreign corporations do not pay home country tax on their non-home country income and thus can more easily access and move this capital to its most efficient use than US corporations can. Critics respond by noting that the situations in Japan and the United Kingdom were quite different than the one facing the United States,[94] and that competitiveness has little to no meaning in a world where US corporations can lower their effective tax rate close to zero.[95]

Stripped down, the debate seems to oscillate between residence and source—proponents of residence see abuse as the need for broader residence rules while proponents of source see it as proof of the failure of the residence regime.[96] In this way, source and residence are framed as mutually exclusive options, with battle lines drawn and everyone needing to choose a side.

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91. For example, the United Kingdom for most of its modern history had a residence-based tax regime with a primary place of management test, but according to at least one book it was precisely the place of management test that led to the rise of the use of abusive tax havens by British corporations. *See* Ronen Palan, Richard Murphy & Christian Chavagneux, TAX HAVENS: HOW GLOBALIZATION REALLY WORKS, 112–14 (2009). Similarly, Ireland recently announced that it would modify its place of management test to prevent the use of so-called "double Irish" structures. *See, e.g.*, *Death of the Double Irish*, THE ECONOMIST, Oct. 15 2014, http://www.economist.com/news/business-and-finance/21625444-irish-government-has-announced-plans-alter-one-its-more-controversial-tax-policies.

92. Graetz, *Inadequate Principles*, *supra* note 89.

93. *See, e.g.*, Edward D. Kleinbard, *'Competitiveness' Has Nothing to Do With It*, 144 TAX NOTES 1055 (Sept. 1, 2014) [hereinafter Kleinbard, *Competitiveness*].

94. *See* Marian, *Meaningless Comparisons*, *supra* note 51.

95. *See* Kleinbard, *Competitiveness*, *supra* note 93.

96. *See* Wells & Lowell, *21st Century*, *supra* note 56.

The most recent example of this phenomenon has been the most recent wave of corporate inversions. Placing inversions into the context of the analytical grid above, the inverted business had both US source business income and foreign source business income. Prior to the inversion, the US company was in the top-right box for its foreign source income—US net income tax with potential foreign tax credits. After the inversion, the inverted company was in the bottom-right box for its foreign source income—no US income tax at all.

That move from one box to another is a significant change in tax consequences for what was, in effect, a relatively small formal legal change with virtually no change in business model, ownership, management, or internal structure. That is precisely what concerned policy-makers about inversions. In terms of the analytical grid, the substantive tax result was being changed from the ultimate desired normative goal simply by moving boxes within the grid through the use of a purely formalistic, effectively elective choice of residence.

In response, Congress enacted section 7874. Among other things, section 7874 represented a dramatic break from the baseline corporate residency rules by redefining a foreign corporation as a domestic corporation if it had acquired the stock of a US corporation and, immediately after the acquisition, more than eighty percent of the stock of the foreign corporation was owned by former shareholders of the US corporation.[97]

From this perspective, section 7874 could be thought of as the first significant attempt to adopt an instrumental definition of residence to achieve a specific result rather than have the residence and source rules interact independently to result in tax consequences, whatever they may be.[98] Congress wanted to continue to treat a corporation as a US corporation if that corporation merely engaged in a formalistic change in structure but did not change its business model or management and did not change its ownership substantially. On the other hand, however, Congress did not want to provide a disincentive for US corporations to be acquired by foreign corporations in real business acquisitions. Congress drew the line at 20 percent to distinguish between the two.

By adopting a bright-line rule, however, as with any bright-line rule, the test was destined to be both over- and under-inclusive.[99] Treasury has addressed a number of these through regulation. While most of the regulatory

97. I.R.C. § 7874(c).

98. At the same time, however, Congress also enacted section 4985, which imposed an excise tax on management holding stock options in inverted companies.

99. Some of the potential over-breadth was almost immediately noted by practitioners. For example, commentators quickly noted that internal restructurings with minority outside shareholders could technically trigger the anti-inversions rules when they were likely not intended to apply. *See* Carl Dubert, *Accidental Inversions*, 16 J. INT'L TAX 22 (2005) [hereinafter Dubert, *Accidental Inversions*].

responses provide common-sense results, they require some significant complexities to get there. For example, internal restructurings are exempt from the anti-inversion rules by excluding the internally owned stock from consideration. This, in turn, can result in even small blocks of stock being considered "controlling" for these purposes, leading to strange results at times.[100]

Conversely, the bright-line 20 percent test unsurprisingly resulted in corporations trying to undertake inversions just past the line. This would require a US corporation finding a foreign corporate acquisition target to merge with such that the shareholders of the foreign target would own slightly more than 20 percent of the combined company. Such inversions technically comply with section 7874 and thus the new foreign parent is not treated as a US corporation. Since section 7874 did not change the default corporate residency test, all these companies needed to do was to fall outside the 20 percent rule to end up back under the place of incorporation residency rules.

In response, two competing calls for reform have arisen. The first embodies an anti-abuse approach, including proposals to increase the threshold in section 7874 from 20 percent to some higher number, typically 50 percent.[101] The second involves calls to prevent the ability to strip income out from under the former US parent after an inversion. While different in their technical approaches, both represent an instrumental approach to the initial adoption of section 7874. They identify corporations that "should" pay US tax, either on historic earnings or future earnings, or both, and then propose rules that would accomplish this result notwithstanding where the corporation fit within the analytical grid based on default definitions of residency and source.

As part of a growing trend, this Article argues that the instrumental approach to defining corporate level tax embodied in the anti-inversion debates should be adopted explicitly as a whole rather than implicitly through anti-abuse type rules on a case-by-case basis. Under such an approach, first the normative decision should be made as to which corporations should fall within the US residency based tax regime, and second the definition of residency should be adopted to achieve that result.[102] From this perspective, the proposal in this Article would tie together source and residence as a single, unified regime to achieve such a result.

Using source as a solution to residence may strike many as odd or inappropriate or even harmful. Yet, when boiled down, the justification for a

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100. *See id.* at 24-25 (describing how a US corporation with a single large corporate shareholder and a single small individual shareholder acquired by a foreign corporation would be treated as an inversion because the large shareholder would be disregarded but the small shareholder would not, resulting in a 100 percent ownership fraction).

101. *See, e.g.*, Mindy Herzfeld, *News Analysis: What's Next in Inversion Land?*, 143 TAX NOTES 1225 (June 16, 2014).

102. *See* Marian, *Jurisdiction*, *supra* note 21.

worldwide-based residency tax regime based on ability to pay ultimately comes down to one of a taxpayer's minimum connections with a country.[103] What demonstrates a greater connection to a country by an entity than earning the majority of its income from sources within that country? Recall that entities cannot have a physical presence, at least not in the same way as individuals, and the legal status test seems to have unraveled as too easily manipulated. Source rules, by contrast, are based on underlying policy choices of a state with respect to particular items of income, are difficult to manipulate (or at least more difficult than place of incorporation or place of management), and represent real, substantive connections to a country. These match remarkably well with the ultimate justifications for imposing a residency-based tax on a taxpayer in the first place.[104]

While this would mean that an entity earning sufficient US source income would potentially be subject to US taxation on the entity's foreign source income, there is no reason that this is less defensible than taxing the foreign source income of an entity under other proposed alternatives, such as doing so solely because a large shareholder is a US resident (under a significant shareholder test) or because one board member refuses to travel outside the United States for board meetings (under a place of board meetings test). Either way, the residence taxation of the entity is being used as a backstop to the use of the entity to undermine the ability to pay rationale for the residence taxation of individuals.[105] Thus, while using source to define residence indirectly ties residence to benefits received from a country, it is important to note that it does not convert a worldwide income tax from ability to pay to benefits taxation. Rather, it uses benefits indirectly to define the relevant community necessary to impose an ability to pay income tax regime with a second-best entity tax backstop. While this is a subtle difference, it will prove crucial in determining the application of the rules below.

It is true that a source-based regime could be over-inclusive; for example, such an approach might impose tax on a foreign-organized entity owned exclusively by foreign shareholders. In such a case, there presumably would be no need for an individual tax backstop since none of the individual shareholders would have been taxed in the United States on their foreign source income had they earned it directly. What is crucial to note, however, is that *any* definition of residence for entities will always be over- and under-inclusive for this and other reasons. The mere fact that using source to determine residence could be overbroad is not a reason in itself to reject it as a proposal, at least so long as the United States uses some form of corporate

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103. *See, e.g.*, McDaniel, *Tax Systems*, supra note 54; Shay, Fleming & Peroni, *Source Rules*, *supra* note 12.

104. *See supra* Part II.A.

105. *See, e.g.*, Fleming, Peroni & Shay, *Fairness*, *supra* note 8.

income tax at the entity level to serve as a second-best backstop to an individual ability to pay based tax.[106]

Further, while a foreign-organized entity with foreign shareholders might be subject to tax on its foreign source income under this approach, it is not entirely clear who bears the incidence of that tax. Thus, it is possible that US persons could ultimately bear the incidence of the tax on such an entity. Conversely, an entity tax imposed on a domestic-organized entity owned primarily by US shareholders but which operates primarily in foreign markets could well fall on non-US persons. Taken together, there ultimately can be no first-best policy argument regarding the definition of entity residence based on the ultimate incidence of the tax. Rather, the issue comes down to whether the definition of residence most closely achieves the normative goals of the tax system as a whole, and not just the corporate tax regime.

Of course, conforming changes would need to be made under the proposal as well. There is no reason to think that this would be more complex or difficult than the challenges under current law—whether it be adopting statutory anti-abuse rules such as section 7874, more aggressively asserting section 482 or other transfer pricing authority, or aggressively expanding regulatory authority under section 385 or other provisions.[107] In fact, one significant benefit of tying residency to sourcing rules is that the residency definition would automatically update to reflect changes in the sourcing rules.

Lastly, while not a tax issue *per se*, delinking the tax residence of an entity from its place of legal organization could permit taxpayers to choose more efficient business entity forms. The current place of organization definition of residence would prevent a foreign business from forming a Delaware corporation to operate, even if Delaware corporate law was superior to, for example, Bermuda corporate law. Under the proposal, that business could incorporate in Delaware and operate under the superior corporate law without necessarily being treated as a domestic corporation for US tax purposes. Similar consequences would arise with a place of listing rule or place of management and control rule. As noted above, any line will create distortions at the margins of that line. The only relevant question is whether the distortions are larger or smaller based on where the line is drawn.

C. Source-Based Residence as Self-Help Coordination

One of the largest issues facing the international tax regime is the lack of cooperation and coordination among the countries of the world, which

106. *Id.*

107. *See* Stephen E. Shay, *Mr. Secretary, Take the Tax Juice Out of Corporate Expatriations*, 144 TAX NOTES 473 (July 28, 2014); *cf.* Rachelle Y. Holmes, *Deconstructing the Rules of Corporate Tax*, 25 AKRON TAX J. 1, 46–50 (2010).

permits multinational taxpayers to shift profits around the world with impunity, undermining the tax base of all countries and resulting in "stateless" income subject to tax in no country.

Using source to define residence could be seen as a form of self-help coordination, that is, coordination of national tax regimes without requiring formal agreement among multiple countries. This is for three reasons. First, a source-based definition of residence would minimize the exercise of US taxing power over the foreign source income of corporate taxpayers. Second, using source to define residence can help coordinate the regimes of nominally worldwide systems and nominally territorial systems. Third, a source-based rule would easily fit within a shift to a formulary apportionment model of allocating income rather than a transfer pricing model.

This issue should only prove more important as countries continue to move to primarily source-based tax regimes. In a world with only source-based taxation, any gaps in the sourcing rules of countries will result in income being lost to the system. Absent complete harmonization, however, gaps will necessarily continue to exist. Residence backstops help prevent this problem, but in turn raise the problem of potential double taxation. This concern only grows the more the definition of source and residence diverge. Tying the definition of residence to the source rules, by contrast, results in a closer fit between the two regimes. Thus, using source as a solution to residence could be one way to move towards a more harmonized international regime in which source-based taxation becomes the norm without the need for a difficult, if not impossible, to achieve multinational agreement, especially if the United States continues to hold out and use a residence-based system.

The following sections will discuss how using source as solution to residence can lead to a form of self-help coordination under three specific analyses.

1. Minimizing the Exercise of Residence Tax over Foreign Source Income

As discussed above, the defining feature of a worldwide tax regime as opposed to a territorial tax regime is the exercise of taxing power over foreign source income of a taxpayer. For individuals, this is justified as a matter of ability to pay based tax theory. For entities, this is often justified under a benefits theory, although it could also be justified as a backstop to the individual residence-based ability to pay tax regime. Regardless, defining an entity as resident in a jurisdiction is the same as exercising the taxing power of that jurisdiction over the foreign source income of that entity.

This issue has been implicit in the debate over residence taxation of entities. For example, many corporations that have inverted claim that they are truly "foreign" companies because they do most of their business outside the United States and thus an inversion merely matches their formal residence with

their economic reality. By contrast, commentators have noted that entities formed in the United States (or managed and controlled in the United States) may only have a worldwide business based on the historic benefits provided by the United States and, perhaps, implicit benefits that come with a US headquarters or incorporation (such as implicit guarantees of US military support for shipping routes). These commentators note that for these reasons the United States should be permitted to impose tax on the foreign source income of such entities, regardless of the current primary place of business operations.

What has received less attention, however, is whether and to what extent any one definition of residence for entities exposes income of that entity to US tax that otherwise would not have been. In other words, how much foreign source income could be subject to US tax? This is an important question because concerns over double tax, and correspondingly the issues implicit in double tax relief, only apply to income that is subject to tax in more than one jurisdiction.

In this respect, one benefit of the source-based residence proposal is that it minimizes the amount of foreign source income subject to the US tax regime. Any other definition of residence—whether it be place of incorporation, place of sales, place of management and control, or place of public listing, among others—that is not linked to source of income could potentially lead to the United States imposing its taxing power on significantly more foreign source income. This is true for the simple reason that, under the proposal, a company is domestic for US tax purposes only if it earns over half of its income from sources within the United States. Thus, by definition, less than half of the income of the entity consists of foreign source income. By contrast, under a place of incorporation test, a company could earn the entirety of its income from sources outside the United States and yet the United States could impose its taxing power over all of that income of the company.

From a policy standpoint, the more foreign source income the United States exercises taxing power over, the more potential for double taxation exists and, perhaps more importantly, the more potential for abuse of the foreign tax credit exists.[108] Thus, purely from a US standpoint, adopting a residence definition that furthers the underlying goals of the overall income tax regime and that minimizes this effect would prove beneficial. Only a source-based definition of residence achieves this.

2. *Nowhere Corporations and Self-Help Source Taxation*

Assume a world in which every country adopted a source-based definition of residence. Under such a scenario, a truly multinational company that did not earn more than half of its income from any one country would not

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108. *See, e.g.*, Fleming, Peroni & Shay, *Fairness*, *supra* note 8.

be resident in any country. Thus, a source-based definition of residence could lead to a proliferation of "nowhere" companies. Would this be a good or bad result from a tax policy standpoint?

This question has become crucial in light of recent concerns over so-called "stateless" income and the ability of multinational corporations to avoid meaningful tax in any country.[109] It is important to note, however, that the concerns over stateless income are not the same as the concerns over nowhere corporations. The reason is that while nowhere corporations would have no residence tax imposed on them, they would be subject to source tax in all the source countries in which they operate. Assuming away conflicting definitions of source (for simplicity), this would be the same as if every country in the world moved from a worldwide tax regime to a territorial tax regime, but only for nowhere corporations. While this would put increased pressure on the definitions of source, it would not do so any more than a territorial tax regime would.

It is for this reason that the concerns over both stateless income and nowhere companies can be substantially mitigated under a source-based definition of residence, notwithstanding the potential rise of a significant number of "nowhere" companies. In other words, true multinational companies that do not earn more than half of their income sourced in any one country would not be a tax resident in any country. Unlike the current regime, however, this does not mean the income becomes stateless. Rather, by conceding that a corporation is resident nowhere, that corporation effectively only becomes subject to source taxation.

From a policy standpoint, this could actually support worldwide tax regimes rather than undermine them. For the most part, arguments against worldwide tax regimes for multinational corporations involve claims that they result in double taxation, lead to significant abusive tax planning, and undermine the ability of source countries to impose tax at source. The typical response is a call to move to a territorial tax regime. These calls are often opposed on the argument that "truly" domestic corporations should not be exempt on small amounts of foreign source income. The source-based definition of residence solves this problem. The United States would be permitted to continue to use worldwide taxation for individuals and for entities as a backstop to the individual tax, but would effectively only impose source taxation on truly multinational companies without a majority of income earned from sources in any single country. This is effectively a "self-help" form of the United States coordinating with the increasing number of countries adopting a territorial tax regime without having to completely abandon worldwide taxation for most US persons and corporations.

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109. *See* Edward D. Kleinbard, *Stateless Income*, 11 FLA. TAX REV. 699 (2011).

Correspondingly, an additional benefit would be that the foreign tax credit would no longer be necessary for these "nowhere" companies—which are precisely the ones that most easily abuse the foreign tax credit under the existing system. It has been established that multinational companies with highly mobile income can manipulate the foreign tax credit to result in negative effective tax rates on foreign source income.[110] The primary reason this is possible is because these companies are domestic for US purposes because they are legally organized in the United States but can easily move income around the world due to their multinational business model solely to maximize tax benefits. In this way, such companies can free up foreign tax credits to be used effectively against US source income with impunity. Under a source-based residence regime, these companies would effectively be taxed under a territorial regime, meaning they would pay zero US tax on foreign source income. Since zero is greater than negative, this is an improvement from a tax policy standpoint as a second-best matter. Other, more domestic, corporations that cannot easily move income around the world would remain subject to the worldwide tax regime.

3. Source-Based Residence and Formulary Apportionment

One of the most significant movements in international tax in recent years has been the move towards adopting formulary apportionment instead of transfer pricing as the appropriate method to divide tax base among countries. Formulary apportionment requires two significant changes from current law: (1) treat multinational corporate groups as a single taxpayer and (2) allocate the income in accordance with some objective factor, such as sales or employees. For example, assume a multinational corporation earns $1 billion in taxable income worldwide and has 40 percent of its sales in the United States and 60 percent of its sales in China. Under formulary apportionment using a sales-only factor, 40 percent of the income would be US source and 60 percent would be Chinese source, regardless where any subsidiary is legally organized or assets such as intellectual property are held.

One of the benefits of using a source-based residence rule is that it could easily piggy-back on the benefits of formulary apportionment, just as it could with any change in source rules (assuming that the United States would prefer to keep a worldwide residence tax regime for multinational corporations after adopting formulary apportionment). In the example above, under the formula, less than 50 percent of the income of the multinational corporation is US source and thus the corporation would not be domestic for these purposes. If the opposite allocation resulted—60 percent to the United States and 40 percent to China—the corporation would be domestic for these purposes. In the latter case, the United States could claim the power to tax 100 percent of

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110. *See, e.g.*, Fleming, Peroni & Shay, *Fairness*, *supra* note 8.

the income of the corporation but would grant a foreign tax credit against the 40 percent Chinese source income.

In fact, adopting a source-based residence definition may actually make adopting formulary apportionment easier and more effective for the United States than trying to do so under the existing worldwide tax system. One of the primary criticisms of formulary apportionment is that it cannot achieve its desired goals unless it is adopted by all (or most) countries of the world. Absent this, any formulary based apportionment could conflict with a transfer price based apportionment used in other countries, leading to more double tax or, even worse, more double non-taxation. This result can be mitigated by combining formulary apportionment with a source-based residence definition. Under this approach, the United States could unilaterally adopt formulary apportionment based on whatever factors it preferred. Once in place, the formula would determine the residency of the multinational. If the formula resulted in more than half of the income of the multinational being US source, it would be a US resident. Thus, the United States could enforce its taxing power over the foreign source income of the multinational (subject to the foreign tax credit) regardless what other countries do. In this way, multinational corporations would not be able to exploit mismatches between formulary apportionment and transfer pricing merely by changing the place of incorporation of an entity as it can under current law.

IV. SOURCE AS A SOLUTION TO RESIDENCE: THE PROPOSAL AND EXAMPLES

Most of the debate over the future of international tax tends to focus on the move from worldwide taxation to territorial taxation. A common rejoinder in this debate is that the move to territorial taxation will only place more emphasis on the source rules, since under a territorial regime a country only taxes income sourced from its country regardless of the residency of the entity at issue. The conclusion of this Article is that the globalization of the modern economy is placing increasing pressure on the definitions of both source and residence, for the same reason. Assuming this is true, more attention needs to be paid to rationalizing the source and residence rules together as a whole to achieve the underlying goals of the international tax regime in the first place.

As discussed above, the standard assumption for all worldwide regimes has been that residency is determined first, and then source is applied to calculate tax. There is no reason, however, that the order could not be reversed, especially if the world is moving from a primarily residence-based model to a primarily source-based model. Under such an approach, source would determine residency—precisely the opposite of what is typically

assumed.[111] In this manner, the definition of residency itself can be tied directly to the concept of earning income connected to the jurisdiction, rather than using some other proxy such as place of incorporation or place of management.[112]

There are many benefits to using source to define residency, a number of which have been outlined above. In the modern economy with electronic commerce, highly mobile capital, multinational business models, bilateral investment treaties, and highly liquid currency, the proxies of the past have lost their connection with the sovereign power of a jurisdiction to impose tax.[113] Instead, under these conditions, the normative justifications for defining the source could be used to justify a residence tax.[114]

Perhaps equally, if not more, important, from a doctrinal standpoint using source to define residence can actually resolve a long-standing but often overlooked tension in the residence rules—the difference in treatment between corporations and partnerships. Looked at from this perspective, residence rules actually create two margins for which there are distortions. First, there is a distortion at the resident-nonresident margin. Second, there is a distortion at the corporations-partnership margin. While it is true that the check-the-box rules have minimized this margin under the current place of incorporation residency test, the issue will arise once again if any other residency test is adopted. For example, a residency rule based on primary place of management and control may work extremely well for publicly traded corporations with large boards of directors. But how would it be applied to a Cayman limited partnership or a Nova Scotia unlimited liability company?

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111. *See, e.g.*, Michael J. Graetz & Michael M. O'Hear, *The "Original Intent" of U.S. International Taxation*, 46 DUKE L.J. 1021, 1060 (1997).

112. In many ways, this goal of using source as a solution to residence shares many features with a proposal made by the Joint Committee on Taxation in 2005 in which the residence of a corporation would be determined based on the location of its primary place of management and control. *See* STAFF OF THE JOINT COMMITTEE ON TAXATION, OPTIONS TO IMPROVE TAX COMPLIANCE AND REFORM TAX EXPENDITURES, JCS-02-05 (2005). According to that report, "A corporation's primary place of management and control is where the executive officers and senior management of the corporation exercise day-to-day responsibility for the strategic, financial and operational policy decision making for the company (including direct and indirect subsidiaries)." *Id.* at 180. The difference is that, under the proposal of this Article, the connection with the United States would be based on source of income, which incorporates the underlying policy rationales of the source rules, rather than management policy decision making.

113. *See* Christians, *Sovereign*, *supra* note 7.

114. *See* Shay, Fleming & Peroni, *Source Rules*, *supra* note 12; *see also* JCT, TAX REFORM ACT OF 1986, *supra* note 64, at 937 ("Congress was concerned that the prior [source] rules for dividends and interest paid by 80/20 companies ceded primary tax jurisdiction away from the United States for income that should have borne U.S. tax.").

In the modern economy, most entities are formed as flexible entities such as limited liability companies that may organize their management however they wish. For example, in the United States, an LLC may be member-managed, board managed, or managed by an independent management company. Imposing a residency test based on primary place of management and control, therefore, can prove difficult to enforce for entities where management and control can be contracted for anywhere in the world. By contrast, partnerships are typically managed by the partners rather than a board. Where is a General Partnership managed and controlled when every partner has the power to bind the partnership?

Of course, different tests could be adopted for corporations and partnerships, or for publicly traded entities and non-publicly traded entities. But if that is to be adopted, it should be done so for affirmative policy reasons and not as a result of unexpected consequences of drawing a line meant for one type of entity that does not apply to other types of entities. One significant benefit of using source to define residency is that it is neutral as to the type of entity involved. Rather, all that matters is the source of the majority of the income of the entity.

The remainder of this Part will describe the proposal in more detail and provide two examples of what such an approach would look like under the US tax regime, demonstrating how such an approach can not only more closely fit with the normative goals of an income tax as applied in the international setting but also prove easier to implement and harder to abuse than other proposed alternatives to residency, as applied to both corporations and partnerships.

A. Source as a Solution to Residence: The Proposal for Corporations

1. Defining Residency for Corporations

As a starting point, under the proposal the definition of domestic corporation in 7701(a)(3) would be amended to read as follows: "the term domestic corporation shall mean any entity treated as a corporation for US tax purposes for which (1) 50 percent or more of the gross income of such corporation for the taxable year is income from sources within the United States, or (2) the average percentage of assets held by such corporation during the taxable year which produce income from sources within the United States or which are held for the production of income from sources within the United States is at least 50 percent."[115]

This definition is loosely based on the same standard as the "passive foreign investment company" (PFIC) rules, with certain exceptions to be

115. The proposal would adopt rules substantially similar to section 1297(e) and the regulations thereunder for measuring assets under the asset test.

discussed in more detail below. In particular, this definition would adopt the look-through rule of section 1297(c) for purposes of determining the income of domestic corporate subsidiaries. More specifically, if a corporation owns (directly or indirectly) at least 25 percent (by value) of the stock of a domestic corporation, the corporation would be treated as if it held its proportionate share of the assets of the other domestic corporation and received directly its proportionate share of the income of the other domestic corporation, for purposes of determining residency.

In effect, the look-through test for the residency rule would adopt the opposite rules of the section 1298(b)(7) test for stock of domestic corporations held by foreign corporations for PFIC purposes. Under that section, if a foreign corporation owns more than 25 percent of the stock of a domestic corporation it is not considered a passive asset. Implicit in this rule are two presumptions. First, Congress is not concerned about US shareholders of PFICs improperly deferring income through a foreign corporation that owns significant stock in a domestic corporation. This must be the case because greater than 25 percent domestic subsidiaries are effectively disregarded for PFIC testing purposes. Second, and more relevant for this proposal, the status of the lower-tier corporation must first be established before the status of the upper-tier corporation can be established. This proposal adopts a similar tiered-ordering rule, in which the residency status of lower-tier corporations must be determined prior to determining the status of upper-tier corporations.

With respect to the stock of foreign subsidiaries, the dividends of the foreign subsidiaries would be sourced according to section 861(a)(2)(B) which adopts a look-through rule for sourcing unless the corporation earns less than 25 percent of its income from US sources. This means that dividends paid on stock in "true" foreign subsidiaries (that is, subsidiaries earning less than 25 percent of income from US sources) would be considered entirely foreign for purposes of testing the residency of the parent corporation. Taken together with the residency definition and the tiered-ordering rule, this rule would only apply to dividends received from foreign corporations that earn more than 25 percent but less than 50 percent of their income from US sources, because otherwise the subsidiary would be treated as a domestic corporation and would be subject to the look-through rule described above.

In addition, the proposal would adopt a start-up rule substantially similar to the one found in section 1298(b)(2). The policy behind the start-up exception is that corporations in their first year could well only generate gross income from passive sources, such as interest on bank accounts, because their active business is not yet up and running. This may be especially true for businesses that require intensive up-front research and development such as pharmaceuticals or computer software companies. The proposal would adopt a provision as follows: "A corporation legally organized under the laws of a jurisdiction other than the United States, any State thereof, or the District of Columbia, shall not be treated as a domestic corporation for the first taxable

year such corporation has gross income if: (A) no predecessor of such corporation was a foreign corporation, (B) it is established to the satisfaction of the Secretary that such corporation will not be a domestic corporation for either of the 1st 2 taxable years following the start-up year, and (C) such corporation is not a domestic corporation for either of the 1st 2 taxable years following the start-up year." The policy behind adopting this test is to permit start-up companies that intend to focus primarily on foreign markets to be formed with capital from the United States without being deemed domestic, since in their first year the only income they earn could well be interest on US bank accounts or similar income.

The proposal would adopt a rule substantially similar to the "once a PFIC, always a PFIC" rule.[116] The idea behind this somewhat draconian rule is to prevent corporations from trying to manipulate earnings over particular years solely to avoid the application of the PFIC rules in a year of sale for a particular shareholder. Similarly, corporations should not be permitted to manipulate their residency status year-to-year solely due to managing gross income.

From a policy standpoint, once a corporation earns more than half of its income from US sources in any given year it would be appropriate to presume that the corporation continues to use and exploit sufficient US public goods to treat it as a US person going forward and thus impose residency taxation based on ability to pay. This will not always necessarily be the case, however. Businesses grow over time, business models change, and markets react. For example, the company that Michael Dell started in his dorm room at the University of Texas looks nothing like the multinational company that Dell Computer is today. For that reason, perhaps Dell Computer truly should no longer be treated as a US resident.

The proposal takes this into account by providing for a one-time election to change residency status from domestic to foreign in the first year in which a domestic corporation earns more than half of its gross income from foreign sources.[117] Such an election is not unprecedented in the tax law. For example, a foreign corporation may elect to be treated as domestic for purposes of FIRPTA.[118] A number of other elections for entities to be treated as a

116. Under the "once a PFIC, always a PFIC" rule of section 1297(b)(1), if a shareholder owns stock in a PFIC for any year, the stock is always tainted by the PFIC surcharge, unless the PFIC makes a "qualified electing fund" election or the shareholder makes a mark-to-market election, regardless if the corporation ceases to be a PFIC in a subsequent year.

117. Similar to a section 754 election, this would be permitted only as a one-time election and would be permitted to be changed only upon approval by the Commissioner. *See* Reg. § 1.754-1. For foreign corporations earning more than half of their gross income from US sources, US residency would be mandatory.

118. I.R.C. § 897(i).

resident different from their default residency exist as well.[119] Thus, the issue is not whether a residency election is permissible in the tax law, but whether it is a good idea.

In some ways the proposal would be more generous than current law while in some ways it would be less so. Under the proposal, a company that organically grows over time from a primarily domestic corporation to a primarily foreign one would be permitted to expatriate by election. Permitting such an election would represent the economic reality that the company is no longer primarily exploiting US markets or public goods after such time.[120] As with any election, however, the concern for abuse arises as well.[121] As an initial matter, the requirement that the election be permitted only in the first year in which the corporation's income is primarily foreign source mitigates this concern to some extent. This one-shot rule, tied to real business income, would prevent many of the concerns that arose in the check-the-box context for foreign eligible entities[122] precisely because it ties the availability of the residency election directly to the fundamental business operations of the company rather than permitting taxpayers the discretion to make the election at any time, even if solely for tax reasons.

In addition to this one-shot requirement, there are two transition issues based on current law that could be adopted to minimize the potential for abuse of the election while maintaining the recognition of fundamental changes in the business model of an entity: (1) the section 1374 built-in-gain taint for S Corporations converting to C Corporations and (2) the section 367 deemed realization rules for expatriating transfers of assets. Each has relative strengths and weaknesses, and can potentially be used together or separate.

Under the section 1374 approach, if a domestic corporation earns less than half of its income from US sources in a given year it would be permitted to elect to convert into a foreign corporation. At that time, any built-in-gain of the domestic corporation would be tainted for US tax purposes such that if it is realized within the five-year period beginning on the first taxable year in which the company is treated as a foreign corporation, the corporation would have to report and pay US tax on that income at full graduated rates.

This approach has two significant benefits. As an initial matter, it assumes that most of the built-in-gain of assets directly owned by active multinational businesses would arise from either inventory or depreciable assets. Presumably a company would want to sell inventory as fast as possible

119. *See infra* notes 126–128.

120. Recall that, under the source rules, this would include the corporation not collecting income from US patents or intellectual property or receiving US source interest or dividends.

121. *See* Heather M. Field, *Choosing Tax: Explicit Elections as an Element of Design in the Federal Income Tax System*, 47 HARV. J. ON LEGIS. 21 (2010).

122. *See, e.g.*, Lee A. Sheppard, *News Analysis: Defending the Obama International Proposals*, 123 TAX NOTES 1391 (June 22, 2009).

even if subject to US tax, making a five-year waiting period impossible to comply with as a real-world business matter for such companies. With respect to depreciable assets, presumably these are long-lived assets of the company. If the company disposes of significant long-lived assets it likely is liquidating or terminating and thus the United States has a legitimate claim to impose tax on such assets because it granted the benefits of the depreciation in the first place.

The default residency rule would continue to apply, meaning that if in any given year the company once again earns more than half of its income from US sources it will once again become a US corporation. Thus, there is little to no benefit for a corporation to elect to be treated as foreign if it knows that the five-year taint would apply—effectively preventing stripping out assets US tax-free—and that it would likely return to being treated as a domestic corporation within the five-year period. While it may be possible for a corporation to manipulate the sources of income for a year or two, doing so for five years would likely prove difficult as a real-world business matter. However, if this was a concern then an additional anti-abuse rule substantially similar to sections 7874(c)(3)–(4) could be adopted to provide that if the corporation entered into transactions as part of a plan to artificially accelerate US source income into a pre-election year or artificially defer US source income past the five-year window, such income would be considered as being earned within the five-year window.

The other option, which could be adopted instead of, or in addition to, the section 1374 approach would be to provide domestic corporations with an election to be treated as foreign if, in the year of election, the election was deemed to be a reorganization under section 368(a)(1)(F) subject to the rules of section 367. In many respects, this approach is similar to several rules that the United States has adopted already, under current law and in the past. For example, under the now-repealed "extraterritorial income" (ETI) regime, certain foreign corporations could elect to be treated as domestic for all purposes of Title 26.[123] Crucially, this election was not solely for purposes of calculating ETI but for all purposes, including treaty qualification, consolidation, sourcing, and all other purposes. Upon such an election, the foreign corporation was treated as if it transferred its assets to a US corporation subject to section 367.[124] Conversely, if the corporation ceased to be treated as a domestic corporation, for purposes of section 367 such corporation would be treated as a domestic corporation transferring all of its assets to a foreign corporation (in a 354 transaction) on the first day of the first taxable year to which the election ceases to apply.[125] Similar rules apply for foreign

123. I.R.C. § 943(e) (2001).

124. Rev. Proc. 2001-37, 2001-1 C.B. 1327.

125. *Id.* Congress enacted a one-year exemption from this rule as part of the repeal of the ETI regime in 2004, subject to authority granted to the Secretary to

corporations in Mexico or Canada that can elect to be treated as domestic to be consolidated with a US parent,[126] for certain foreign insurance companies,[127] and for stapled entities.[128]

Of course, applying section 367 to a deemed asset transfer with respect to a tax-motivated corporate expatriation would likely prevent such expatriations from occurring. If a corporation had to pay tax on all of its assets today as the price to save taxes in the future, the corporation would likely not do so. As discussed in more detail below, the solution in the inversion context has been for the corporations to "flip" the structure but leave the US corporation in place such that there is no realization event at the US corporate level—absent a realization event, the rules of section 367 do not apply. While this would remain true under the proposal, the main difference would be that the new foreign parent would then itself have to determine its residency based on the source of its income, including looking through the former domestic parent. So long as the new foreign parent earns more than half of its income from US sources, taking into account income earned through the former domestic parent, it would be treated as a domestic corporation.

To avoid this result, the foreign acquirer would need to be larger than the US target in terms of income and assets—otherwise known as a takeover. Under the proposal, instead of needing to find a foreign takeover partner for a US company to become foreign once its business becomes primarily foreign, it would be able to elect to do so. For this reason, the section 1374 approach may be superior to the section 367 approach in that it would not create an unintended tax subsidy for foreign takeovers of US businesses. Alternatively, the section 367 approach could be adopted as an anti-abuse rule, introducing uncertainty into any expatriation occurring other than through an explicit election to become foreign with a section 1374 style taint.

Some conforming changes would be necessary within other parts of the Code to implement this new definition of residency. For example, the general rule for sourcing gains from the sale of property under section 865(a) would need to be amended. Currently, the default rule for the source of income from the sale of personal property is determined based on the residency of the seller, which would be circular in a world where source is used to determine residency in the first place. This could be addressed by excluding section 865(a)-type gains from the definition of residency altogether.[129] For gains

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prevent abuse. American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 101(e). It is safe to say that this one-year exemption was *sui generis,* as was most of the unique history regarding ETI repeal. *See, e.g.*, Wesley Elmore, *What a Long, Strange Trip It's Been for ETI Repeal*, 105 TAX NOTES 295 (Oct. 18, 2004).

126. I.R.C. § 1504(d); Reg. § 1.367(b)-2(i).

127. I.R.C. § 953(d).

128. Reg. § 1.269B-1(c).

129. This approach has the benefit of implementing the underlying policy of section 865(a) that presumes such gains should be outside the US taxing authority as

sourced under any of the other rules under section 865, such as the inventory exception of section 865(c), the US office exception of section 865(e), or the intangibles exception of section 865(d), exclusion would not be necessary because these rules are not sourced based on residence of the seller and thus avoid the circularity problem presented by section 865(a).

Thus, it is important to note that this exclusion applies only to gains sourced under section 865(a) and not income from inventory or sales attributable to a US office. This significantly narrows the real-world scope of the application of the exclusion. For the most part, gains sourced under section 865(a) are of a type for which timing is easy to manipulate and income can get bunched into a single year, due to the realization requirement. The reason is that inventory, sales based through a US office, personal property subject to US depreciation, and certain intangibles are excluded from the section 865(a) source rule. After applying all of these exceptions, section 865(a) applies mostly to personal property held for investment, such as portfolio stock. While portfolio investment in the United States is an important issue, it bears little relevance to the question of the residency of the investor under any approach to the definition of residency. Thus, it makes sense to exclude these gains from the determination of how connected a corporation is to the United States, at least in terms of using source of income for purposes of determining residency.[130]

Similarly, corporations do not typically generate significant section 865(a) gains, as distinct from gains on the sale of inventory or sales made through a US office, for the simple reason that corporations tend not to make passive investments in other businesses as opposed to reinvesting in their own business. Assuming this is true, excluding section 865(a) gains likely would not distort the extent to which the source of the corporation's income reflected the underlying economic activity of the corporation; it would, however, prevent abuse of the source-based residency rule through corporations manipulating the timing of gains from the sale of capital assets solely to meet the 50 percent threshold.[131] The one significant exception to this assumption

foreign source income of non-residents. If the corporation is foreign based on the source of its income other than section 865(a) gains, then such gains would be foreign source, while if it would be domestic based on the source of its other income, the gains would be US source.

130. This approach is similar to the one used for nonrecurring tax items under GAAP so that only the fundamentals of a business can be taken into account by investors. *See* Michael Calegari, *Income Tax Allocation and Financial Statement Presentation*, 127 TAX NOTES 309 (Apr. 19, 2010).

131. Another nice aspect of this approach is that it leaves section 865(a) intact for sourcing of gains for individuals, thereby permitting foreign individual investors to realize gains from the sale of US stocks and other capital assets without paying US tax. The difficulties raised in applying the rule to partnerships are discussed at Part IV.B.1 *infra*.

would be stock of subsidiary corporations. Since the proposal looks-through the stock of greater than 25 percent subsidiary corporations, however, this should not present a problem to the operation of this rule in the real world.

2. *Example: Corporate Inversions*

The United States has faced a wave of corporate inversions over the past year or so, with the issue garnering attention from academics,[132] practitioners,[133] government officials,[134] politicians,[135] the press,[136] and even the Daily Show.[137] Among the number of alternatives proposed to stop the second wave of inversions has included: (1) raising the 7874 threshold from 20 percent to 50 percent and (2) denying interest deductions for loans made between a US Corporation and a member of the Expanded Affiliated Group (EAG) of the corporation. In addition, Treasury published Notice 2014-52,[138] strengthening the rules calculating the ownership fraction and addressing transactions aimed at accessing trapped cash such as "hopscotch" loans.

While much attention has been paid to corporate inversions, less attention has been paid specifically to what about corporate inversions troubles so many policy-makers. From the perspective of defining residency in a worldwide corporate tax, it is possible that the normative concern is that corporations with significant ties to the United States are improperly avoiding paying residency-based US tax merely by changing the form of ownership and not any substance of the business. Extrapolated one step further, the concern could be that corporations with some level of connection to the US economy—through benefitting from US public goods to exploiting US markets—are not paying in accordance with ability to pay due solely to largely artificial structures.

Assuming this is the ultimate concern in the inversions debate, the proposal in this Article would address the problem of corporate inversions by

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132. *See* Kleinbard, *Competitiveness*, *supra* note 93.

133. *See Letter to the Editor: Blanchard Argues Against More Anti-Inversion Rules*, 144 TAX NOTES 1335 (Sept. 15, 2014).

134. *See* Press Release, Remarks by Treasury Secretary Jacob J. Lew on a Press Conference Call Regarding Announcement on Corporate Tax Inversions (Sept. 22, 2014), http://www.treasury.gov/press-center/press-releases/Pages/jl2648.aspx.

135. *See* Rep. Sander Levin, Levin Floor Statement on Corporate Tax Inversions (Sept. 10, 2014), http://democrats.waysandmeans.house.gov/press-release/levin-floor-statement-corporate-tax-inversions.

136. *See, e.g.*, Joseph Walker, *Medtronic's Tax Inversion: Not as Easy as It Seems*, WALL ST. J., June 19, 2014, http://www.wsj.com/articles/medtronics-irish-jig-not-as-easy-as-it-seems-1403220286.

137. *Inversion of the Money Snatchers*, THE DAILY SHOW, July 30, 2014, http://thedailyshow.cc.com/videos/ehvwjx/inversion-of-the-money-snatchers.

138. Notice 2014-42, 2014-42 I.R.B. 712.

directly tying the definition of residency to the source of income of a corporation. Thus, a corporation legally organized in Ireland but which earns more than half of its income from sales within the United States would be considered domestic. In this manner, corporate inversions would no longer be possible for corporations intending to exploit the United States as its primary market. This satisfies one of the primary concerns expressed in a number of critiques of inversions, that is, that corporations are exploiting US markets without paying US residency-based tax.

Again, such a rule could permit companies to merge with foreign businesses such that more than half of the total worldwide income of the new foreign parent was foreign source income rather than US source. Real mergers with real foreign companies resulting in primarily foreign source income are not the focus of most anti-inversion zeal, however. Even under the most extreme anti-inversion proposals, acquisitions of domestic corporations by foreign corporations in which shareholders of the foreign corporation would own more than 50 percent of the combined company would still be permitted. The difference between this proposal and proposals to "strengthen" section 7874 is not in substance but rather how to measure "foreign-ness"—while section 7874 looks to ownership, this proposal looks to source of income. Given that source of income is based on connections with the United States, using source would provide a superior claim to impose residency taxation on a corporation than the mere fact of overlap of ownership. This is particularly true since the overlapping shareholders need not be US persons. In fact, the inversion rules can apply to domestic corporations with 100 percent foreign shareholders.[139]

For example, assume a pharmaceutical company (PharmCo) is legally organized under the laws of Delaware with its primary place of business in Ohio. PharmCo decides to merge with an Irish pharmaceutical company (IrishCo) and expatriate as part of the merger, with shareholders of IrishCo owning 25 percent of the combined company to satisfy current anti-inversion law. PharmCo believes its foreign business will be high-growth and its US business is mature and low-growth and wants to isolate the profits of its future foreign business from US tax. However, for the next several years, over half of the income of the combined companies (IrishPharmCo) will be earned from sales of pharmaceuticals within the United States. For the sake of argument, also assume that PharmCo owns a US patent on the pharmaceuticals that are sold in the United States but they are manufactured in Mexico through a wholly owned Mexican subsidiary corporation (MexCo).

To determine the residency of PharmCo before the merger, first determine the source of the income from the sale of pharmaceuticals. PharmCo licenses the patent and other intellectual property to MexCo for purposes of manufacturing the pharmaceuticals. MexCo manufactures the drugs and sells

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139. *See* Dubert, *Accidental Inversions*, *supra* note 99.

them to PharmCo, which in turn sells them through pharmacies, which purchase the pharmaceuticals outright as inventory and bear all risk of sale. Under these facts, PharmCo earns income from the sale of purchased inventory with title passing in the United States, making the income US source. In addition, PharmCo earns royalties on US patents and intellectual property, which will also be US source income.[140] PharmCo also owns 100 percent of the stock of MexCo, which earns income from the manufacture of the drugs which would be foreign source income. Under these facts, PharmCo would be a US corporation regardless of its place of legal incorporation. The entirety of the income earned by PharmCo is US source. The income of MexCo is foreign source income but it is not included in the income of PharmCo until a dividend is paid (actually or deemed under section 951) to PharmCo because MexCo is a foreign corporation.[141]

This potentially means that PharmCo could use dividends from MexCo to manipulate its gross income in any given year. There are several limits on the ability to do so, however. First, for US tax purposes, MexCo earns income based on the transfer price established between PharmCo and MexCo. If PharmCo adopts a transfer price that allocates more than half of the value of the business to MexCo manufacturing rather than PharmCo intellectual property and sales, the Commissioner could reject this under section 482. This, in turn, would impact the amount of earnings and profits (E&P) at MexCo and MexCo could only pay dividends treated as foreign source income to PharmCo out of E&P. To the extent distributions exceeded current and accumulated E&P, the distribution would first be treated as a return of capital (which would not impact the analysis) or capital gain under section 301. This, in turn, would either be treated as no income or US source income, thus limiting the ability to use distributions to artificially inflate foreign source income.

Second, MexCo would be limited in what it could pay out as a dividend to the amount of free cash available at MexCo. To the extent PharmCo needed MexCo to have cash to operate the business, it would not be able to pay a dividend. While it might be possible for MexCo to pay a dividend without distributing cash, for example by distributing a note, this too would have some limitation, either under statutory capital requirements or simply the wishes of third party vendors to have a superior claim to any such debt. In addition, dividends from MexCo to PharmCo would presumably be subject to

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140. It is possible that PharmCo also owns a Mexican patent on the manufacture of the drugs which it licenses to MexCo, the royalties of which would be foreign source. For these purposes, it is assumed that the bulk of the value in the intellectual property is in the right to sell in the United States and not the manufacturing process itself.

141. Under the tiered-ordering rule, the residence of MexCo would be established first. MexCo would be foreign because 100 percent of its income attributable to manufacturing pharmaceuticals would be foreign source.

some Mexican withholding tax, placing a real cost on the payment of dividends up to PharmCo.

Another possible structuring technique used in existing structures would be to place the intellectual property of PharmCo in an offshore IP holding company located in a low-tax jurisdiction such as Ireland (IPHoldCo). Under current law, PharmCo could allocate the intellectual property to IPHoldCo and pay substantial royalties to IPHoldCo as a way to strip income out from the United States and into a low-tax jurisdiction. The income would not be Subpart F income and thus would achieve deferral. The only potential weapon against this would be the use of section 482 by the Commissioner, but it is reported that many of these structures were entered into subject to an Advance Pricing Agreement (APA) with the Service, meaning that the Commissioner could not reallocate the transfer price under section 482. Even absent an APA, it would be difficult to argue that the IP—especially in the case of pharmaceuticals—does not carry the bulk of the value of the business.

This problem is resolved under the proposal. For these purposes, IPHoldCo would receive royalties on US patents which would be US source under section 861(a)(4). To the extent these royalties exceeded 50 percent of the income of IPHoldCo, it would be a treated as a domestic corporation for US tax purposes. Since it would be a member of the affiliated group of PharmCo, the income of IPHoldCo would be treated as income of PharmCo for purposes of determining the residency of PharmCo. This would result in additional US source income located at PharmCo, preventing PharmCo from using IPHoldCo to avoid US taxation of the royalty income.

PharmCo could attempt to avoid this by stuffing IPHoldCo with foreign source income-producing assets. This presents two structuring problems for IPHoldCo, however. First, IPHoldCo is relying on the section 954(c)(6) exemption from Subpart F for its royalty income. To maintain this exemption, it must continue to be in the business of actively managing royalty income from intellectual property under Regulation section 1.954-2(d). This effectively restricts the ability to stuff non-IP related assets into IPHoldCo, and even restricts the ability to stuff purchased IP into a cost-sharing based IPHoldCo.[142]

Second, even if PharmCo had sufficient foreign intellectual property that it could stuff into IPHoldoCo (and enough activity to satisfy the active management test), this foreign IP would have to generate royalties greater than the royalties paid on the US intellectual property. These royalty payments could be challenged by the Commissioner under section 482, making such claims riskier for IPHoldCo than simply relying on an APA for the initial US royalty payments. This, in turn, places an effective cap on the amounts that PharmCo can transfer price to IPHoldCo, since PharmCo could only pay royalties on US intellectual property in amount comfortably less than the

142. Reg. § 1.954-2(d)(3), Ex. 2.

amount of royalties owed under the foreign intellectual property to avoid gaving IPHoldCo treated as a domestic corporation.

PharmCo could attempt to stuff IPHoldCo with other income-producing assets generating foreign source income to avoid this result, but this too would lead to difficulties. Any assets generating Subpart F income would either need to be actively used in the IP business of IPHoldCo to conform with Regulation section 1.954-2(d)(2) or would result in Subpart F inclusions, partially defeating the point. Perhaps more importantly, however, stuffing passive assets such as bank accounts or interest-bearing notes into IPHoldCo would mean that the cash from those assets would be trapped in IPHoldCo if they were not treated as Subpart F income. At some point, PharmCo would be limited in how much real cash and liquid assets it could place into IPHoldCo based on the cash management needs of the worldwide business more generally. IPHoldCo could try to manage this using an internal group finance company, but this too would require significant planning and maintenance and would also potentially contradict the basis for the exemption from the royalties being treated as Subpart F income.[143]

As the hypothetical demonstrates, using source to define residency effectively prevents a number of existing structuring methods meant to strip income out of the United States from achieving their desired effect, all without requiring the IRS to undertake costly case-by-case anti-abuse rules or audits and litigation.[144] Presumably, companies would have an incentive to restructure in response. One potential restructuring in the hypothetical might be to liquidate MexCo and have PharmCo operate the manufacturing business directly. Typically under current law this would always be a bad idea since it would place income that could be deferred under the foreign subsidiary directly in the US parent, subjecting it to current US tax (subject to the foreign tax credit). Under the proposal, however, it might make sense, for the following reason: under section 865 and section 863(b)(2), PharmCo would be engaged in mixed-use sale of inventory, which could be allocated 50-50 under Regulation section 1.863-3(b)(1) for sourcing purposes. Since the manufacturing income relates to the Mexican factory, half of all the income from sales of drugs would be foreign source under this approach. Thus, PharmCo would only need to find one dollar of additional foreign source income to have a majority of foreign source income and thus no longer be a domestic corporation.

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143. For a discussion of a recent case involving an IRS challenge to an internal finance company structure under Subpart F, see Lee A. Sheppard, *News Analysis: Intercompany Debt Used to Distribute Earnings Challenged*, 144 TAX NOTES 1223 (Sept. 15, 2014).

144. *See* Edward D. Kleinbard, *Through a Latte, Darkly: Starbucks' Window into Stateless Income Tax Planning*, http://ssrn.com/abstract=2264384.

The simplest way to accomplish this would presumably be to hold working capital in an offshore bank account generating some minimal foreign source interest. Conversely, this would also be the simplest to prevent as well. For example, the income of a corporation could be split into section 904 foreign tax credit baskets and the income rule could apply separately to each basket. More specifically, a corporation could be a domestic corporation if at least half of its income in either the general basket or passive basket was income from US sources. In this manner, a corporation could not use easily mobile passive income to change its residency.

Another similar approach would involve adopting a tracing rule for sourcing of interest substantially similar to the one used in section 864(c)(2) for ECI. Under such an approach, any bank account used in the active business of PharmCo would be sourced in the same manner as the related business—in this case 50-50. Under the tracing approach, income from passive assets would not change the relative sourcing of active income and thus would not be problematic from a residency standpoint either.

A third approach would involve directly addressing Regulation section 1.863-3 itself. Under the Regulation, the 50-50 split method is allowed as a presumption and not as a safe harbor. Thus, the Service could adopt a rule that the 50-50 split presumption would not apply for purposes of determining residency, or that the 50-50 method would automatically subject a corporation to audit for purposes of determining residency. Alternatively, Treasury could revise Regulation section 1.863-3 to incorporate a section 482-type discretion into the 50-50 presumption (which it already has under the books and records method). This would introduce uncertainty with regard to reliance on the 50-50 method as a means to manipulate the residency definition. In other words, under current law the 50-50 method may have minor benefits to companies in terms of freeing up foreign tax credits but otherwise has relatively minor consequences whereas under the proposal it could impact the residency of the entity itself. Conversely, if the corporation improperly relies on the 50-50 presumption under the proposal it would not only result in a minor loss of foreign tax credits but also in the worldwide income of the company being subject to US tax. Increasing the cost of a tax structure, at the same risk of detection, should reduce the occurrence of it.[145]

B. Source as a Solution to Residence: The Proposal for Partnerships

1. Defining the Residency of Partnerships

Under the approach of this Article, the definition of a foreign partnership for purposes of section 7701 would be amended in much the same

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145. *See, e.g.*, Kyle D. Logue, *Optimal Tax Compliance and Penalties When the Law is Uncertain*, 27 VA. TAX REV. 241 (2007).

manner as for corporations to read as follows: "the term domestic partnership shall mean any entity treated as a partnership for US tax purposes for which (1) 50 percent or more of the gross income of such partnership for the taxable year is income from sources within the United States, or (2) the average percentage of assets held by such partnership during the taxable year which produce income from sources within the United States or which are held for the production of income from sources within the United States is at least 50 percent."[146]

In addition, as with domestic corporations, section 865(a) gains would be excluded from the gross income of a partnership solely for purposes of determining the residence of the partnership, the "once a domestic partnership, always a domestic partnership" presumption would apply, as would the one-time election to become foreign in the first year in which more than half of the gross income of the partnership is foreign source.

Under these rules, partnerships (including foreign eligible entities electing to be treated as a partnership) can be treated as domestic or foreign regardless where legally organized. Unlike with corporations, however, this does not mean that the United States would impose a net income tax on the income of the partnership. Rather, the importance of the residency of partnerships turns primarily on the obligations of the partnerships to file tax returns and the obligations of the partnership to withhold on certain payments. Taken together, from a policy standpoint, once a partnership establishes sufficient connections with the United States based on its source of income it would be permissible to impose additional reporting and withholding obligations on the partnership. If the purpose of the residence definition for partnerships is to require information reporting and withholding for partnerships earning significant income connected to the United States, it makes sense to tie the definition of the residence of a partnership directly to such income as well, regardless of place of legal organization.

The primary benefit of defining a partnership as domestic is that the partnership would be required to file information returns[147] and to withhold on

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146. This is similar to the rule applicable to controlled foreign partnerships, in which a partnership is deemed controlled if more than 50 percent of the interests in capital or income are owned by US persons. Reg. § 1.6038-3(b). For example, in most private equity and hedge funds the controlling partner is the sponsor acting as a General Partner (in a limited partnership) or Managing Member (in an LLC) with little capital investment and, typically, a 20 percent profits interest. Regardless, if half the investment capital is coming from companies actively engaged in the conduct of a lending or broker-dealer business, it is safe to assume as a starting point that the partnership could well be engaged in such lines of business even if the investors cannot control the day-to-day operations of the partnership. Correspondingly, looking to the majority of the source of the income can inform as to the intent of the partners as to where they wanted to invest or conduct business as well.

147. Reg. § 1.6031(a)-1(a)(1).

US source FDAP.[148] By contrast, foreign partnerships only need file information returns if they earn ECI or, in certain circumstances, US source income,[149] although they are required to reliably associate US source FDAP paid to it with the status of its partners to avoid having the payors of FDAP income from withholding on the payment.[150]

Unlike with corporations, however, the definition for partnerships cannot necessarily end there. The reason is that several of the reporting obligations of foreign partnerships are tied to ECI and US Source income. Thus, whether and to what extent a partnership earns ECI directly impacts the scope and purpose of the residence definition as well.

This, then, turns to the crucial issue of whether the partnership is engaged in a US trade or business, and in particular the self-trading safe harbor of section 864(b)(2)(A)(ii). Under this rule, a foreign partnership is not engaged in a US trade or business to the extent it invests for its own account. Since such partnerships are not considered to be engaged in a US trade or business, none of the income of the partnership is ECI and thus there would be no withholding on distributions to foreign partners under section 1446, regardless of the identity of the ultimate partners or their business reason for investing in the United States. This result has come under scrutiny, however.[151] In particular, two concerns have been raised with respect to such entities: (1) they are not really "foreign" and (2) even if they are foreign, they are in reality engaged in a trade or business of being a broker-dealer or lender and should not be entitled to the benefit of the safe harbor.[152] The answer to this question then determines the withholding obligations of the partnership with respect to US source income, which would include section 865(a) gains for investment partnerships in which most of the income other than capital gains is comprised of US interest and dividends.

To address this issue, section 864 would be amended by adding a new section 864(b)(2)(A)(iii) to read as follows, "Subsection (ii) shall apply to a partnership only if the partnership can reliably associate more than 50 percent of the distributive share of its gross income for the taxable year to partners who are US Persons or nonresident individuals entitled to the benefits of reduced rates of withholding by treaty." In addition, foreign corporate partners of a partnership would be permitted (but not required) to provide the information necessary for the partnership to reliably associate distributions

148. Reg. § 1.1441-5(b)(2). In addition, both domestic and foreign partnerships are obligated to withhold on allocations of ECI to foreign partners under section 1446.

149. Reg. § 1.6031(a)-1(b).

150. Reg. § 1.1441-5(c).

151. *See, e.g.*, Lee A. Sheppard, *News Analysis: How to Fall Out of the Securities Trading Safe Harbor*, 146 TAX NOTES 298 (Jan. 19, 2015) (discussing ILM 201501013 (Jan. 2, 2015)).

152. Sheppard, *Neither a Dealer Nor Lender*, *supra* note 88.

from the partnership to the ultimate shareholders of the foreign corporation. This would entail having the shareholders in the corporation provide withholding certificates to the foreign corporation, which would in turn provide them to the partnership.[153] This revised rule, combined with the revised definition of residency for partnerships, would more closely implement the purposes of both the policies underlying the partnership withholding rules and the policy to attract inbound foreign passive investment.

For example, assume a partnership organized under the laws of Bermuda, and owned primarily by foreign banks and insurance companies, is engaged in the conduct of a US banking business because it takes deposits and makes loans in the United States. Since it is in the business of making loans, all of the income collected with respect to the loans would be effectively connected income under section 864(c)(3). The entity would be considered a US partnership for US tax purposes, and the partnership would have to file annual returns and withhold on distributive shares of both ECI and US source FDAP income (if any) allocated to foreign partners.[154]

By contrast, assume a partnership organized under the laws of the Cayman Islands in which all the investors are foreign individuals resident in treaty jurisdictions buys and sells publicly traded bonds for its own account. Under the self-trading safe harbor, the partnership would not be considered engaged in a US trade or business and thus none of its income would be ECI. Thus, while the partnership would be treated as domestic to the extent it earned any US source income other than section 865(a) gains, the partnership would not be obligated to withhold on any of the gains allocated to the foreign investors. Even further, to the extent the partnership generated only section 865(a) gains, the partnership would be treated as foreign and thus would not have any withholding obligations.

This approach provides two benefits missing under current law. First, it acts as a sorting mechanism between passive type investors for whom the self-trading safe harbor was intended and other investors seeking to indirectly engage in a trade or business in the United States under the guise of passive investing without paying US tax. Second, it provides a powerful tool to the IRS to enforce the policies of these rules. By tying the residency of the partnership to its business connections to the United States, more partnerships engaged in US activities would be required to file information returns and withhold on US source FDAP income. This minimizes the long-held concern that partnerships can be used to avoid such reporting obligations by making it "nearly impossible" to locate partners once money left the partnership.[155] While the proposal shares the same concerns as those underlying the adoption

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153. This would be substantially similar to the qualified intermediary rule except for the requirement that the QI be a foreign financial intermediary.

154. I.R.C. § 1446.

155. *See* JCT, TAX REFORM ACT OF 1986, *supra* note 64, at 1055.

of section 1446, it changes the approach from imposing additional reporting obligations on foreign partnerships to changing the definition of the residence of the partnership to reflect its significant connections with the United States.

2. Example: Offshore Hedge Funds

Offshore hedge funds have attracted significant attention, both in raising troubling tax concerns in themselves and in acting as conduits for troubling behavior by investors.[156] There is no commonly accepted definition of an offshore hedge fund, although the basic idea is relatively straightforward. For the most part, hedge funds are private investment vehicles that are not regulated as banks or other investment funds such as mutual funds. In turn, this permits hedge funds significant flexibility not only in their investment models but also in their structuring.

For these purposes, I will rely on a recent description of the structure of offshore hedge funds verbatim to provide a common base upon which to describe the proposal:

> The usual hedge fund setup is a master-feeder arrangement. The "master" hedge fund itself is organized as a partnership in a tax and banking haven, giving it foreign residence according to the code. . . .
>
> The fund has two "feeders" that invest as partners: the domestic feeder for U.S. resident taxable investors and the foreign feeder for foreign investors and U.S. tax-exempt investors. The domestic feeder is a limited partnership, so all of its items of income, gain, deduction, or loss pass through to its partners. . . .
>
> The foreign feeder is usually a corporation organized in a no- tax jurisdiction. A corporation, as we shall see, provides anonymity to investors, blocks exempt investors from being considered owners of certain kinds of assets, and avoids putting foreign investors directly in a U.S. trade or business that generates effectively connected income.[157]

As structured, the offshore hedge fund provides a number of benefits. US taxable investors are able to obtain a single level of tax on the income generated by the fund, US tax-exempt investors are able to block potential UBTI due to the presence of leverage at the fund level and foreign investors

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156. *See* Sheppard, *Neither a Dealer Nor Lender*, *supra* note 88.

157. Martin A. Sullivan & Lee A. Sheppard, *Offshore Explorations: Caribbean Hedge Funds, Part 1*, 118 TAX NOTES 95 (Jan. 7, 2008).

are able to remain outside any US tax reporting obligations as shareholders in the foreign corporation.

Crucially, for most hedge funds not only do they need to be respected as foreign for tax purposes but they also must not be considered to be engaged in the conduct of a US trade or business for ECI purposes. For the most part, for hedge funds active in the debt markets, this means relying on the "self-trading" safe harbor. Under the self-trading safe harbor, buying or selling assets for one's own account is not considered a US trade or business while being in the business of making or modifying loans in the United States is the conduct of a US banking business. For the most part, assuming the hedge fund is not a dealer and does not make the section 475(f) election, the gains from such investments would be treated as capital gains under the self-trading safe harbor. Under section 865(a), the capital gains would be foreign source income. Thus, under current law, so long as the offshore fund is not engaged in a US trade or business and only generates capital gains, it will be treated as a foreign person with foreign source income, and thus no US tax.

The entire point of most of the complexity in the structure of the offshore hedge fund is to maximize the tax efficiency of investing in the United States. To do so, the fund organizes as a foreign partnership with a foreign corporation feeder through which US tax-exempts and foreign investors invest. For the most part, these investors can be pooled through a single feeder because the corporate form provides the protection each is looking for without requiring any separate reporting obligations. Thus, it is typically impossible to determine whether a particular offshore hedge fund is comprised primarily of US tax-exempt investors or foreign investors since they are combined in a single feeder.

This, in turn, makes it very difficult to determine with certainty whether the offshore hedge fund is, in reality, a passive pool of foreign individual investors seeking to invest in US securities markets, or large foreign banks, insurance companies, speculators, or other professional investors looking to exploit the US lending market without paying US net income tax. The former group of investors is what the self-trading safe harbor was intended to protect while the latter was not. Due to the formality of the residency rules, however, the use of an offshore hedge fund with a foreign feeder corporation makes it impossible to apply the rules with sufficient granularity to make this distinction.

Offshore hedge funds, of course, could try to structure around this rule. First, and most obviously, the fund could simply eliminate the foreign corporate feeder. In this way, foreign investors could invest directly in the hedge fund. In some ways, this is actually a useful solution. Once invested directly, it would become easier to identify the foreign investors. To the extent more than half of the investors were comprised of foreign corporations such as banks or insurance companies, the limitation on the self-trading safe harbor would apply again unless the corporations provided withholding certificates.

Again, it is safe to assume that such entities would not want to do so, either because they have no connection to the United States and do not want to enter the US tax system or they already do have a connection to the United States and are attempting to conceal that from the IRS.

Another approach that a hedge fund might adopt could be to use parallel funds or a hub-and-spoke structure rather than a master-feeder structure for its investments. For example, the hedge fund could establish two parallel foreign partnerships, one each for US tax-exempt investors and foreign investors respectively. This approach actually improves the situation from a US standpoint under the proposal. The reason is that US tax-exempt investors presumably will insist on a foreign blocker corporation to prevent debt-financed UBTI but, since they are already US entities that file information returns with the IRS, also presumably would be indifferent to providing a Form W-9, Request for Taxpayer Identification Number (TIN) and Certification, to the blocker corporation. Assuming all the US tax-exempt partners do so, the US tax-exempt parallel fund partnership would be treated as a foreign partnership entitled to the self-trading safe harbor. There is nothing troubling from an international tax policy standpoint with this result, assuming one is not troubled by the use of blocker corporations to avoid UBTI more generally.[158]

The foreign investor parallel fund, on the other hand, would have all of its capital interests owned by a foreign corporation that could not provide withholding certificates under the assumption that foreign investors desire anonymity. In turn, the partnership, and thus the foreign feeder corporation, would be deemed engaged in a US trade or business and would pay tax on ECI.[159] In essence, the proposal could result in hedge funds segregating the foreign investment from the US tax-exempt investment in a way that permits the US to more narrowly target the ECI tax on foreign lenders into the United States.

While this is merely an example based on simplifying assumptions, the strength of tying residence to source emerges relatively quickly. Under current law, offshore hedge funds have an incentive to combine US tax-exempts and foreign investors through a single foreign feeder corporation and structure their investments in US debt to comply with the self-trading safe harbor through "season and sell" and other techniques. Under the proposal, the hedge fund would have an incentive to isolate out US tax-exempts and foreign investors into separate funds (or feeders) to keep both as investors. Only the investments coming indirectly from the foreign investors would then be

158. *See* Samuel D. Brunson, *Repatriating Tax-Exempt Investments: Tax Havens, Blocker Corporations, and Unrelated Debt-Financed Income*, 106 NW. U. L. REV. 225 (2012).

159. Under the tiered-ordering rule, the residence of the partnership would be determined prior to the residence of the feeder corporation.

subject to the ECI tax while the investments held by US tax-exempts would remain effectively tax-free.

V. CONCLUSION

The construct of source and residence as two competing and irreconcilable poles has dominated the international tax debate since its inception. Yet, this construct, while correct as an economic matter, is largely incorrect as a legal and doctrinal matter. Rather, both the source rules and the residence rules can, and should, be used as instrumental tools to be used to divide taxing authority in a globalized world with mobile capital. Under this approach, there is no reason why "source" rules as a doctrinal matter need to be used only for "source" taxation as an economic matter, or that residence rules as a doctrinal matter need be used for residence taxation as an economic matter.

Instead, this Article introduced a new legal and doctrinal approach to international tax: using the source rules to solve the problems with the residence rules, by defining the residency of an entity based on the extent it earns US source income over a threshold amount. While this is not intended to serve as a normative defense of an income tax generally, of an income tax on corporations as entities, or of a residence-based international tax regime, this Article demonstrates that tying the definition of entity residence to the source of income earned by the entity can better achieve the ultimate goals of both a residence-based tax regime and a source-based tax regime. In this manner, the best policy goals of both residence-based taxation and source-based taxation could be furthered.

Using, in part, existing rules already found throughout the Internal Revenue Code, the proposal demonstrates how this source-based definition of residence can be implemented as a doctrinal matter. The Article then applied this new source-based definition of residence to two of the most troubling issues facing the US international tax regime currently: corporate inversions and offshore hedge funds. By tying residence to the actual business activities of the entities, the ability of an entity to manipulate its tax residence solely for tax savings proves difficult, if not impossible. While this is true as a practical matter, using source rules to accomplish this would also more closely match the doctrinal definition of residence with the ultimate, underlying goals of the modern US international tax regime.

In this manner, using source as a solution to residence hopefully can prove to be the conceptual step needed to bridge the intellectual gap facing the competing sides of the modern international tax debate.